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SOUND POLICIES
for
BANK MANAGEMENT

A DISCUSSION FOR BANK OFFICERS
AND DIRECTORS

By

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FOREWORD

The problems that confront bank officials at the present time are not easy of solution. With interest rates abnormally low, owing largely to governmental competition, on all classes of investments which banks are allowed to hold,—securities, commercial loans and even real estate mortgages,—the task of a bank's management has become increasingly difficult and it takes careful study and painstaking attention to earn sufficient income to cover expenses, pay moderate dividends to stockholders, add to the surplus account and at the same time maintain adequate assets of a liquid character to meet any unusual demands of customers for loans or withdrawals of deposits.

The volume of government securities which banks are carrying is not only large but will be increasingly large until war financing comes to an end and therefore while diversification is becoming more difficult more attention should be given to the staggering of the maturities of government issues.

This situation is especially difficult for banks having a large percentage of their deposits in savings or other interest accounts. A goodly percentage of such funds are invested in real estate mortgages and these will have to be handled with the utmost care. More consideration should be given to the responsibility of makers of real estate loans than has sometimes been the practice in the past and agreements should be made for the reduction of each mortgage at regular intervals irrespective of assessed valuations or expert opinion of market values.

There can be little doubt as to the postwar period presenting much greater problems to the banker, and therefore this is the proper time for him to analyze carefully the character of the business of his bank and to study means to make every deposit and every service furnished bring in adequate returns. Large deposits both in commercial and savings departments should be

considered constantly as they may be affected by government needs.

In preparation for the postwar period the banker should make now a thorough survey of the locality which his bank serves in order to be prepared to make loans for additional use of businesses endeavoring to return to peacetime operation. He should keep informed of all new devices for lending and should be prepared to take an attitude of responsibility and initiative when that time comes. While the first responsibility of banks is to safeguard deposits, it is of the greatest importance that they should assist and encourage the commercial, industrial and agricultural activities of its community.

Dr. Rodkey in this book lays much emphasis upon the character of information which banks should furnish to the public. While all bank officials will agree readily that directors should be kept fully informed of the condition and activities of the banks in which they serve, there may be much difference of opinion as to the form and extent of information given to stockholders and to the public in published form. Banks would appear to be in a class by themselves and are dependent for their standing in a community on certain intangible factors and are therefore not comparable to the average business corporation in their relations to the public. Business corporations have few creditors, largely the banks from which they borrow and to whom they make statements at regular intervals and to whom they can explain in confidence any unusual changes in their condition, while a bank makes and publishes a statement whenever the supervising authorities call for it. Furthermore, a bank has many creditors, its depositors, many of whom are not experienced in the interpretation of changes in a bank's condition caused by temporary fluctuation in money rates as they affect the market price of securities held as investments at the time of a particular call for a report of condition. The keenness of competition between banks should also be borne in mind in determining the detailed information given to stockholders, depositors and the public. On the other hand, every effort should be made by supervising banking authorities, both Federal and State, to come to some agreement as to nature and extent of

information which should be given to the public, and then require all banks to publish uniform statements.

The difficulties experienced by all banks at the time of the bank holiday are still fresh in the minds of most bank officials, but the suggestions which appear in this book should prove most helpful to every banker and its publication at this time is most opportune. The author is a recognized authority on banking practices and he presents the results of his studies and research in a simple and clearly understood manner and the bank official and the public as well should feel indebted to him for his able presentation of a subject which is difficult for the average person to understand.

FREDERIC H. CURTISS

Chairman of the Board, Federal Reserve Bank of Boston, 1914-1942

PREFACE

The development of general policies in any business organization is always the prime function of a board of directors chosen by the stockholders. A corollary function is the selection of top-management to which is entrusted the duty of putting into effect the policies thus laid down. In actual practice, however, there is frequently no sharply defined line of demarcation between the board and the officers directly responsible for managing the activities of the enterprise. The president or other chief executive officer is usually a member of the board and he is often able to exercise decisive influence in the board's deliberations. In many cases, possibly even in the great majority of cases, policies actually adopted by the board are those recommended to it by its chief executive officer. That this is the common situation in banking institutions is a matter of general knowledge. Primarily to top-management in the broad sense indicated is this volume addressed.

The problems discussed herein are those which can be decided only by this top-management. Basically they pertain to the setting up and carrying out of general policies which will guarantee both liquidity and solvency, foster healthier public relations, and make the bank a really constructive influence in the community which it serves. To insure successful accomplishment of these ends those policies must be adopted and executed which will warrant maximum confidence in the ability of the bank to meet all its obligations however adverse future conditions may turn out to be.

We are not here concerned with technical routine operations. Improvements in operating technique are more fruitfully discussed at banking conventions, in banking periodicals and in books devoted to bank administration. In such places general policies are also frequently considered, but it seemed desirable to bring together under one cover a discussion limited to major

policy problems. So far as a number of these problems are concerned no unanimity exists among bankers as to what constitutes sound policies. Where there is such wide room for legitimate differences of opinion nobody can presume to have all the right answers. If the discussion herein should stimulate even a small minority of bankers to reappraise certain of their own policies in the light of the arguments advanced it will have served its intended purpose.

Acknowledgment and thanks are due to the many members of the banking profession who, consciously or unconsciously, contributed to this book. Especially valuable were the criticisms and suggestions made by Mr. Frederic H. Curtiss, formerly Chairman of the Board of the Federal Reserve Bank of Boston, and Mr. Raymond T. Perring, Vice President of The Detroit Bank, both of whom were kind enough to read a preliminary draft of the manuscript. The author, of course, assumes full responsibility for the ideas set forth.

ROBERT G. RODKEY

Ann Arbor, Michigan
November, 1943

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PART I

A SURVEY OF CENTRAL PROBLEMS IN BANK MANAGEMENT

CHAPTER 1

CENTRAL PROBLEMS IN BANK MANAGEMENT

The sweeping structural changes in American banking which we have experienced since the first election of Woodrow Wilson in 1912 have served to ease certain traditional difficulties which beset the path of the successful individual banker. With the advent of the Federal Reserve System he was no longer concerned about the possibility of a shortage of cash so long as the banker held large volumes of paper eligible for rediscount and government bonds. With the institution of the Federal Reserve par collection system he no longer needed to devote excessive time and energy to the economical collection of out-of-town items. With the passage of the Bank Act of 1935 it might seem that he no longer needed to worry about the problem of liquidity. If he were successful in seeing to it that his earning assets were all sound enough to satisfy the Reserve Bank officials, then all earning assets could be converted into cash and he would be in position to pay off all his depositors on demand. Something more than superficial examination, however, reveals the fact that the character of the fundamental problems which always confronted the banker still remains unchanged, and in addition new problems of great difficulty have presented themselves.

It is still necessary for a bank to be conducted in such fashion that it remains sound. It is not a requisite for soundness that a bank be able to pay off all its liabilities on any one day, or week, or month. It is true that a bank unable to meet whatever demands depositors may make for the payment of their deposits cannot continue as a going institution. In the face of a hysterical run even a thoroughly sound bank might have to close its doors. The likelihood of such runs, however, has been considerably diminished if not entirely eliminated by

deposit insurance. But the quality of soundness may be said to be achieved if two fundamental conditions are constantly maintained. The first of these conditions is the ability to meet, without recourse to borrowing, any reasonably to be expected short- or long-run demands from depositors, and with something to spare. The other condition is that the value of all its assets must at all times exceed the sum of all its liabilities to depositors and other creditors.

In order to fulfill these conditions, it is clear that there must be sound utilization of all funds which come into the possession of the bank. This is the heart of the banking problem from the standpoint of the individual institution. It always has been the heart of the banking problem. From the standpoint of liquidity the problem has been somewhat simplified because of the assumed readiness of the Reserve banks to make advances on all sound assets. On the other hand, conditions prevailing since the early years of the great depression have made the problem even more difficult than was formerly the case.

The unprecedented decline in effective demand for short-term commercial loans has deprived the banks not only of the principal source of their traditional earning power but also of their most desirable type of earning asset. In such loans, for instance, no question of market price is involved. So long, therefore, as there exists no doubt of the ability of the borrower to make repayment such loans are always worth their face value. They are desirable, also, because of their relatively high yield and because their short maturities provide the bank with frequent opportunities to reappraise situations. So far as the individual bank is concerned the total volume of sound commercial loans to customers remains liquid.

The drying up of the demand for local loans has eliminated one of the favorite methods by which unsound bank management formerly expressed itself. Prior to the depression many bankers felt that it was not only their duty but also in their own best interest to meet all demands for good local loans. In the days when this demand was large this practice often left banks with insufficient outside investments properly to

spread the risk. In other words it was not uncommon for bankers to fail to recognize the applicability to banking of the insurance principle of spreading the risk both industrially and geographically. Their policy was to make all the good local loans possible and then to seek outside employment for any funds remaining. Sound policy requires that first adequate outside diversification be provided for and then only such amounts as are not needed for this purpose be lent locally. If the demand for good local loans cannot be met with the use of the remaining funds then the bank presumably needs additional capital.

A much more dangerous opportunity for going wrong appeared when inability to secure local loans in adequate volume forced banks into the general investment market. Increased demand from banks alone probably would have been sufficient under any conditions to force interest rates down. But the constantly growing demand for bonds came to the investment market during a period in which the volume of new private issues was deteriorating. Thus, prior to the war, bankers were competing with each other and with other large investors for the strictly limited volume of bonds available. The consequent bidding up of prices forced yields down to the lowest level of modern times.

With the fall of France in the early summer of 1940 we inaugurated our defense program, and this involved still larger deficits and still larger volumes of government obligations. Our entrance into the war in December, 1941, was to be followed by government borrowing on the largest scale ever known. At the heart of this financing process stood the commercial banking system. Its duty to cooperate with the Treasury wholeheartedly was obvious. But if the war was to be financed successfully it was equally important that the soundness of the individual banks should be preserved.

Essentially the business of banking consists of dealing in future values and these future values depend in large measure upon what course economic and political forces will take over the months and years ahead. Since no dependable method has yet been devised for forecasting these forces, it behooves the

banker to shape his policies in such fashion that his bank will be prepared, as well as it is humanly possible to make it, to ride out whatever storms the future may hold in store. Storms in the future may be more or less severe than those encountered in the past, and they may be of an entirely different character. But the wise procedure is to chart a course which will assuredly provide protection against such contingencies as have arisen in the past and in addition leave a margin of safety against possibly greater requirements in the future.

All good bankers are usually well prepared to meet seasonal fluctuations in deposits and in the demand for loan accommodation. But there is reason to fear that fair-weather banking is still practiced to some extent. By fair-weather banking is meant inadequate preparation to meet sudden and drastic declines in deposits or long-drawn-out major loss of deposits such as have been experienced in the past. Fair-weather banking may be exemplified also in excessive exposure to risk of changing interest rates. Periods of low interest rates have always been followed by periods of much higher rates, which have a depressing influence on high grade bond prices. It is of supreme importance that a bank shall not assume risks in this respect greater than it is able to bear. The maintenance of adequate asset and contingency reserves and definite limitation of the size of the permanent bond portfolio are clearly essential requirements of sound bank management.

Because of the unprecedented increase in deposits occasioned by the tremendous influx of gold and deficit financing through the banks by the federal government, banks were operating in prewar years on thinner capital margins than at any other time in the past. Before our active participation in the war this development attracted a good deal of attention and much adverse criticism. Under war conditions old standards in this respect have had to be relaxed. However, the duty of individual bank managements in this matter is obvious even under war conditions. The investment of funds must be made in such fashion that risks from depreciable assets shall bear a reasonable relationship to the capital buffer actually available.

There is no business in which the development of sound

public relations is more important than in banking. Wholesale bank failures leading up to the banking holiday in 1933 brought the banking business as a whole a considerable measure of disrepute. This opprobrium was, of course, not deserved by banks able to survive. Nevertheless, even for continuing banks more emphasis should be placed on the development of good public relations. The "truth in securities" legislation pointed out quite definitely one area in banking which needed both intensive and extensive cultivation. Reference is to general failure on the part of banks to make complete disclosure of information necessary for the sophisticated outsider—whether depositor or investor—to determine the soundness of individual banking institutions. Only a small minority of bankers seem to recognize the crucial nature of this problem. It seems that a reexamination of the traditional attitude of concealment would be well worth while.

No bank can remain sound in the absence of a reasonable degree of profitability. Yet profitability is manifestly difficult to attain in the face of low volume of local loans and unprecedentedly low yields on high-grade bonds. Service to a local clientele on a profitable basis must be the economic justification for the very existence of a bank. This service comprises not only the making of commercial and mortgage loans but also the serving as a clearing house for all local transactions and for the transactions of the home community with the rest of the world. It is not uncommon for these latter services to be taken for granted by local citizens, a situation for which the attitude of bankers themselves in the past may be largely responsible. But under conditions existing since the banking holiday it has become a life-and-death matter for the successful bank to charge for the various services rendered fees which are at least large enough to cover the cost of each. A knowledge of costs is clearly necessary if these charges are to be fair to all customers using various services in different degree.

Developments of recent years have served to lessen materially whatever prestige or glamour formerly attached to banking as a profession. If banks are to assure themselves of an adequate supply of future executive material, they must be

willing to compete on a price basis with other forward-looking, progressive business enterprises for a minimum of superior talent in the annual additions to their staffs. Only by doing so can the banking profession hope to regain any substantial portion of the prestige formerly enjoyed by it.

Directors who do not direct are far too common in American banking. This means that frequently active managements assume greater responsibility than is wholesome. The remedy lies in more forward-looking policies in the selection of new directors and in keeping them more fully informed regarding the real condition of the bank and the issues it must face.

In the preceding paragraphs reference has been made to certain fundamental management problems confronting bankers today to which more or less extended consideration will be given in this volume. Major attention naturally will be directed toward the formulation of sound policies for the conversion of funds in the individual bank. Other matters discussed are related to this central problem and to each other only in the sense that in each instance a fundamental policy decision by the management is necessary. Many elaborate treatises are available which discuss at great length sound technical procedures in credit and investment analysis, cost analysis and controls, service charges, duties and responsibilities of directors, and modern methods of personnel management. Nothing is to be gained from attempting to duplicate such material herein. Rather the emphasis is to be placed on certain aspects of general policies such as those suggested above, to which it is believed forward-looking bankers might profitably direct their attention.

CHAPTER 2

LIQUIDITY AND SOLVENCY

Liquidity and Shiftability.—The fundamental requisite of a going banking institution is the necessity for meeting its obligations on demand. For this reason bankers are thoroughly justified in placing the emphasis that they do on the problem of liquidity. Modern banking is conducted on a basis of fractional reserves. By this is meant merely that of the cash and cash items which are deposited with it by its customers something less than 100 per cent can be retained by the bank in the entirely unproductive form of cash in vault and balances with other banks. The part not so retained in these forms is converted into earning assets through the loan and investment process. At no time, therefore, does the modern bank have cash on hand and free balances with other banks in amount sufficient to pay off all its depositors in any one day. Yet all its deposits are, in fact, demand liabilities and therefore indeterminate as to time.

If economic conditions were to remain fairly stable indefinitely, and if that fact were known in advance, it would be a relatively simple process to manage a bank with at least a minimum degree of success. But banking must be carried on in depressions as well as in periods of prosperity, under conditions of war as well as in peace. If fair-weather banking is to be avoided, it is necessary in intervals of stability for bankers to prepare for stormy weather. For when adverse conditions develop, many customers find it a difficult matter to repay their loans, bond prices may decline substantially, and at the same time withdrawals of deposits are likely to exceed new deposits by a considerable margin. These are extremely unfavorable conditions for the reconversion of earning assets into cash and its equivalent.

Prior to World War I generally accepted doctrine required banks to invest primarily in short-term paper representing current commercial transactions. Such paper was considered self-liquidating. By this was meant that sales of the goods financed provided means for repayment of the loans. In the ordinary course of events sound loans of this character could be liquidated by the borrower provided a satisfactory market could be found for the goods financed. Even though substantial loss might be realized by the borrower in this process, receipts from their sale should be large enough to repay the loan. These so-called self-liquidating loans were contrasted with longer-term capital loans, funds for the repayment of which must come from profits realized in the future. Commitments in this latter type of loan were contrary to orthodox commercial banking theory. By investing its depositors' funds in a series of short-term, self-liquidating loans, well diversified as to maturities, a constant inflowing stream of cash might be confidently expected. In this way commercial banks were supposed to be able to minimize their inherent vulnerability in a situation in which their deposit liabilities were in effect demand liabilities and their immediate means of payment represented only a minor fraction of such liabilities.

No competent banker ever thought, however, that maturing commercial loans could be relied upon exclusively to provide a bank with adequate funds during any extended period in which its volume of deposits was decreasing substantially. Even in relatively stable periods many loans are not paid at maturity and it becomes necessary to grant renewals. In times of crisis and general loss of confidence a substantial percentage of such loans may become frozen, and attempts to force payment merely add to the deflationary forces at work and thus accentuate the seriousness of the situation. In this stage of the cycle, banks should be in position not only to renew all sound loans already outstanding but should also make new loans freely to all customers whose financial positions appear to be fundamentally sound. At the very time, therefore, that the bank finds itself in urgent need of additional funds the stream of payments from maturing loans is very likely to dry

up. If its position at such times is to be made at all tenable it is obviously necessary to supplement reliance upon maturing local loans for the necessary inflow of funds by short-term commitments outside the home community. To the extent available open-market commercial paper and bankers' acceptances are two of the most appropriate items for this purpose.

After World War I it gradually came to be recognized that even though its short-term commercial advances, both local and open market, might be liquid for the individual bank, for the banking system as a whole such commitments were no more liquid than longer-term paper. When the manufacturer sells the goods financed by short-term loans he is provided with funds for the repayment of his loan. But the wholesaler must now borrow from *his* bank until he can dispose of the goods to retailers, and then the latter must borrow. When the goods are finally sold to the ultimate consumer they are paid for largely out of wages and salaries, but in order to pay wages and salaries the manufacturer must borrow again. It is apparent that when this short-term paper constitutes a large portion of most banks' earning assets no substantial nation-wide liquidation is possible if the processes of production, distribution, and consumption are not also to be curtailed. Reduction of loans in any one bank is likely to be reflected in increased loans in other banks. In other words, there is merely a shifting of the burden, not any general liquidation.

As will be shown shortly, general recognition of the validity of this line of reasoning has had important repercussions despite the great decline in total volume of commercial loans which has been witnessed during recent decades. Numerous explanations of this decline have been offered. Reasons most frequently mentioned are lower inventory requirements due to development of motor transport and the speeding up of railroad freight service, and the growth of many smaller business enterprises to a size which has made possible recourse to the long-term capital market, thus reducing or completely eliminating dependence on banking connections for short-term funds. Reliance upon their banks for frequent accommodation has always been repugnant to businessmen, and they have not been slow

in taking advantage of changed institutional conditions which made it possible for them to curtail the volume of such borrowing. This development, however, has been extremely unfortunate from the standpoint of the banks. Faced with the loss of a substantial share of their most lucrative business they were forced more and more into the investment market for the purchase of bonds, often buying bonds of their own former borrowing customers. These bonds represented both fixed capital and permanent working capital, and funds for their repayment depended upon the future prosperity of the issuer. By no stretch of the imagination could they be considered self-liquidating.

However, even though not self-liquidating, to the extent that the purchased bonds are parts of large issues having ready marketability, they can be sold with little or no delay at going market prices, and thus they can serve to supplement whatever inflow of funds there may be from maturing commercial paper. It is true, of course, that buyers must be on the other end of such transactions. And these buyers will surely be other banks or customers of other banks. In either case the result is the same; funds for their payment come from other banking institutions, and the burden has been merely shifted. We have already seen, however, that this is what happens when the commercial loans of any one bank are reduced. From the overall standpoint, therefore, any sharp distinction between liquidity and shiftability tends to disappear. As a matter of fact, among bankers it never has been common to make any distinction between liquidity and shiftability. In this position they have been joined in recent years by many economic analysts such as Moulton and Hardy. Moulton goes so far as to say: "Liquidity is, in fact, tantamount to shiftability." [1]

While there may be no significant difference between these two concepts when judged from the viewpoint of the banking system as a whole, it does not necessarily follow that there is no meaningful distinction so far as the individual bank is concerned. When its short-term paper is paid at maturity, it is of

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[1] H. G. Moulton, *Financial Organization and the Economic System*, p. 318.

no interest to a bank that the funds come indirectly from other banks. After all it gets its money back and will lend it again only in the light of conditions prevailing at that time, and only to borrowers who, it believes, will be able to meet their obligations at maturity. These opportunities for constantly reappraising risks, not only of borrowers but also of any adverse change in business conditions, make commitments in short-term self-liquidating loans more attractive than other assets—just as sound fundamentally—which can be turned into cash only by shifting directly to others, and at going market prices.

Solvency.—The position of a bank is vulnerable not only because of the system of fractional reserves mentioned above, but also because, to be financially successful, a bank must operate on a thin equity. In 1943 stockholders' funds for all member banks amounted to less than 8 per cent of their gross deposit liabilities and only a little over 11 per cent of depreciable assets. It is obvious, therefore, that a bank whose condition approximates the average in these vital relationships is in no position to withstand substantial depreciation of its earning assets. For two reasons a policy of restricting commitments largely to short-dated paper is best suited to insure its ability to meet all demands of depositors and to protect its own solvency.

In the first place there is always some risk involved in making advances, whether they be short-term loans to industry or purchases of bonds. The shorter the period for which the original commitment is made the less risk is there that the bank has misjudged the ability of the debtor to take care of his obligations. The longer the period the greater is the possibility that new factors may emerge which could not be foreseen and which may impair the debt-paying ability of the obligor. When a three to six months' loan is made to a sound business firm means of repayment are clearly in sight. But a multitude of adverse developments might be encountered by the same concern during the following fifteen or twenty years which could impair seriously its ability to take care of a bond maturity at that distant date. Likewise, from the same standpoint of in-

ternal uncertainty, a five-year bond obviously entails much less risk for the investor than does a twenty-year bond of the same issuer.

We have also to consider, in the second place, the problem of external uncertainty. There is, for instance, the possibility that interest rates may advance substantially. If a bank invests only in money bonds—as it should—sharply advancing interest rates mean a corresponding fall in market prices. For money bonds maturing gradually over a period of not more than five or six years this decline in market price cannot be serious. As these bonds mature they add to the bank's inflow of funds from other sources. If they do not mature fast enough they can be sold without vital loss. But for bonds maturing in the distant future the decline in market quotations will be rather substantial. To whatever extent it may be necessary to sell them in order to raise funds a major loss is thus actually realized. For a bank loaded with these long-term bonds, even if it is unnecessary to sell them, market depreciation may be so considerable as to constitute a positive threat to the solvency of the holding institution. On the other hand, short-term commercial loans will be unaffected by this development.

Summary.—This brief discussion may be summarized as follows. The modern bank is basically vulnerable because of the fractional reserve system and the fact that it trades on a thin equity. Because of the fractional reserve policy its earning assets must be confined principally to short-term local and general market advances to commerce and industry and to readily marketable bonds. In so far as these assets are sound they provide a constant inflow of funds, which may be supplemented, if necessary, by shifting to others without possibility of substantial loss. Because of low capital-deposit ratios, long-dated paper, whatever its quality, may constitute a threat to the bank's solvency, and should be avoided.

PART II

LIQUIDITY

The problem of determining the amount of liquidity actually needed by any individual bank is obviously basic in its implications. Too little liquidity may be fatal. Too much liquidity means the bank is unnecessarily foregoing income. In this Part a method is set forth the use of which requires the banker to take two different but quite definite steps. He must, in the first place, analyze his own bank's experience, over a considerable period of the past, with both short and long-drawn-out downward fluctuations in different classes of his bank's deposits. Having done this he must decide upon the most desirable means for supplying whatever liquidity is necessary, as judged by the past, to insure that his bank will always be able to meet such demands in the future with a minimum of internal stress. The method itself is rather mechanical but its use requires management decisions of fundamental importance. It is presented in the hope that, in some small way, it may serve to encourage long-range, careful, and intelligent planning.

CHAPTER 3

ASSET RESERVES

The importance of acquiring only thoroughly sound earning assets cannot be overstated. But this alone is not sufficient to insure a sound institution. If liquidity and solvency are to be maintained it is necessary, in addition, to achieve a wise allocation among different classes of assets of all funds coming into the possession of the bank. The starting point for this allocation is found in the problems of reserves. It seems appropriate, therefore, to begin our analysis with that subject.

In industrial and mercantile enterprises the term "reserves" appears exclusively on the liability or equity side of balance sheets or as short-extended deductions from certain asset items. Reserves are frequently used in this same sense in banking and attention will later be directed to the importance of adequate reserves of this character. But in banking the custom also prevails of using this term with reference to certain assets or groups of assets. We are here concerned with this unique use as employed in the field of banking. Thus we have in common use the terms primary reserves, legal reserves, and secondary reserves. It is proposed herein to add a fourth—the investment reserve.

Primary Reserves

Primary reserves comprise those assets which are cash or its full equivalent. Such assets are maintained by the banker because of his normal day-to-day requirements and to guarantee his ability to meet all reasonably to be expected demands of his depositors. For such purposes an ample fund of currency must be carried in the bank at all times and also free balances in other banks must be maintained. In addition a bank has on hand at all times checks drawn on other banks, which will

automatically turn into cash or its equivalent as soon as collected. These cash items in process of collection may also properly be considered part of the primary reserves.

Every banker would find it necessary to maintain some primary reserves even in the absence of any legal compulsion. And every good banker would see to it that such reserves were amply adequate, as judged by his experience with his own depositors. But in the distant past many bankers failed to maintain primary reserves of sufficient magnitude. Because of their failure in this respect during the nineteenth century there gradually developed the custom of requiring by law that banks maintain reserves equal to a certain specified minimum percentage of deposits. Today all banks which are members of the Federal Reserve System must maintain these legally prescribed minimum reserves as free balances with the reserve banks. Each state requires by statute certain specified minimum reserves for state banks not members of the Federal Reserve System. It is proper to consider these legal reserves as part of the primary reserves, and yet they differ from all other portions of the primary reserve in one fundamental respect. The primary reserve as a whole is designed to meet both the routine and emergency demands of depositors. But the legal reserve is of value to the bank only in emergencies. A bank finding it necessary to make use of its legal reserve is assessed a penalty rate, but if such deficiency continues after due warning, Regulation D provides for the revocation of the charter and forfeiture of the membership privilege. As a means of national credit control to the Board of Governors of the Federal Reserve System is delegated the power to alter minimum legal reserve requirements within definitely prescribed limits, but from the standpoint of the individual bank such reserves are of value only as a protection against temporary emergencies or final liquidation.

The Banking Act of 1933 specifically forbids the payment of interest on demand deposits, so that free balances with other banks now join currency on hand, cash items in process of collection, and reserves at the Reserve banks as nonearning assets. Because such assets earn nothing there is a natural tendency for

bankers to wish to retain in the form of primary reserves no larger volume than is believed to be necessary. Prior to the depression of the thirties, banks aimed to keep the size of their legal reserves down to the minimum prescribed by law, and varied the amounts of currency required and the size of balances with other banks to suit their individual requirements. Primary reserves are, of course, a function of deposit liability and their size should properly vary not only with the size and make-up of deposits but with the experience of the individual bank with short-run fluctuations of its deposit totals in the past.

The importance of adequate primary reserves is self-evident. With the exception of the legal reserve portion—over the minimum size of which the banker has no scope for the exercise of judgment—the primary reserves really constitute the working reserves of the bank, and no banker whose institution is otherwise in a sound condition would fail to maintain a volume of cash in his own vault and free balances with other banks equal to his needs. The instinct of self-preservation is ubiquitous and it requires no great amount of acumen or knowledge of banking in general for the individual banker to determine how much he needs to meet ordinary requirements and reasonably to be expected extraordinary demands. In view of these considerations he is not concerned with the emphasis in banking literature which has been directed to the subject of primary reserves. Because the legal reserve element in primary reserves furnishes a convenient medium for attempts at national credit control that portion of the primary reserves is deserving of study by social scientists. But from the standpoint of sound private bank management the subject may be looked upon as meriting a minimum of attention, at least so long as the requirements are not obviously excessive.

The Secondary Reserves

We have just seen that the primary reserves serve as a first line of defense against the demands of depositors and that, since the items comprising the primary reserves earn nothing, it is desirable to maintain such reserves in no larger volume than appears to be consistent with safety. The volume actually

needed in any individual case is conditioned to a large extent by the size and quality of the second defensive position against future developments. To the group of items comprising this second line of defense the name secondary reserve is commonly given.

Secondary reserves consist of earning assets—promises to pay—and hence can be used in liquidation of claims against the bank only after they have turned into cash. If this reserve is to provide the bulwark intended, it is evident not only that there must be no doubt that the constituent items actually will turn into cash but that they will do so in the very near future. In other words, highest quality and early maturity are the fundamental requisites.

In constructing the working capital position of nonbanking enterprises it has long been the custom to include as current assets not only cash and its equivalent but also inventories and receivables. This is sound practice in such businesses because in any well-managed manufacturing or merchandising enterprise a large percentage of both inventories and receivables is likely to be transformed into cash during the succeeding twelve months. All debts which must be paid within one year are properly treated as current liabilities. These debts will not shrink, but will have to be met dollar for dollar. On the other hand inventories and receivables may turn out to be worth less than one hundred cents on the dollar. A sound position requires, therefore, that the current assets exceed the current liabilities by a comfortable margin. This excess is known as the net working capital. If a concern is to meet the acid test, however, its cash and equivalent plus its receivables must equal its current liabilities. For this purpose inventories are omitted. So far as they are concerned there still remain both the selling process which will transform them into receivables and the collection of the receivables. Both of these processes must be completed before cash arising from current inventories will be available to meet current debt. And this may not be soon enough to meet debts outstanding at a given moment of time.

The analogy with banking is far from perfect, yet it is illuminating to consider both resemblances and points of dif-

ference. The primary reserve of a bank corresponds, of course, with the cash and marketable securities of the industrial enterprise. Both secondary reserves and receivables are but one step removed from cash, and both should automatically turn into cash within one year. On the other hand the banker cannot know with any measure of certainty how much he will be called upon to pay out during any given period in the future. Yet he must be prepared to meet whatever demands actually materialize. Therefore his secondary reserve must be of higher quality than the receivables of the industrial enterprise. They must be one hundred per cent dependable, not only eventually, but when due. Furthermore, they should comprise exclusively general money market obligations having no connection with the home community. Depositors are primarily members of this home community and demands upon the bank come from them. To meet such demands the bank must be prepared to draw funds from entirely outside sources. Loans to customers, therefore, however good, and regardless of maturities, have no proper place in the secondary reserve. There is discernible a rough correspondence between such loans and the inventories of the industrial enterprise. And, it will be recalled, inventories are omitted when making the acid test.

No other banking concept has been accorded a greater diversity of treatment than that given to secondary reserves. Yet from the above there emerge definite requirements for eligibility which are entirely in line with classical tradition. If the secondary reserve is to perform its function under any and all conditions it must consist only of highest quality outside credit instruments of unquestioned marketability which mature as regularly as possible over the succeeding twelve months. Such instruments are liquid because they automatically turn into cash within one year. They are also shiftable because, if need arises, they can be turned into cash instantly without possibility of material loss, and usually without recourse.

In spite of the position maintained above, it is not the intention here to insist that there is anything especially sacred about a twelve months' limitation. The argument for that limitation seems strong in view of its general acceptance in all

other lines of business, a great majority of which have far less need for liquidity than do banks. The Bank Management Commission of the American Bankers Association in 1932 recommended[1] the inclusion of maturities up to eighteen months. In 1938 the same Commission said that "maturities in the secondary reserve should not exceed one to two years."[2] There can be cited also authority for still longer maturities. Thus J. Harvie Wilkinson sets four years as his maximum.[3] James W. Wooster, Jr., goes him one better and includes five-year maturities.[4] In a matter about which informed opinion varies substantially there is no point in insisting that a maximum maturity of one year is sound while a two-year is unsound, especially during a period in which the yield basis available is so low. What is essential is that items qualifying for this reserve shall be of highest quality and readily convertible into cash in advance of maturity with no material loss. Intermediate term securities are important enough to justify the special attention later accorded them, but for the purpose of this analysis all items with maturities longer than one year will be excluded from the secondary reserve classification. To some this will seem overly conservative and in the analysis which follows they may make the necessary adjustment to correspond with their views on this point.

So far as long-term securities and those of second grade are concerned there is general agreement that they do not belong in the secondary reserve. Even here, however, one dissenting voice is raised. Professor Ray B. Westerfield apparently includes all readily marketable securities without regard to quality or maturity, thus making the secondary reserve practically synonymous with any well-managed bond account.[5]

The essential function of the secondary reserve is two-fold: (1) to enable the bank to keep invested the maximum percentage of its funds, and (2) at the same time to provide it

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1 *American Bankers Association Journal*, October, 1932, p. 15.
2 *Statement of Principles and Standards of Investment for Commercial Banks*, 1938, p. 11.
3 *Investment Policies of Commercial Banks*, p. 13.
4 *Bankers' Handbook of Bond Investment*, p. 100.
5 *Money, Credit, and Banking*, pp. 215-216.

automatically with a constant stream of cash for the regular replenishment of its primary reserve in the first instance, or for reinvestment in other earning assets if the cash is not needed in the primary reserve. With an adequate secondary reserve having all the characteristics enumerated above it becomes a simple matter for the bank to maintain its working primary reserves at the desired level in the face of unusually heavy demands for loans from good customers or unusually heavy withdrawals of funds by depositors. Should the necessity be great enough to warrant doing so it has already been indicated that maturities may be anticipated by disposal of the items in the secondary reserve on any business day, usually without recourse, and without loss or other expense.

It must be obvious that not many classes of credit instruments meet all the eligibility requirements specified above. Those that conform in all respects are: bankers' acceptances, open-market commercial paper of the highest quality, Treasury bills, and highest quality readily marketable bonds within one year of maturity.

Bankers' Acceptances.—Bankers' acceptances more closely than anything else approximate the ideal instrument for the secondary reserves. They are obligations of large well-known banks and have short maturities, seldom running over six months. They can be disposed of promptly either at the Reserve bank or in the open market. Furthermore, acceptance credits properly granted and used meet the most exacting requirements as to the traditional and classic use of commercial bank funds. The bill market has not developed in this country to the extent that it has elsewhere. As a result the available supply of bills is usually limited and the rate of return is always low relatively to that which can be earned on other private credit instruments. In practice they are available only to large banks in the central money markets, and will, therefore, be given no further consideration in this study.

Commercial Paper.—Second only to bankers' acceptances in desirability for inclusion in the secondary reserve is open-market commercial paper of prime quality. The funds raised in

this way by borrowers are used for current self-liquidating purposes, funds for repayment coming from the sale of goods whose purchase or processing has been thus financed. Prime names are firms of substantial size and with unquestioned credit standing. The paper is short term, seldom over seven months, and as renewals are out of the question it must be paid at maturity. In common with other credit instruments the total volume of commercial paper has declined to an extremely low level, and it is not usually available directly to country banks. It is necessary for such banks, therefore, to rely upon direct contacts with issuers and their correspondent banks in order to obtain any appreciable volume of this paper. The paper is usually drawn to the order of the borrower and endorsed in blank, thus making it possible for it to pass from holder to holder without further endorsement. In the event of necessity for prompt recovery of funds thus employed it may be sold to others without recourse.

United States Government Obligations Due within One Year.—During the war years 91-day and 92-day Treasury bills have been offered in large volume, and in 1943 over eleven billions were outstanding. They carry no interest and are offered for bids on a discount basis. From every standpoint except that of yield they are an ideal instrument for the secondary reserve. With a yield which approximates only three-eighths of 1 per cent, however, they have been of interest only to large metropolitan banks in position to bid for extremely large volumes. However, as will be pointed out in connection with war financing problems, even relatively small banks can hold these instruments advantageously.

Treasury notes are issued for periods of over one year but not exceeding five years. When within one year of maturity they also constitute excellent secondary reserve assets. On such maturities, however, yields are no greater than on Treasury bills. In order to earn as much as 1 per cent it has been necessary to reach for two-, three-, and four-year maturities, which bars them from the secondary reserve classification according to the standards suggested herein.

Certificates of Indebtedness were resurrected by the Treasury during 1942. These obligations fill in the gap between the bills and the notes. Their maximum maturity is one year and those issued in 1943 carried a yield of seven-eighths of 1 per cent. The total volume outstanding approximates seventeen billions and maturities are spaced at short intervals. So long as these conditions continue, banks will have no difficulty in maintaining adequate secondary reserves. As to quality, however, it is obvious that these certificates are in no way superior to Treasury bonds which have approached to within one year of maturity.

Corporate and Municipal Issues Approaching Maturity.—Highest-grade corporate and municipal issues maturing within twelve months may be included in the secondary reserves if they are so actively traded in as to assure a quick, close market. It is evident that at any one time not many issues meet these requirements. Certain railway equipments meet the test of quality but for most of them under normal conditions trading activities are not extensive. This is true, also, of the serial issues of many municipalities. But under the above heading the principal source of supply for the secondary reserves is likely to be highest-grade corporate issues which have been outstanding for many years and are within one year of maturity. Commonly such bonds will have been purchased originally for the permament bond portfolio. If not called or sold they would become eligible first for the investment reserve and, when within one year of maturity, finally pass into the secondary reserve classification.

Call Loans to Brokers.—This is an item which is usually included without question in the secondary reserves. It is true that they do not mature automatically within twelve months as do the other items described above. But under any conditions short of a national emergency they may be called on any business day, and in view of the obviously adequate collateral security the risk of loss is practically nil. It should be borne in mind, however, that national emergencies do arise from time to time. In 1914 the stock exchange was closed for four months,

during which time all loans to brokers were completely frozen. During that period bankers' acceptances and open-market commercial paper were paid regularly at maturity. In November, 1929, these loans as a whole became frozen again, and but for the ability of the New York banks to step in and take over loans called by correspondent banks and others large losses might have been incurred generally.

The position taken here is that in no single respect is it wise for banking to be conducted on a fair-weather basis. To be prepared for storms its reserves must be not only adequate in size but also each individual item should be of a character which will insure the bank's ability to turn it promptly into cash without appreciable loss even in the face of a general national emergency. Measured by this standard loans to brokers do not qualify for the secondary reserves in spite of their fundamental soundness and high degree of normal shiftability. While strict logic thus requires the elimination from the secondary reserves of call loans to brokers, to insist upon their ineligibility is to run counter to all generally accepted ideas on the subject. Nothing is to be gained by an unnecessarily captious and unrealistic attitude which a great majority of bankers would consider overly conservative. For the purpose of this study, therefore, call loans to brokers will be considered eligible for the secondary reserve.

All Longer-Term Issues Omitted.—All longer-term issues, without respect to quality, are omitted from the secondary reserve classification. If they are listed and actively traded in, or if there is an active over-the-counter market, it is true that they can be disposed of at any time at going market prices, but these prices may be higher or lower than either cost or book value. If the condition giving rise to the need for replenishment of the primary reserves is at all general it will be found to be a particularly inopportune time in which to sell bonds because other banks will be doing the same thing. There is grave danger, therefore, that substantial losses will be realized. The essence of a real secondary reserve is that it shall provide funds either at regular intervals or as needed during the twelve months im-

mediately ahead. Not only do longer-term issues fail to provide funds automatically but if it becomes necessary to dispose of them under unfavorable conditions there is even possibility of real loss.

Even government bonds are by no means immune from substantial price fluctuations. For the purpose of computing a liquidity ratio it is the common practice to include all United States Government obligations. It will be shown later,[6] however, that this liquidity ratio is a makeshift device necessitated by lack of information concerning secondary reserves in banks' statements of condition. It is true that in the absence of any general desire or necessity to sell them at the same time all government obligations have the highest degree of shiftability. They may also be used as collateral at the Reserve banks, but the borrowing bank still remains liable for the full sum borrowed. Price fluctuations concomitant with changing interest rates cannot be avoided; hence there is no assurance that they can be disposed of at any particular time without recourse or without loss. Memory is still too vivid of the depths to which Liberty bonds fell in the early postwar years.

General Considerations Pertaining to Secondary Reserves.—The discussion in the preceding sections was concerned with the constituent elements properly to be included in the secondary reserves. It is a much more difficult task to try to determine the proper size of these reserves. Indeed it is impossible to arrive at a definite proportionate figure which should always be attained. Conditions differ widely from bank to bank and the variables are so numerous that it is not the part of wisdom to lay down any hard and fast rules. What are these variables and what are some of the conditions which differ so widely in different banks?

One variable is the size of the primary reserves which banks find it necessary or expedient to carry, for this is far from uniform from bank to bank. The size of the minimum legal reserve is beyond the control of the individual bank and is uniform

[6] Chapter 10.

for the members of each reserve classification—central reserve city, reserve city, and country banks. Although banks have no control over the volume of items in the process of collection, the actual amounts for individual banks differ in accordance with the variations in the character of the business of customers. For the same reason some banks find it necessary to carry a much larger percentage of currency than others, and the free balances maintained with correspondent banks differ widely from institution to institution. It is obvious that the larger the primary reserves (exclusive of legal reserves) the smaller the secondary reserves might properly be.

A second factor which must be considered in determining the proper size of the secondary reserve for an individual bank is the composition of its deposit liability. The larger the percentage relationship of time deposits to total deposits, the smaller the secondary reserve needs to be. It is true that savings deposits, the principal component of time deposits, are, in practice, payable on demand, just as are demand deposits. Despite some statements to the contrary in recent years savings deposit totals for any group of typical continuing banks fluctuate through a much narrower range than do demand deposits, and hence a bank does not need to have the same degree of individual liquidity in the assets purchased with savings funds as is necessary in order to service demand deposits properly. In all jurisdictions recognition of this fact is supplied in the smaller legal reserve requirements against time deposits.

So far as legal reserve requirements are concerned, however, all laws assume a homogeneity among demand deposits which does not, in fact, exist. Three distinct classes of demand deposits are discernible: individual demand deposits; bankers' balances; and public funds. Such surveys of their deposit behavior as have been made for individual banks reveal little similarity in steadiness between individual demand deposits and the other two classes.[7] Both bankers' balances and public deposits tend to fluctuate much more violently than do individual demand deposits and this lack of stability makes it highly de-

[7] See, for example, R. G. Rodkey, *Legal Reserves in American Banking*, pp. 442-449.

sirable that the funds representing such deposits be kept in highly liquid form. If this contention is sound it follows that banks whose holdings of such balances are large in relation to total demand deposits need correspondingly larger secondary reserves. On June 30, 1941, for all national banks, public funds and bankers' balances combined constituted almost 34 per cent of total demand deposits. This situation serves to emphasize the vital importance of conservative investment of demand deposits.

Deposit experience also differs widely from bank to bank with respect to balances of corporations and individuals. A careful survey of this experience for the individual bank is a necessary preliminary to determination of the percentage of such deposits which it is wise to carry in the secondary reserves. The less dependable the total, the greater the need for secondary reserves.

As the names indicate the assets comprising the primary and secondary reserves constitute a bank's first and second lines of defense against demands of depositors as well as against future developments of such general character that it is impossible to foresee them. Primary reserves of course earn nothing and items in the secondary reserve must be selected with quality and maturity as the prime motivating force, and with earnings thereon as a distinctly minor consideration. The larger the secondary reserves the more closely may primary reserves be held to a minimum. With no secondary reserves, or a definitely inadequate volume thereof, a much larger percentage of the bank's assets must be held in the entirely unproductive form of primary deposits.

The scarcity of bankers' acceptances and open-market commercial paper has already been commented upon. In the years immediately preceding Pearl Harbor all government obligations maturing within one year provided a truly microscopic return. This situation was relieved to some extent in 1942 by the reintroduction of certificates of indebtedness offering yields as high as seven-eighths of 1 per cent. Nevertheless, under conditions existing most of the time since the banking holiday a bank had to depend for some considerable portion of

its secondary reserve upon items which had been purchased originally for the permanent bond portfolio or its investment reserve and which had come to within one year of maturity. In other words, long-term planning with particular reference to quality and marketability of items purchased originally for the permanent bond portfolio and investment reserve is essential if a truly productive secondary reserve of adequate size is to be maintained. What constitutes "adequate size" for the secondary reserve can be determined only in connection with specific facts in an actual case. The process involved will be described in detail in Chapter 4.

The Investment Reserve

In the preceding section the contention was advanced that there should be excluded from the secondary reserves all earning assets which are not self-liquidating within a twelve-month period or which cannot be disposed of instantly without recourse and without possibility of appreciable loss. Nevertheless, highest quality readily marketable securities maturing at regular intervals in what might be called a period of intermediate length deserve special classification. The term Investment Reserve is suggested as an appropriate title for this group of securities. The use of this term for the type of securities suggested would serve to clarify managerial thinking about investment problems particularly with reference to the fundamental matters of liquidity, shiftability, and exposure to risk from changing interest rates and deterioration of credit standing of obligors. It would also make possible greater precision in the discussion of different phases of the investment problem and at the same time be a useful tool in the general allocation of funds among different types of earning assets, as will be demonstrated a little later. Should the use of the term Investment Reserve receive general acceptance the temptation would be lessened to include in the secondary reserves items which do not belong there. This is likely because the investment reserve is designed as an intermediate category lying between the secondary reserve and the permanent bond portfolio. As used herein the investment reserve will desig-

nate United States government and other issues of AAA quality:

(a) With maturities of one year or longer but not in excess of six years and spaced at as even intervals as possible.
(b) Readily marketable at all times at intrinsic values.

Every bank has, of course, a substantial volume of securities which meet these requirements for investment reserve eligibility. What is suggested here, therefore, is merely the desirability of grouping such assets under a heading which differentiates them from both the secondary reserve and the longer-term issues in the bond account proper. It is equally important to have clearly in mind the fundamental function of this reserve and to develop a formula by means of which the banker is enabled to determine the minimum volume of such securities that he should have on hand at all times. These are aspects of the problem which are discussed at some length in Chapter 4. At this point certain considerations of a more general character are appropriate.

Spacing maturities as evenly as possible over the five-year period covered by the investment reserve has already been indicated as being one of its most desirable features. As individual items in the investment reserve come to within one year of maturity they pass automatically into the secondary reserve classification, since it is only because of their longer maturities that these items are not eligible for the secondary reserve in the first place. Furthermore, as these assets finally mature, funds received therefrom will, in the absence of other needs, be available for reinvestment in investment reserve items of six-year maturity. After these two revolving funds in the secondary and investment reserves have been definitely in operation over a period of time, the bank is thus enabled to reinvest funds from maturing items at the yields available on securities with six-year maturities, which yields have, in recent years, been substantially higher than those obtainable on shorter-term issues.

It remains to be observed that the investment reserve itself to some extent will be automatically replenished from time to

time as items in the longer-term bond account proper which otherwise qualify for the investment reserve come to within six years of maturity. To the extent of such replenishments, funds received from maturing items are available for reinvestment in longer-term permanent bond portfolio items on a still more favorable yield basis. It is evident, therefore, that for best earning results careful long-range investment planning is essential.

The real function of the investment reserve is to provide a third line of defense—a defense against extraordinary developments that no banker can be expected to foresee. Any reasonably well-managed bank is always prepared to take care of ordinary seasonal fluctuations in loans and deposits. It is equally important that neither embarrassment nor serious loss shall ensue from major longer-term movements—upward in the case of loans, downward in the case of deposits. In the past bankers acquired the reputation for being poor bond buyers. While far too many bankers have sacrificed quality for yield this poor reputation derives primarily from a different factor—bad timing. They seemed to be forced to buy at the wrong time and to sell at the wrong time. In the upward swing of the business cycle both loans and interest rates tend to rise. Rising interest rates tend to depress the prices of quality bonds, but in order to take care of the increasing demand for good loans the typical procedure has been to sell bonds. This concentrated selling from many banks forces prices still lower. The process is reversed as we pass from prosperity to depression. Interest rates fall, bond prices rise, loans are paid off, and banks, in order to keep their money working, must buy bonds at high prices. This latter phase did not come into operation in the downward sweep from the high prosperity level of 1929 to the depression depth of 1932 because it was accompanied by a major loss of deposits and unprecedented inability of borrowers to repay their loans.

Banks otherwise soundly managed and which had in 1929 adequate secondary and investment reserves, could face with equanimity the developments of the succeeding three or four years. Their earning power was likely to become impaired,

but ability to meet all their obligations would never have been questioned by those familiar with the real situation. Furthermore, they would not have found it necessary to sell bonds from their permanent bond portfolio in the bad market prevailing during those years. If the spaced maturities of their investment reserve bonds failed to mature rapidly enough to meet the loss of deposits and to meet the demand for all good loans, then additional items from the investment reserve maturing two or three years hence could have been disposed of. Proximity to maturity would make it impossible for such issues to deviate far from par. These observations are based on two assumptions: (1) that the investment reserve contains money bonds exclusively; and (2) that the reserve as a whole is adequate in size. Where such assumptions are warranted the secondary and investment reserves combined would provide the means for meeting a sudden and drastic loss of deposits or the long continued major loss of deposits incident to the decline from great prosperity to the depths of a great depression. Considerations incident to the determination of adequate sizes of the secondary and investment reserves will be discussed in the next chapter.

CHAPTER 4

DETERMINATION OF MINIMUM SIZES OF ASSET RESERVES

It is an elementary proposition that a bank's total reserve position must be predicated upon the extent of possible or probable demands of its depositors. An examination of its own records will reveal the magnitude of such demands in the past. Reliance upon records of the past is a device far from satisfactory. The future may turn out to be so different from the past that such records will prove to have been a faulty guide. But since nobody can possibly know what the future may hold, recourse—however unsatisfactory—must be to our experience over the years behind. Future crises may turn out to be even more severe than those encountered in the past. About as much as can reasonably be expected, however, is to follow policies which will assuredly provide protection against a recurrence of such adverse contingencies as have arisen in the past with perhaps some margin to spare for even worse emergencies.

The great depression of the early thirties provided the most serious peacetime emergency with which our banks have had to deal in the twentieth century. On June 30, 1929, there was no widespread suspicion that just ahead lay drastic deflation and the most severe depression of modern times. On that date loans and discounts for all banks, amounting to 41.4 billions, represented almost 72 per cent of gross deposits of 57.9 billions.[1] As optimism vanished and pessimism emerged a large percentage of these loans became frozen. As pessimism deepened it was accompanied by a crumbling of values on which these loans had been based in the first place. With the crum-

[1] Figures in this discussion derived from *Report of Comptroller of Currency*, 1933, p. 641.

bling of this underlying security billions of dollars of loans became not merely frozen but definitely uncollectible. This development necessitated their removal from book assets. Between June 30, 1929, and June 30, 1932, loans and discounts decreased over 13¼ billions while deposits decreased 12½ billions. Solvent borrowers paid off their loans with checks on their deposit accounts, and such deposits as insolvent borrowers had were likewise utilized.

During this three-year period book value of government and other securities held by all the banks actually increased by $875,000,000.

Systemic Aspects of the Problem.—Closer examination of this liquidation process may be worth while. From the standpoint of the banking system as a whole the decline in total deposits of 12.5 billions may represent liquidation of loans of the same volume. If so the reserve position of banks as a whole would be proportionately improved. If we assume—as of that period—that required reserves equal 10 per cent of gross deposits, the decline in deposits of 12.5 billions would mean a decline of 1¼ billions in their required reserves. If the decline in deposits came about solely through the liquidation of loans their actual reserves would be unaffected. This means they could have paid out to their depositors for hoarding or other permanent purposes 1¼ billions and would have had left reserves at least equal to the legal minimum.

As a matter of fact currency in circulation actually increased approximately one billion dollars during the three-year period ending June 30, 1932. It is true that a low level of business activity and a falling price level are two conditions which ordinarily lead to a decline in the volume of currency in circulation. Thus, between the fall of 1920 and midsummer of 1922, currency in circulation declined approximately one billion dollars. In the ordinary course of events, therefore, one would have expected the circulating medium to decline sharply between June, 1929, and June, 1932. Since instead of declining it actually increased by a billion dollars we have evidence that the total volume of hoarding was by no means limited to the

amount of increased money in circulation. The total hoarding might have been as much as two billions; it could not have exceeded that figure in any substantial degree because total currency outstanding at that time amounted only to 5¾ billions.

Individual Bank Aspects.—From the standpoint of hundreds of individual banks the picture is quite different. Not only was the underlying security back of their loans crumbling but market values of their bond portfolios were spiralling downward. From such banks skeptical depositors were demanding their money. The absence of adequate secondary and investment reserves compelled these banks to force payment of their customers' commercial and real estate loans and to throw overboard at panic prices the marketable portion of their permanent bond portfolios. In the midst of a great depression this policy is suicidal.

The volume of currency actually hoarded during the banking crisis never reached the levels frequently assumed. In March, 1933, the amount outstanding spurted to approximately seven billions, or about 2½ billions more than had been outstanding during most of the preceding decade. This is small compared with the total decline of deposits between 1929 and the reopening of the banks in March, 1933, yet had there been no hoarding whatever it seems reasonable to suppose that a good many hundreds of banks which actually failed might have been able to weather the storm. No banking crisis ever had its origin in the liquidation of large volumes of sound loans and the corresponding decline in deposit totals. On the other hand there can be no assurance of safety arising out of a small volume of loans as compared with total deposits. In 1943 total loans and discounts of all insured commercial banks represent less than 28 per cent of total deposits, whereas in 1929 the corresponding relationship was 72 per cent. If widespread hoarding should develop once more our banking system would be in for trouble again unless proper precautions had been taken. With federal deposit insurance in force, and with many thousands of really weak banks having been weeded out, it may be

argued with some plausibility that there can be no recurrence of almost universal hoarding, and that banks, therefore, are overly conservative whose policies are shaped to guard against a return of 1929-1932 conditions.

It must be admitted that incentives for widespread hoarding are by no means obvious even in the midst of a great war. Yet even so sight should not be lost of certain factors which might have a bearing on this practice.

In the first place, it is doubtful that the average workingman or average housewife can have any clear understanding of the fundamentals of deposit insurance, while many of them still have vivid recollections of what happened to their bank balances between 1930 and 1933. In the event of any widespread loss of confidence engendered by adverse political or war developments, it is by no means certain that the average uninformed person would continue to prefer bank deposits to cash. Among the somewhat more sophisticated, on the other hand, there might be some doubt about the soundness of deposit insurance and the ability of the Federal Deposit Insurance Corporation to meet its obligations should there be another severe epidemic of bank failures.

In the second place, it must be remembered that deposits are insured only up to $5,000 for one individual. Individuals with large cash funds may prefer the security of safe deposit vaults to the unknown soundness of particular banking institutions. And unless the loss of confidence extends to all banks the "smart money" of corporations will be transferred to stronger institutions.

In the third place, currency circulation statistics are by no means reassuring. Money in circulation during the prosperous twenties ranged slightly below the five billion dollar mark, and even during the 1919-1920 inflation it never reached the six billion dollar level. The hoarding so prevalent during the great depression is clearly reflected by a rise in circulation to new highs during 1931, 1932, and 1933, but it never reached the six billion dollar level until early in 1933 when, as already pointed out, it advanced briefly to nearly seven billions. After the reopening of the banks, and particularly after deposit

insurance became effective, circulating currency declined to about 5½ billions. Since that time there has been a fairly steady upward trend, and a new all-time high of 19¼ billions was reached in 1943. Full employment at high wages accounts for much of the increase since 1940. A considerable volume of currency may have left the country and much of it may belong to nationals of other countries the funds of which have been frozen. But even though much of this increase may have arisen from factors having nothing to do with the soundness of banks the effect on bank deposits and reserves is to decrease them just as tellingly as though the cause had been doubt of soundness of banks in general.

In light of the above considerations it appears unwise for the individual banker to dismiss summarily the possibility of a major loss of his deposits. For purposes of illustration it will be assumed here that loss of deposits for a particular bank might be as great as the overall loss experienced by banks from 1929 to 1933. It may well be that some bankers will consider this overly conservative and others not conservative enough. But whatever his ideas might be in this respect, the illustration to be described can be applied to any individual bank with such other assumptions as seems appropriate to the individual banker.

For a good many years and particularly since the onslaught of the great depression many attempts have been made to set up standards for the allocation of all funds. A large number of progressive bankers have done this for their own institutions, while various specialists have attempted to set up standards which individual bankers might adapt for their own use. In 1932, for instance, the Bank Management Commission of the American Bankers Association set up arbitrary standards for the conversion of funds from all sources.[2] But it is impossible to set up hard and fast standards which shall be appropriate for banks in general. No two banks are exactly alike, and no two have identical problems to solve. Because of these differences no two banks have had identical experiences

2 See also "Conversion of Commercial Bank Funds," by H. E. Zarker, *Bankers Magazine*, November, 1941.

with fluctuations on deposits and loans. Nevertheless, the *manner* by which the problems of sound standards of allocation should be attacked is the same for all banks. For the process which is to be described it will be necessary, therefore, for each banker to substitute for the illustrative figures the figures which his own bank furnishes.

For purposes of the illustration it is assumed that the position of no bank is as good as it should be if it cannot meet without any real embarrassment a return to 1929-1933 conditions and at the same time be able to carry on its business otherwise in a normal fashion. As was pointed out in Chapter 2, widespread insistence upon the liquidation of sound loans and the forced sale of securities from the permanent investment portfolio merely tend to accentuate the vicious spiral of deflation. As depression deepens, of course, there is a natural tendency for the total volume of loans to decrease because of the slackening pace of business activity and the consequent decline in inventories and receivables. But a bank should be able to meet whatever demand there is for good new loans and to grant renewals on a normal basis. Furthermore, it should not be necessary to raise cash through borrowing on or selling bonds in the permanent bond portfolio. If its individual assets are as sound as they should be and if its reserves are adequate a bank can meet all demands and at the same time carry on its main functions in the usual way.

The first step in the process by means of which the minimum size of an adequate secondary reserve may be determined is an examination of a bank's own record over at least a ten-year period. The actual period used should exclude abnormal wartimes and should always extend back far enough to include a year or two of the preceding period of major prosperity. In the nineteen forties that would mean going back to 1928 and 1929. Figures should be prepared showing declines in both demand and time deposits year by year down to the bottom of the depression or until such time as the trend in the particular bank was definitely reversed. As a substitute for such figures unavailable here it is necessary to resort to the device of a hypothetical bank. For this purpose we shall assume our hypo-

thetical institution to be a country member bank of substantial size. Since it is highly important that the figures used for this hypothetical bank shall have a thoroughly realistic basis, we turn to aggregate figures in Member Bank Call Report #92 for December 31, 1942. We use figures in the column headed "Country Member Banks" and round them off to the nearest thousand to derive a statement of condition for our hypothetical bank. This gives us an institution with resources of approximately $25,000,000.

The various items shown in this call report were reclassified on a functional basis. Under the heading Fixed Assets were placed not only bank premises, furniture and fixtures, and other real estate, but also stock of Federal Reserve Bank and other corporate stocks owned. Items entirely unimportant for our purpose, such as customers' liability for acceptances and income earned but not collected, were placed under Miscellaneous Assets. Miscellaneous Liabilities includes acceptances outstanding, income collected but not earned, and interest, taxes, and other expenses accrued and unpaid. Constructed in this manner a tentative statement of condition for our hypothetical bank is presented in Table I.

It should be emphasized, perhaps, that the figures in Table I show a bank in which all pertinent relationships between different items are average relationships. Whether the derived statement represents an average bank, however, is immaterial. We are interested in constructing a statement for a country national bank of substantial size which is not purely imaginative, and averages used for this purpose insure a statement which has a realistic basis. The statement in Table I is called tentative because it is desirable to make several adjustments in order to eliminate two abnormalities which have developed in recent years. But first attention is called to certain relationships actually existing in these average figures.

The deposit-capital ratio corresponds roughly with the standard set up by the Federal Deposit Insurance Corporation, gross deposits being just slightly in excess of eleven times invested capital. The total of Fixed Assets is less than 30 per cent of the capital account and real estate loans amount to only

TABLE I. HYPOTHETICAL BANK

STATEMENT OF CONDITION (Tentative)

Resources

Primary Reserves			
Currency and Coin	$ 542,000		
Cash Collection Items	554,000		
Balances with Other Banks	3,700,000		
Reserve with Reserve Bank	2,842,000		
Total Primary Reserve		$ 7,638,000	
Securities			
U. S. Governments, Direct and Guaranteed	$ 9,175,000		
State and Municipals	1,252,000		
Other Bonds	907,000		
Total Securities		11,334,000	
Real Estate Loans		2,500,000	
Other Loans		2,536,000	
Fixed Assets		500,000	
Miscellaneous Assets		49,000	
Total Assets			$24,557,000

Liabilities and Capital

Demand Deposits			
Balances of Other Banks	$ 1,231,000		
Public Deposits	2,650,000		
Other Demand Deposits	11,989,000		
Total Demand Deposits	$15,870,000		
Time Deposits			
Savings Deposits	$ 6,397,000		
Other Time Deposits	193,000		
Total Time Deposits	6,590,000		
Total Deposits		$22,460,000	
Miscellaneous Liabilities		56,000	
Total Liabilities			$22,516,000
Capital Account			
Capital Stock		$ 926,000	
Surplus		703,000	
Undivided Profits		291,000	
Contingency Reserve		121,000	
Total Capital			2,041,000
Total Liabilities and Capital			$24,557,000

25 per cent of savings deposits. As is to be expected other loans are abnormally low, amounting to only 22 per cent of demand deposits. Total volume of securities held is approximately 5⅓ times total capital. In these vital relationships the tentative statement indicates a bank which is adequately capitalized and conservatively managed.

Reference was made above to certain desirable adjustments. In common with other banks outside the leading financial centers our statement shows that the hypothetical bank is maintaining what are apparently excessive balances with other banks. Reference to Table I discloses the fact that these balances are equal to over 16 per cent of gross deposits. In the Report of the Comptroller of the Currency for 1928 we find that country national banks found it necessary to carry with correspondent banks an amount equal to only 8.6 per cent of gross deposits, and this in spite of the fact that at that time interest was paid on such balances. There is no evident reason why balances actually needed now are larger than those required before the depression, and for our purpose it is desirable that any item over the size of which the bank has control shall be of reasonable magnitude. To be conservative, however, let us assume that banks really require balances with other banks equal to 10 per cent of their gross deposits instead of the 8.6 per cent with which they succeeded in getting along in 1928 or the 16 per cent shown for 1942. With this assumption the item Balances with Other Banks becomes $2,250,000 instead of the $3,700,000 shown in Table I. The difference between these two figures, $1,450,000, will remain temporarily unallocated.

In the years immediately following the banking holiday bankers discovered it was impossible to find productive outlets for all their funds, and as a result large excess balances were commonly maintained at the reserve banks. Even under the stress and strain of war finance in the summer of 1943 country banks were still maintaining substantial idle funds in this form. They can be put to work and liquidity still preserved by converting such free balances into Treasury bills and certificates of indebtedness for the secondary reserve. We shall assume, therefore, that our hypothetical bank should carry at the reserve bank just the legal minimum which is required. After the above suggested change in the balances carried with other banks the minimum required reserve for this bank, on the basis of the present requirements of 14 per cent against net demand deposits and 6 per cent against time deposits, is $2,225,000 instead of the $2,842,000 shown in the statement. The amount

thus released, $617,000, will remain temporarily unallocated.

With the alterations just suggested the Primary Reserve section of Table I would appear as in the following tabulation:

Primary Reserves	
Currency and Coin	$ 542,000
Cash Collection Items	554,000
Balances with Other Banks	2,250,000
Reserves at Reserve Bank	2,225,000
	$5,571,000

In all later drafts of the hypothetical bank statement except the final one the figures in the above tabulation will be used for the Primary Reserve. Table II presents the first revised draft of the statement. It will be noted that it includes an Unallocated section. This section includes both the $1,450,000 removed from the item Balances with Other Banks and the $617,000 actual excess at the reserve bank. For a reason indicated later the securities section is eliminated and the $11,334,000 investment in securities shown in Table I is also included in the Unallocated section.

The total primary reserves of $5,571,000 are applicable, of course, both to demand and time deposits. The required legal minimum reserve for time deposits is 6 per cent, and for a bank of this size and general characteristics an additional 1 per cent should provide sufficient primary reserves to meet all extra requirements for vault cash, balances with other banks, and collection items which are occasioned by the presence of savings and other time deposits.[3] The primary reserve allocated to time deposits is, therefore, 7 per cent of $6,590,000, or $461,000. Deducting this $461,000 from the total primary reserves of $5,571,000 leaves $5,110,000 available as primary reserves against demand deposits. This figure is approximately 32 per cent of such deposits.

Minimum Size of the Secondary Reserve.—The statement was made in Chapter 3 that one variable in the determination

[3] In Report No. 18 of the Federal Deposit Insurance Corporation (p. 34) cash, balances with other banks, and cash items in process of collection for all insured mutual savings banks amounted, on December 31, 1942, to about 6½ per cent of their total deposits.

TABLE II. HYPOTHETICAL BANK

STATEMENT OF CONDITION (First Adjustment)

Resources

Primary Reserves			
Currency and Coin	$ 542,000		
Cash Collection Items	554,000		
Balances with Other Banks	2,250,000		
Reserve with Reserve Bank	2,225,000		
Total Primary Reserve		$5,571,000	
Real Estate Loans		2,500,000	
Other Loans		2,536,000	
Fixed Assets		500,000	
Miscellaneous Assets		49,000	
Unallocated			
From Balances with Other Banks	$ 1,450,000		
From Reserve with Reserve Bank	617,000		
From Securities	11,334,000		
Total Unallocated		13,401,000	
Total Resources			$24,557,000

Liabilities and Capital

Demand Deposits			
Balances of Other Banks	$ 1,231,000		
Public Deposits	2,650,000		
Other Demand Deposits	11,989,000		
Total Demand Deposits		$15,870,000	
Time Deposits			
Savings Deposits	$ 6,397,000		
Other Time Deposits	193,000		
Total Time Deposits		6,590,000	
Total Deposits		$22,460,000	
Miscellaneous Liabilities		56,000	
Total Liabilities			$22,516,000
Capital Account			
Capital Stock		$ 926,000	
Surplus		703,000	
Undivided Profits		291,000	
Contingency Reserve		121,000	
Total Capital			2,041,000
Total Liabilities and Capital			$24,557,000

of the size of the secondary reserve must be the size of the primary reserves actually being maintained. Having now determined a reasonable size for the primary reserve for our hypothetical bank, we are in position to take account of other

factors which must be considered in arriving at a reasonable minimum size for the secondary reserve.

Because of their volatility conservative practice requires that all public deposits and balances of other banks be covered completely by a combination of primary, secondary, and investment reserves. For our hypothetical bank 32 per cent of *all* demand deposits are covered by primary reserves. So far as public deposits and bankers' balances are concerned, therefore, 68 per cent remain to be backed by secondary and investment reserves. For purposes of illustration let us assume that this remaining 68 per cent be divided equally between the secondary and investment reserves, or 34 per cent for each of these reserves.

The secondary reserves should also contain an amount equal to whatever normal downward fluctuations in other demand deposits, savings deposits, and other time deposits a bank finds by examination of its own record over a period of years. In addition there should be an analysis of individual demand and savings accounts which appear to be larger than normal. In some banks accounts in excess of normal will be found more common among savings than among demand deposits. Lack of attractive investment opportunities since the depression and uncertainty arising out of war conditions have combined in recent years to induce individuals to build up their savings accounts far beyond their normal size. In a sense such amounts are not real savings at all. They merely represent funds held temporarily in suspense, awaiting a return of confidence in the future. It is advisable for the banker to look upon such accounts with suspicion and to assume that they are far less dependable than the run-of-mine savings account.

On the supposition that the analyses suggested in the preceding paragraph have been carried out we shall assume for our hypothetical bank that secondary reserve protection is needed to the extent of 3 per cent of other demand deposits, 6 per cent of savings deposits, and 18 per cent of other time deposits.[1] The

[1] These assumed percentages are derived from averages of figures supplied by four country banks.

minimum total size of its secondary reserve would thus be built up as shown in the following tabulation:

COMPUTATION OF SECONDARY RESERVE

34 per cent of public deposits	$ 901,000
34 per cent of balances of other banks	418,000
3 per cent of other demand deposits	359,000
6 per cent of savings deposits	383,000
18 per cent of other time deposits	35,000
	$2,096,000

If the actual secondary reserve falls below a figure of approximately $2,100,000, the amount of the deficiency should be carried in the primary reserve, presumably as increased balances with other banks. For our hypothetical bank we shall assume that sound bond investment policies in the past are serving currently to replenish the secondary reserve with a substantial volume of high grade and readily marketable bonds within one year of maturity so that it is possible for it to maintain really productive secondary reserves of the desired magnitude.

So far as our statement of condition is concerned this $2,100,000 for the secondary reserve is deducted from the total unallocated sum of $13,401,000 shown in Table II. The second revision of the statement, showing the primary reserve as a single item, the secondary reserve of $2,100,000, and the remaining unallocated amount of $11,301,000, is presented in condensed form in Table III.

Minimum Size of the Investment Reserve.—The next task is to determine the minimum size of the investment reserve. All the securities shown in the original statement of condition may be eligible for this reserve. In any conservatively managed bank certainly a substantial portion of them would meet all requirements. To the extent that securities originally held are eligible it is necessary merely to allocate them formally to the investment reserve. But for the purpose of illustrating the process involved, it appears simpler to begin with a clean slate so far as securities are concerned. It was for that reason that the securities section was eliminated in Table II and that the entire sum so invested was treated as unallocated funds.

TABLE III. HYPOTHETICAL BANK

CONDENSED STATEMENT OF CONDITION (Second Adjustment)

Resources

Primary Reserves		$ 5,571,000	
Secondary Reserves		2,100,000	
Real Estate Loans		2,500,000	
Other Loans		2,536,000	
Fixed Assets		500,000	
Miscellaneous Assets		49,000	
Unallocated ($13,401,000−$2,100,000)		11,301,000	
Total Resources			$24,557,000

Liabilities and Capital

Demand Deposits				
Balances of Other Banks	$ 1,231,000			
Public Deposits	2,650,000			
Other Demand Deposits	11,989,000			
Total Demand Deposits		$15,870,000		
Time Deposits				
Savings Deposits	$ 6,397,000			
Other Time Deposits	193,000			
Total Time Deposits		6,590,000		
Total Deposits			$22,460,000	
Miscellaneous Liabilities			56,000	
Total Liabilities				$22,516,000
Capital Account				
Capital Stock			$ 926,000	
Surplus			703,000	
Undivided Profits			291,000	
Contingency Reserve			121,000	
Total Capital				2,041,000
Total Liabilities and Capital				$24,557,000

The investment reserve differs fundamentally from the primary and secondary reserves. The combined primary and secondary reserves should protect the bank against all normal fluctuations in loans and deposits, as well as other fluctuations that can be anticipated with some degree of certainty. It should be observed in this statement that there is intended no implication that they are unavailable should major losses of deposits eventuate. But the investment reserve is intended *primarily* as a protection against unanticipated *major* losses of deposits, whether such losses be sudden in character or of the long-drawn-out variety. In order to determine an adequate size for

the investment reserve it is necessary for any actual bank to look into its own record over a period sufficiently long to include the latest major depression and the period of prosperity immediately preceding that depression. A recently organized bank, having no such record of its own to which it can refer, may be able to use the experience of some other bank similarly situated.

So far as our hypothetical bank is concerned we have no record available. It is necessary, therefore, to make certain assumptions about its experience, particularly with reference to the major deflationary period 1929-1933. Reserves sufficient to protect against that phenomenon might not be adequate for some future catastrophic development. But nothing else might be sufficient either.

In order that our assumptions might have a basis of reality a study was made of the experience of forty-four continuing country banks of approximately the same size as our hypothetical bank. A procedure of this sort provides a more dependable basis for realistic assumptions than would recourse to aggregate figures available in the reports of regulating authorities, since the total number of banks is constantly varying, and this was especially true during the years 1929 to 1933. For the forty-four continuing country banks, therefore, it was found that between October 4, 1929, and the bottom of the depression, demand deposits declined by approximately 50 per cent and time deposits by 22 per cent. For the purpose we have in view here the assumption to be made is that our hypothetical bank's experience during that period is identical with the average of these forty-four continuing country banks. On the basis of this assumption we are in position to determine the minimum size of the investment reserve if the hypothetical bank is to be prepared at all times for the return of such conditions.

If the hypothetical bank is to be prepared to lose 50 per cent of its demand deposits and 22 per cent of its time deposits, the total decline against which it must guard is $7,935,000 plus $1,450,000, or $9,385,000. Furthermore, if it is to be run as well as it should be, it must be able to meet this situation without insisting on the liquidation of good loans or the utilization

TABLE IV. HYPOTHETICAL BANK

CONDENSED STATEMENT OF CONDITION (Third Adjustment)

Resources

Primary Reserves	$ 5,571,000	
Secondary Reserves	2,100,000	
Investment Reserve	4,644,000	
Real Estate Loans	2,500,000	
Other Loans and Discounts	2,536,000	
Fixed Assets	500,000	
Miscellaneous Assets	49,000	
Unallocated ($11,301,000 − $4,644,000)	6,657,000	
Total Resources		$24,557,000

Liabilities and Capital

Demand Deposits			
Balances of Other Banks	$ 1,231,000		
Public Deposits	2,650,000		
Other Demand Deposits	11,989,000		
Total Demand Deposits		$15,870,000	
Time Deposits			
Savings Deposits	$ 6,397,000		
Other Time Deposits	193,000		
Total Time Deposits		6,590,000	
Total Deposits		$22,460,000	
Miscellaneous Liabilities		56,000	
Total Liabilities			$22,516,000
Capital Account			
Capital Stock		$ 926,000	
Surplus		703,000	
Undivided Profits		291,000	
Contingency Reserve		121,000	
Total Capital			2,041,000
Total Liabilities and Capital			$24,557,000

DETERMINATION OF MINIMUM SIZE OF INVESTMENT RESERVE

Assumed Total Protection Required			
50 per cent of Demand Deposits	$ 7,935,000		
22 per cent of Time Deposits	1,450,000	$ 9,385,000	
Sources of Protection			
Primary Reserves 32 per cent of $7,935,000	$ 2,540,000		
Primary Reserves 7 per cent of $1,450,000	101,000		
Total Protection from Primary Reserves	$ 2,641,000		
Total Protection from Secondary Reserves	2,100,000		
Total Protection from Primary and Secondary Reserves		4,741,000	
Additional Protection Needed from Investment Reserve			$ 4,644,000

of any bonds in the permanent bond portfolio. In other words, the bank must be prepared to meet a loss of this magnitude merely by recourse to its varied reserves.

Since the primary reserves contain an amount equal to 32 per cent of demand deposits and 7 per cent of time deposits, the primary reserves provide one source of funds to meet the extraordinary drain. In other words, 32 per cent of the loss of demand deposits, or $2,540,000, and 7 per cent of the loss of time deposits, or $101,000, a total of approximately $2,641,000, can come from the primary reserves without impairing in any way the primary reserves against remaining deposits. We have assumed a secondary reserve of $2,100,000, all of which may be utilized. From the primary and secondary reserves combined, therefore, we obtain a total sum of $4,741,000 which is available to meet the extraordinary loss. The difference between the total assumed loss of $9,385,000 and this $4,741,000, or $4,644,000, must come from the investment reserve. We are forced to the conclusion, therefore, that the minimum size of the investment reserve must be $4,644,000. Table IV shows the adjusted statement of condition for the hypothetical bank with this investment reserve substituted for the original securities section and showing a sum remaining unallocated of $6,657,000. All of this $6,657,000 is available for the permanent bond portfolio. It remains for later analysis, however, to determine to what extent it is wise and conservative for this fund to be thus invested.

PART III

SOLVENCY

While adequate liquidity is an essential condition for solvency, liquidity alone cannot insure solvency. A business enterprise may be liquid enough to meet all its liabilities currently due and for which payment is demanded and yet be insolvent. To be solvent the value of all its assets must be, at a minimum, as great as the sum of all its liabilities to outsiders. Many banks which were able to withstand the tremendous loss of deposits which they experienced between 1929 and the banking holiday in the spring of 1933 were judged insolvent and not permitted to reopen.

In this Part the problem of insuring continued solvency is studied. The mechanistic device of the hypothetical bank is continued in order to promote still further careful, long-range planning.

CHAPTER 5

MAXIMUM SIZE OF THE PERMANENT BOND PORTFOLIO

A. Under Conditions of Peace

In preceding chapters frequent references have been made to what is called here, for lack of a better name, the permanent bond portfolio. By this term are meant issues which do not qualify for the secondary and investment reserves, because of longer maturities, quality perhaps below the very highest, or lack of ready marketability so essential for reserve status. With adequate primary, secondary, and investment reserves the presumption is that no forced sale of items in the permanent bond portfolio would ever be necessary for the purpose of raising cash. The intention is rather to hold such issues to maturity with income the prime objective.

Because of large loan portfolios or other sources of substantial income, some bankers find it unnecessary to seek the larger income return available on bonds with maturities beyond the six years which was assumed as the maximum for our investment reserve. Indications are that bankers enjoying this favorable position comprise a relatively small minority. But whatever their number they need not be concerned about problems connected with the permanent bond portfolio. For income reasons, however, the great majority of bankers find themselves obliged in some measure to resort to longer-term issues. It is of the utmost importance for them to determine as definitely as possible how far they can safely go in this direction. At this point we are concerned with the problem under conditions of peace. Necessary wartime modification will be discussed in Section B of this chapter.

Because of the low yields on items eligible for the secondary and investment reserves our problem in Chapter 4 was to

determine adequate minimum size of these reserves. Since protection is the fundamental purpose of such reserves income derived therefrom must be a minor consideration. But we have seen that the prime function of the permanent bond portfolio is the production of income. When other sources of income are inadequate there is always the temptation to expand the bond account proper beyond the limits of safety. Our task in this chapter, therefore, is to determine the *maximum* safe size of the permanent bond portfolio. Table IV shows $6,657,000 still unallocated. Specifically would it be sound to place this entire sum in the permanent bond portfolio with the maturity schedule otherwise decided upon?

Significance of Changing Market Quotations.—The solution to the problem of the maximum size of the permanent bond portfolio is of the utmost simplicity if it properly can be assumed that no significance attaches to changing market quotations of quality bonds when the intention is to hold such issues to maturity. Under that assumption there would appear to be no limit whatever to the size of the permanent bond portfolio. Whatever funds are available might be invested safely in long-term money bonds embracing no internal uncertainty. Changing market prices of bonds of this high quality merely reflect changing interest rates, and at maturity they will surely be paid off.

Perhaps few students of the subject, and certainly no practical bankers, would make the assumption in the unqualified form presented above. If market quotations decline drastically it is much better to have cash instead of bonds so that new commitments may be made at the new lower levels. Under these conditions the bank which is able to take advantage of the changed situation will thereafter be able to earn a larger income on its bonds than will the bank which finds itself fully invested. But this difference is one having to do only with varying degrees of prosperity in the future. While this is, of course, a matter in which every good banker is vitally interested it contributes nothing to the question of safety with which we are here concerned.

It is sometimes argued that changing market quotations of money bonds held for permanent investment can be ignored *with safety.*[1] Current rulings of the regulating authorities not only support this position but go even farther. These rulings provide that variations in market values of all bonds eligible for new commitments need not be reflected on the books nor in the statements of condition. Bonds in the fourth rating classification are eligible but nobody would argue that they are money bonds. The presumption seems fully warranted, however, that modern American bankers are too sophisticated to fail to realize the limitations of such rulings. Certainly nobody would argue that a bank should write up the book value of its bonds merely because of market appreciation. It would be equally preposterous to insist on writing them down with every market decline. Yet a major advance in interest rates eventually would force down market quotations of the typical bond portfolio of long-term money bonds to an extent which could not fail to be a matter of real concern. As of December 31, 1942, combined bond accounts of all country member banks averaged something over 5¼ times the total volume of capital funds. A decline of only 12½ per cent, therefore, is equivalent to five-eighths of the capital funds. In the spring of 1932 United States Treasury 3s were selling at 88. And older bankers at least will recall that some government issues declined as much as 17 per cent in 1920. Even though he may continue to retain the old values on his books the difference between such values and going market prices must be compared with the capital accounts available to cushion such declines. If realistic solvency is to be preserved, therefore, it is of the utmost importance that total volume be so limited that severe depreciation cannot threaten the ability of the institution to continue as a going concern.

One final word with respect to this aspect of the problem. Figures derived from market quotations can represent only a nominal value for any permanent bond portfolio. The problem becomes acute only in times of declining prices and at such

[1] N. L. Silverstein, "Some Considerations in the Management of Commercial Bank Investments," *Journal of Business,* April, 1940, p. 136.

times it is obvious that no large volume actually could be liquidated at prevailing quotations. Nevertheless, these prices do supply a maximum current value to the portfolio as a whole. Because we are able to derive by this means only a maximum current value, the limit referred to above must be arrived at by most conservative assumptions about the extent of possible advances in interest rates and also the length of time in which such advances might become effective. Both of these phases of the subject are discussed in later sections of this chapter.

Make-Up of the Capital Account.—In coming to grips with our problem numerous angles of the matter have to be considered. Since all other pertinent factors must be appraised in light of their relation to the make-up of the capital account, it appears logical first to focus our attention on the cushion provided by capital funds.

In the literature of the subject one important distinction is frequently overlooked. The capital funds in their entirety provide a margin of safety for depositors. If the assets actually held by the bank are worth neither more nor less than their book value, the sum of the capital accounts represents the investment of the stockholders and this investment must be entirely wiped out before depositors are subject to loss. Perhaps no remark could seem more trite or more platitudinous than to observe that no bank is carrying out its function adequately unless its depositors' funds are safe. Yet that statement is significant because successful banking must insure not only the safety and availability of its depositors' funds but its own solvency as well. Naturally, if a bank must fail, its management would prefer that the general public lose nothing. To be able to look one's former customers in the eyes should be worth something. But it is poor consolation for the officers and directors whose investment has been wiped out and whose business reputation has suffered, especially in the home community where their neighbors and friends live.

Application of these considerations to the problem in hand lies in the fact that only so long as a bank's capital stock account remains unimpaired can it be considered a sound and

solvent institution which will be permitted to continue as a going concern. This being the case, the cushion protecting solvency is not the sum of the various capital accounts nor the sum of these capital accounts less fixed investment, but the sum of the accounts other than the capital stock account itself. To be able to meet demands of depositors is a test of liquidity. We have already seen that while liquidity and solvency are closely related they are by no means identical. A bank unable to meet the demands of its depositors must close its doors even though solvent. Liquidity is a function of the assets and in measuring total liquidity the investment in fixed assets must be excluded. For most business concerns solvency merely requires that the value of all assets, including fixed assets, shall be at least as large as the sum of all outstanding liabilities. For a bank to continue as a going enterprise the value of the assets must be as large as the sum of all outstanding liabilities *plus the par value of the capital stock.* Liquidity for our hypothetical bank is assured by means of adequate asset reserves. But its solvency must not be endangered by excessive exposure to risk in any direction.

If the contentions advanced above are sound, the solvency cushion for the hypothetical bank is the sum of the surplus, undivided profits, and contingency reserve, or $1,115,000. Assets owned might depreciate up to that amount and the bank would still be solvent and its capital would remain unimpaired. It should be noted that this is a much more severe test than the one commonly made without reference to the distinction between solvency and liquidity. The usual test is to take the sum of *all* capital accounts, including capital stock, and to deduct therefrom the investment in fixed assets. In all well-managed and soundly financed banks the investment in fixed assets is never as large as the capital stock account. For all insured commercial banks as of December 31, 1942, the total of fixed and miscellaneous assets was $1,614,600,000, while capital stock amounted to $2,848,600,000. For our hypothetical bank the capital stock figure is $926,000 and the sum of fixed and miscellaneous assets is only $500,000. If we deduct from the gross capital funds of $2,041,000 the $500,000 for fixed and

miscellaneous assets the resulting figure is $1,541,000, as compared with the above more conservative cushion of $1,115,000.

In order to determine the maximum safe size of our permanent bond portfolio we must relate to the above solvency factor all other assets subject to depreciation, and to assign to each asset its proper share in the cushion. Whatever remains may be considered a cushion for bonds.

Assets at Risk Other Than Bonds.—It is common practice to assume that loans and bonds constitute the only assets at risk. Because we are attempting to formulate sound policies for an operating bank that is determined to remain a going and solvent institution, we include the $500,000 representing fixed and miscellaneous assets. So far as continued solvency is concerned a decrease in the value of one asset has the same effect as a decrease in the value of any other asset. We are forced to the conclusion, therefore, that of total resources amounting to $24,557,000 the only assets not at risk are the primary and secondary reserves, the combined total of which is $7,671,000, leaving total assets at risk of $16,886,000. The assets at risk other than bonds comprise real estate loans, other loans and discounts, and fixed and miscellaneous assets, the combined book value of which on the statement of our hypothetical bank is $5,585,000, or approximately one-third of all assets at risk. If the risk of depreciation of these assets is approximately the same as the risk involved in bonds, then one-third of the available cushion of $1,115,000, or $372,000, must be assigned to these assets. The remaining $743,000 would then be available as a cushion for the investment reserve and permanent bond portfolio.

In order to decide this question of relative risks each bank should examine its own record of gross charge-offs on both loans and on bonds. For our purpose we assume the record to be identical with that of all national banks for the ten-year period 1930 to 1939, inclusive. For all national banks the average annual gross charge-offs on loans amounted to 1.62 per cent of the book value of loans, while for bonds the corresponding figure is 1.42 per cent. After 1936, however, recoveries on

loans constituted a somewhat larger percentage of charge-offs than they did for bonds. It does not seem unreasonable, therefore, to assume that there is not much overall difference between the risk on loans as a whole and bonds as a whole. On the basis of this reasoning the $743,000 arrived at above will be considered the available cushion for depreciation of bonds.

Capital Cushion for the Investment Reserve.—The available capital cushion for bonds the size of which has just been derived must cover not only the permanent bond portfolio but also the bonds in the investment reserve. There is no credit risk in the investment reserve but market valuations of these items advance and decline in accordance with changing interest rates. Of course the magnitude of such fluctuations is strictly limited by shortness of maturities. In 1943 items qualifying for the investment reserve could not be purchased with an average yield in excess of three-fourths of 1 per cent. Reference to Table IV shows our hypothetical bank with an investment reserve of $4,644,000. Should interest rates advance so that such securities could be purchased on a 2 per cent basis, bond tables reveal the fact that the indicated depreciation would be 4.21 per cent, or approximately $200,000. It is for this reason that even highest grade items of these intermediate maturities do not belong in the secondary reserve. Only in the event that demands of depositors become so heavy that liquidation of this reserve on a 2 per cent basis is necessary would such depreciation have to be actually realized by the hypothetical bank. Even though no liquidation of the investment reserve should become necessary, however, this potential depreciation cannot be considered inconsequential, for when this $200,000 is deducted from the total cushion available for bond protection there remains only $543,000 as a cushion for the permanent bond portfolio.

Standard of Quality for the Permanent Bond Portfolio.—For determination of a maximum size of the permanent bond portfolio the derivation of the amount of capital cushion available is not the only essential. Another factor is the standard of quality decided upon. Regulations do not permit new commit-

ments falling below the first four rating classifications. But this leaves far more latitude for individual decision than more conservative bankers require. For the week ending May 22, 1943, for instance, the average of yields on all outstanding partially tax-exempt U. S. government issues due or callable after twelve years was 1.90 per cent. On the same date the average yield on high-grade municipals was 2.12 per cent and on high-grade corporate obligations 2.65 per cent.[2]

It is obvious that a permanent bond portfolio comprising only governments can safely be larger than one made up exclusively of Baa corporates. Between these two extremes all sorts of variations actually exist. Because of circumstances in a single institution it might be justifiable to insist that commitments should be confined to government bonds. But for banks in general it would be foolish to argue that any one standard of quality—even the highest—is the only proper one. Problems of quality are discussed in the next chapter, but for the sole purpose of illustrating the process of determining a maximum size for the permanent bond portfolio of our hypothetical bank we shall assume commitments limited to high-grade issues not falling below Aa in quality. With a portfolio of this high average quality, losses due to deteriorating credit of issuers would either be non-existent or so small that they would be no excessive burden as charges against current income.

The Maturity Schedule.—The range of maturities for their bond accounts is a problem about which opinions of bankers differ widely. There seems to be quite general agreement that spaced or staggered maturities are desirable. But what about maximum maturities? In the past, periods of low interest rates were always followed by other periods of much higher rates. Because of this fact many bankers have felt it wise to limit their maximum maturities to five or six years. Believing that extremely low interest rates are a relatively permanent phenomenon other bankers are willing to buy issues maturing thirty or more years hence. It is not the present intention to

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2 *Federal Reserve Bulletin*, June, 1943, p. 545.

venture any judgment as to what constitutes a proper maximum. As one more step, however, in the process of determining the maximum size of the permanent bond portfolio for our hypothetical bank we shall assume, again purely for illustrative purposes, a maximum maturity of fifteen years, spaced as evenly as possible through the nine-year period from fifteen years downward. The indicated range would thus be from six years up to fifteen years and the average maturity would be ten and one-half years. Since some shorter-term maturities might be included because of their failure to qualify for the investment reserve when within six years of maturity, it seems reasonable to assume an average maturity of ten years.

Further Factors Affecting Size of Permanent Bond Portfolio.—For illustrative purposes we have now decided upon the quality and the maturity schedule for our permanent bond portfolio. We know that a capital cushion against market depreciation of $543,000 is available. We are thus brought back to the question with which we started: Can we safely invest in permanent bond portfolio items the entire $6,657,000 remaining unallocated?

As a basis for answering this question, policy decisions must be made with respect to two additional underlying determinants. The first is the extent of adverse changes in interest rates that the individual banker feels he should be ready for. In a world at war some hardening of interest rates is almost universally expected. But whether this is expected or not no policy could be considered conservative which is based on the assumption that rates of interest so clearly subnormal will continue indefinitely. In the summer of 1943 a permanent bond portfolio of the quality decided upon for the hypothetical bank, and with an average maturity of ten years, might be expected to yield about 2¼ per cent on the bases of going market prices. Yields on governments and best grade municipals would be slightly below 2¼ per cent but corporate yields would be somewhat higher. Some bankers might consider it adequate to be protected against an advance to 3 per cent. Others might insist on protection up to 3¼ per cent, or 3¼ per cent or 4 per cent.

The decision made in this respect will have an important bearing on the maximum size of the portfolio.

The second determinant has to do with the period of time within which interest rates are assumed to advance. The shorter the period the greater the depreciation, as shown in Table V. The rates of depreciation shown in this table are based on bonds of ten-year maturity carrying 2 per cent coupons, which give results accurate enough for our purpose. High-grade bonds began to decline early in 1928 and continued downward to early 1933. During that five-year period the decline was only 12.5 per cent. At the beginning of that decline, however, bond prices were by no means high in terms of yields. Today the banker has to guard against declines from the highest price levels (lowest yields) of modern times. He must make his decisions also in the midst of a world-wide war, with the nation engaged in a life-and-death struggle against powerful and aggressive enemies. Under such conditions declines may be much greater and they may come far more swiftly.

TABLE V. RATES OF DEPRECIATION ON 10-YEAR 2% BONDS SHOULD INTEREST RATES ADVANCE FROM 2% TO VARIOUS OTHER RATES

	In 5 Years	In 4 Years	In 3 Years	In 2 Years
To 3%	4.61%	5.45%	6.27%	7.07%
3¼%	5.73	6.76	7.73	8.74
3½%	6.83	8.05	9.24	10.39
3¾%	7.91	9.32	10.69	12.00
4%	8.98	10.58	12.11	13.58

The various rates of depreciation indicated in Table V are applied, in Table VI, to the $6,657,000 available for the permanent bond portfolio of our hypothetical bank and the resulting depreciation in dollars is compared with the capital cushion of $543,000 available.

An inspection of Table VI reveals the fact that ten of the twenty figures exceed the capital cushion available. Bankers who are satisfied with protection against an advance in interest

TABLE VI. INDICATED DEPRECIATION ON $6,657,000 INVESTED IN 10-YEAR 2% BONDS IF INTEREST RATES ADVANCE FROM 2% TO VARIOUS OTHER RATES

	In 5 Years	In 4 Years	In 3 Years	In 2 Years	Capital Cushion Available
To 3%.....	$307,000	$362,800	$418,400	$470,600	
3¼%...	381,500	451,000	524,600	581,800	
3½%...	455,600	535,900	613,400	691,600	$543,000
3¾%...	427,300	617,400	711,700	798,800	
4%.....	597,500	704,300	805,600	904,000	

rates from 2 per cent to not exceeding 3 per cent in two years, 3¼ per cent in three years, 3½ per cent in four years, or 3¾ per cent in five years, will feel it safe, on this score, to invest the entire $6,657,000 in permanent bond portfolio items. In view of all the well-known arguments favoring a continuation of interest rates at abnormally low levels there appears to be considerable justification for this policy. Nevertheless, the all-out war conditions under which banking must be conducted cannot fail to increase risks in all directions, so that even a greater degree of conservatism has much to commend it. Once again, however, it is unnecessary here to render a definitive judgment about an issue with so many ramifications and about which opinions differ so radically. But merely for the purpose of completing our illustration it will be assumed that the management of the hypothetical bank insists on protection against an advance in interest rates to 3½ per cent in two years. In order to do this it is necessary to limit the size of the permanent bond portfolio to approximately $6,000,000. The remaining $657,000 of unallocated funds must be turned back to the riskless primary reserve or almost riskless secondary reserve. At least so long as Treasury bills are readily available it is a simple matter to keep the secondary reserve as large as is desirable. It will be assumed, therefore, that this $657,000 is added to the figure of $2,100,000 already derived for the secondary reserve, giving a total figure for that item of $2,757,000. Table VII shows the statement of condition as finally adjusted.

TABLE VII. HYPOTHETICAL BANK

CONDENSED STATEMENT OF CONDITION (Final Adjustment)

Resources

Primary Reserve		$ 5,571,000	
Secondary Reserve		2,757,000	
Investment Reserve		4,644,000	
Permanent Bond Portfolio		6,000,000	
Real Estate Loans		2,500,000	
Other Loans and Discounts		2,536,000	
Fixed Assets		500,000	
Miscellaneous Assets		49,000	
Total Reserves			$24,557,000

Liabilities and Capital

Demand Deposits			
Balances of Other Banks	$ 1,231,000		
Public Deposits	2,650,000		
Other Demand Deposits	11,989,000		
Total Demand Deposits		$15,870,000	
Time Deposits			
Savings Deposits	$ 6,397,000		
Other Time Deposits	193,000		
Total Time Deposits		6,590,000	
Total Deposits			$22,460,000
Miscellaneous Liabilities			56,000
Total Liabilities			$22,516,000
Capital Account			
Capital Stock			$ 926,000
Surplus			703,000
Undivided Profits			291,000
Contingency Reserve			121,000
Total Capital			2,041,000
Total Liabilities and Capital			$24,557,000

Summary of the Process.—It may be worth while at this point to review the various steps by means of which the finally adjusted statement of condition was developed.

Attention was directed in the first place to items comprising the primary reserves. Currency and coin and cash items in process of collection were unaltered. No bank is likely to keep an excessive volume of currency and coin, while over the volume of cash items in process of collection the individual bank has little or no control. Free balances with other banks, being considered excessive in the light of predepression levels, were reduced by $1,450,000. Reserves carried with the Reserve bank

were found to be in excess of legal requirements to the extent of $617,000. On the theory that during war times banks should be fully invested this excess reserve was completely eliminated. To the sum of these two items was added the amount shown in the original securities section, $11,334,000, making a grand total of $13,401,000 to be allocated later.

The second step was to make certain assumptions as to past performances of deposit totals and as to character of deposits currently. On the basis of these assumptions it was possible to fix the minimum size of the secondary reserve at $2,100,000, all of which was provided by eliminations from the entirely unproductive primary reserve in the original statement.

The third step was to set up an investment reserve, comprising short- and medium-term securities meeting the strictest requirements as to quality and marketability, sufficiently large to protect the bank against an assumed future condition as bad as the 1929-1933 period. To the extent that securities already held qualified for this reserve the process was merely one of proper allocation. Any deficiency below the derived minimum figure of $4,644,000 would have to be made up by shifting out of other bonds and the purchase of additional securities which meet all the requirements for this reserve.

The final step, just concluded in this chapter, was to determine the maximum safe size of the permanent bond portfolio, and to reallocate to the secondary reserves any remaining funds.

A better perspective of the effect of these changes can be secured by inspection of Table VIII. In this table there are presented in comparative form both the original statement of condition and the statement as finally adjusted. It will be noted that the changes are limited to the decrease in primary reserves, the inclusion of the secondary reserve, and the substitution of the investment reserve and permanent bond portfolio for the original securities section. Earning assets in the adjusted statement total $18,437,000 as compared with $16,370,000 in the original statement. This is an increase of $2,067,000, the exact amount which was eliminated from the primary reserves in the original statement. It is true that almost all of this increase in earning assets has gone into the low-earning secondary

TABLE VIII. HYPOTHETICAL BANK

COMPARISON OF ORIGINAL STATEMENT OF CONDITION WITH STATEMENT AS FINALLY ADJUSTED

Resources

	Original Statement	Adjusted Statement
Primary Reserves		
Currency and Coin	$ 542,000	$ 542,000
Cash Collection Items	554,000	554,000
Balances with Other Banks	3,700,000	2,250,000
Reserve with Reserve Bank	2,842,000	2,225,000
Total Primary Reserves	$ 7,638,000	$ 5,571,000
Secondary Reserve		2,757,000
Securities		
U. S. Governments, Direct and Guaranteed...	$ 9,175,000	
Municipals	1,252,000	
Other Bonds	907,000	
Total Securities	$11,334,000	
Investment Reserve		
Governments and AAAA Securities, readily marketable, maturities from 1 to 6 years, average maturity 3½ years		4,644,000
Permanent Bond Portfolio		
Governments and other securities not below AA quality, average maturity 10 years, maximum maturity 15 years		6,000,000
Real Estate Loans	2,500,000	2,500,000
Other Loans and Discounts	2,536,000	2,536,000
Fixed Assets	500,000	500,000
Miscellaneous Assets	49,000	49,000
Total Resources	$24,557,000	$24,557,000

Liabilities and Capital

Demand Deposits				
Balances of Other Banks	$ 1,231,000			
Public Deposits	2,650,000			
Other Demand Deposits	11,989,000			
Total Demand Deposits		$15,870,000		
Time Deposits				
Savings Deposits	$ 6,397,000			
Other Time Deposits	193,000			
Total Time Deposits		6,590,000		
Total Deposits			$22,460,000	
Miscellaneous Liabilities			56,000	
Total Liabilities				$22,516,000
Capital Account				
Capital Stock			$ 926,000	
Surplus			703,000	
Undivided Profits			291,000	
Contingency Reserve			121,000	
Total Capital				2,041,000
Total Liabilities and Capital				$24,557,000

reserve. Yet if the average rate of return on the secondary reserve of $2,757,000 is only three-fourths of 1 per cent it would produce $20,800 annually, or 2.16 per cent on the capital stock.

The actual solution reached for the hypothetical bank is dependent, of course, upon the assumptions which have been made. In any actual bank, for instance, the 1929-1933 loss of deposits may have been larger or smaller than the figures derived from the forty-four continuing banks examined. This means that adequate secondary and investment reserves would need to be either larger or smaller than the figures derived in Chapter 4. Likewise, in any actual bank the investment policy followed for the permanent bond portfolio may result in average maturities either shorter or longer than the ten-year average assumed for the hypothetical bank. If shorter, the maximum size of the bond account can be larger; if longer, its maximum size must be still further reduced. The answer will be different also if the individual banker feels it more reasonable to make different assumptions with respect to the possibilities of advancing interest rates. In view of the fact that market quotations indicate only the maximum amount realizable the assumptions made appear reasonable to the writer. Other assumptions, however, may be equally valid. The aim has been merely to set forth in considerable detail a procedure by means of which, if put into operation by the individual banker, it is possible for him to know at all times where he stands with respect to protection against vagaries of depositors and the possibilities of advancing interest rates. So far as the hypothetical bank is concerned its managers know they are prepared at all times to meet demands of depositors as great as those experienced between 1929 and 1933 without in any way curtailing their normal lending practices. They know exactly the extent to which interest rates may advance so that the concurrent decline in bond prices will not be sufficient to impair the capital stock account. In view of the general chaos prevailing in the world such preparedness does not appear to be excessive.

Earning Power of the Hypothetical Bank.—No plan for the conversion of funds can be considered appropriate if it fails to provide income of at least moderate proportions. An adequate income stream is essential if a banking institution is to remain a strong, going concern. What about the income possibilities for our hypothetical bank? Is the conversion schedule so conservative that reasonably satisfactory net income is precluded?

Several factors must be considered in attempting to answer these questions. In the first place attention is directed to the fact that no changes of any kind were suggested concerning either commercial loans or loans secured by real estate. Whatever income the hypothetical bank had been securing from these sources, therefore, is unaltered. Earnings realizable on the secondary reserve must be considered additional income since funds for this reserve came largely from the entirely unproductive primary reserve. Revenues from service charges might also increase were the hypothetical bank to adopt the complete analysis method discussed in Chapter 11. It seems evident, therefore, that so far as these combined sources of income are concerned no downward alteration is indicated by the suggested conversion process, and there might even be a change for the better.

When we turn our attention to the other earning assets, however, the picture is different. The securities account in the original statement of condition of the hypothetical bank had a book value of $11,334,000, of which amount $9,175,000 was in governments. This entire section was supplanted in the course of our various adjustments by the investment reserve and the permanent bond portfolio with a combined value of $10,644,000. High standards as to maturities and quality were set up to determine eligibility for both of these accounts. Whatever decrease in earning power might follow the adoption of these high standards is traceable directly to standards followed by the hypothetical bank for its securities portfolio lower than those suggested herein.

The large concentration in governments shown in the original statement supplies some evidence that the hypothetical bank

had been following conservative policies in the past. The total of $9,175,000 probably does not differ materially from the volume of governments one might expect in the combined investment reserve and permanent bond portfolio. We know nothing, of course, about the maturity schedule of its government bonds. If it provided for a fairly even distribution of maturities up to fifteen years the income to be derived therefrom could not differ materially from that to be expected from the government bond sections of the investment reserve and permanent bond portfolio. Even with maturities considerably longer it would be difficult to get an average rate of return more than 0.5 per cent in excess of that available in the proposed schedule. If the difference in return is assumed to be as much as this the indicated decrease in earnings from this source would be $46,000.

The hypothetical bank had $617,000 more invested in other securities than was considered available for that purpose in the adjusted statement. The Other Securities section shows $1,252,000 in state and municipal issues and $907,000 in corporates. If we assume for the investment reserve and bond account proper an equal investment in corporates there remains $635,000 available for state and municipals as compared with $1,252,000 shown for the hypothetical bank, a difference of $617,000. Whatever income the hypothetical bank was earning on this $617,000 would be missing from the income figures in the adjusted statement. A liberal estimate would be 2½ per cent, or approximately $15,500. Combining this figure with the estimated decrease of $46,000 on governments we derive, as a maximum, estimated decrease in earnings from securities of $61,500.

In the above analysis no account has been taken of earnings from the secondary reserve, estimated earlier at $20,800. Of total funds for this reserve $2,100,000 came from the non-earning primary reserve and $657,000 from the securities section in the original statement. Deducting this $20,800 from the above $61,500 leaves a net estimated decline in earnings of $40,700. This is approximately 2 per cent on capital funds and 4 per cent on capital stock.

In 1942 all member banks in the Seventh Federal Reserve District[3] earned 7.4 per cent on total capital accounts. If the hypothetical bank had been average in this respect adoption of the more conservative program outlined herein would mean reduction on its rate of profit on capital funds to 5.4 per cent. Cash dividends declared by all member banks in the Seventh Federal Reserve District in 1942 amounted to 2.4 per cent on all capital funds. Thus, the hypothetical bank could pay dividends of this magnitude and still retain over 60 per cent of its earnings as an addition to capital accounts.

In return for this cut in income the bank's soundness is improved in more than one direction. Shortening maturities in its government bond account operates to reduce its vulnerability to adverse market price fluctuations. Elimination of the weakest portion of its municipal account diminishes risks of adverse changes in credit standing of municipal borrowers represented. And this should mean in the future that necessary charge-offs on securities would be substantially lower than in the past.

The answer to our original question thus is plain. Adoption of the conservative investment program recommended would lead to some loss of earning power but would not force income below a level which permits continuation of current dividend rates and would still leave substantial amounts available for annual additions to capital accounts.

B. Under War Conditions

In the preceding section the problem was to determine a reasonable maximum size of the permanent bond portfolio under normal peacetime conditions. Under war conditions there can be no such maximum standard limit to total bond holdings. In the midst of a great war the chief objective of every individual and every institution is to render all possible aid in the prosecution of the war to a successful conclusion. Victory on the actual battle fronts depends in no minor degree upon the sound financing of the whole war effort. Since funds for the huge expenditures involved cannot be raised solely by taxation,

[3] Earnings figures for banks in Seventh Federal Reserve District from April, 1943, issue of *Business Conditions*, Chicago Federal Reserve Bank.

borrowing must be resorted to on a gigantic scale. It is desirable that to as great an extent as possible borrowing shall be from noncommercial bank sources. When individuals buy war bonds out of current income they merely transfer to the government the right to use these funds which otherwise they might spend for the comforts that go to make up our normal high standard of living. In other words purchasing power is transferred from individuals to the government and such funds are directed to the production and utilization of war material. Our productive energies are thus partially diverted from the manufacture and distribution of civilian goods to the manufacture of planes, ships, tanks, guns, etc. Assume for instance a total national income of 150 billions of dollars and total necessary war expenditures of 100 billions annually. If this 100 billion could be raised by means of taxes and sales of war bonds to noncommercial bank buyers out of current income there would be little need for price controls in order to hold prices down. Production of consumers' goods would be down to 50 billions—a figure still far above 1932 levels—and there would be 50 billions of current income with which to purchase these goods and services. The more closely this ideal situation can be approximated the more soundly the costs of war can be financed.

It is obvious, however, that the nation must fall far short of attaining any such ideal balance. There must be resort to other less desirable measures. Accumulated savings which otherwise might be idle may be drawn upon. Or accumulated savings which are not idle but which are being used currently for non-war purposes may be sought out. Even with the most energetic attempts to attract such capital the commercial banks must be called upon to absorb many billions of war bonds. While this situation is deplorable it need be only a relatively minor disadvantage as compared with the calamitous alternative of losing the war.

When commercial banks buy huge volumes of government obligations the impetus toward inflation arises out of the fact that total adjusted demand deposits plus currency in circulation increase correspondingly. For every additional billion of these

bonds purchased by commercial banks the account of the government is credited with 1 billion dollars. This is plain when the volume purchased by individual banks is no larger than their maximum war loan accounts, for the process here is to all intents and purposes similar to the granting of a loan to a customer who wishes the proceeds placed to the credit of his account. As the government draws against such increased balances these checks are deposited by recipients in their respective banks or presented for payment in cash. Since increased deposits and increased currency in circulation both constitute purchasing power we see there is now in the hands of the public 1 billion dollars more purchasing power than there was before these bonds were sold to the commercial banks. That is, there is 1 billion dollars more potential demand for consumer goods. With every additional billion thus purchased the pressure against price ceilings increases. It is as if a kettle of boiling water were placed over a flaming gas jet. With one hand the good housewife attempts to hold down the lid while with the other she keeps turning the gas jet still higher. Patently there is danger of an explosion. In order to prevent an explosion in our national economy it had become necessary early in 1943 to authorize many increases in price ceilings. Increases in cost of living incited labor to demand still higher wages which, in turn, would necessitate still higher prices. Thus the spiral of inflation which had been feared for many years appeared imminent.

It remains to be pointed out that the fundamentals of the situation described above are in no wise altered when the purchases of government bonds are made by banks with no war loan accounts or whose war loan accounts are much smaller than the amount of bonds purchased by them. Such banks pay for the bonds for which they subscribe by drawing upon any excess reserves they may have with the Reserve banks or by drafts on balances held by them with correspondent banks. Since interbank balances are eliminated in determining adjusted demand deposits, it is clear that deposits in the hands of the public increase through the purchase of additional government bonds exactly as they would if every bank maintained war

loan accounts equal to the amounts being currently subscribed for.

That a thorough knowledge of these elementary considerations is a part of the routine equipment of all good bankers is indicated by their energetic and enthusiastic efforts in the promotion of the sale of war bonds to their customers. Good bankers also realize that however unfortunate the process described may be from a national standpoint, they must, nevertheless, stand ready to absorb whatever residue of war bonds cannot be placed elsewhere. Bankers are also well aware of the fact that however important it may be to determine standards for setting the maximum conservative size of bond portfolios in peacetime, standards as to size cannot possibly be applicable to wartime conditions.

All available evidence points clearly to the fact that bankers as a whole are eager to co-operate fully in the war financing program even to the extent of holding securities far in excess of what is considered appropriate for peacetime conditions. Yet one vital element necessary to a successful prosecution of the war is the continued soundness of our commercial banks. It is the basic patriotic duty of each banker to see to it that his own bank shall remain thoroughly sound. Acumen and sagacity of a high order are more essential than ever as we travel an uncharted course through all-out war.

From the practical standpoint the problem of full co-operation in the war financing program for each individual bank may be narrowed down to two questions:

1. How can the individual banker determine the total volume of government bonds he should hold if his bank is to carry its full proportionate share of the total burden?
2. What can he do to increase the capacity of his bank to carry an excessive volume of governments?

In connection with the first problem it may be helpful to glance at certain overall figures. At the very beginning of the defense program, in June, 1940, all member banks held direct and guaranteed governments amounting to 14.7 billions. Their holdings increased during the next twelve months to 18.1 bil-

lions. By June 30, 1943, their holdings had still further increased to 47 billions. As the total of all capital accounts of all member banks approximates 6½ billions it is seen that at the 1943 mid-year member banks were holding governments equal to over 7½ times their entire capital funds. If this rate of increase continues by the end of 1943 their total holdings will approximate 55 billions, or almost nine times their total capital funds. Further additions presumably at least as large will have to be made each year that the war continues.

Against such figures the individual banker should compare his own institution's holdings. If this volume was less than 7½ times the bank's total capital on June 30, 1943, or nine times by the end of 1943, it becomes the patriotic duty of the banker to determine whether there are peculiar circumstances surrounding his institution which make it clearly impossible for it to carry its pro-rata share of the total burden. Among the valid reasons which the individual banker may cite might be mentioned the following:

(a) *No substantial increase in deposits since June, 1940.* Between June 29, 1940, and June 30, 1943, demand deposits of all member banks increased from 39.6 billions to 70.2 billions, or over 80 per cent. Since this overall increase has its source in the tremendously expanded holdings of governments by commercial banks it is the increase in deposits in the individual bank from which funds should be obtained with which to buy additional governments. As increases in deposits do not necessarily go to banks in proportion to their own purchases of these issues, it seems clear that not all banks are equally able to absorb additional bonds. In other words, an individual bank might be thought of as doing its full duty in this respect if it added to its holdings of governments in proportion to its own increase in demand deposits. That is, whatever increases in demand deposits are experienced by an individual bank from year to year, less the increase in necessary reserves occasioned thereby, should be considered as available for absorption of additional government obligations.

(b) *Savings deposits large in relation to demand deposits.* In the overall figures for member banks, demand deposits are

over five times as large as savings deposits. Yet on June 30, 1943, for all operating insured banks not members of the Federal Reserve System demand deposits were only 3 times as large as savings deposits. And there are many individual banks whose savings deposits are as large as or larger than their demand deposits. Since it is the custom to tie up a large percentage of savings deposits in real estate loans, it is clear that the higher the percentage of savings deposits the less able is an individual bank to carry a pro-rata share of governments. Even here, however, its holdings of governments might properly be expected to increase in proportion to whatever increase in demand deposits it may experience.

While many other valid reasons undoubtedly exist for under-par government holdings, they are usually bound up with peculiar circumstances in individual situations. No two banks are exactly alike and without all the evidence it would be manifestly unjust to accuse any particular banker of being derelict in his duty to support fully the war finance program.

The fact that many valid reasons exist for failure to carry a pro-rata share of governments should not be permitted to obscure the fact that certain invalid excuses are frequently given. In this connection attention is first directed to the problem of "other securities." And this leads to one answer to our second question, namely: What can a bank do to increase its ability to hold governments?

On June 30, 1943, all member banks held nongovernment securities with a book value of 5.3 billions as compared with their government holdings of 47.0 billions. These other securities are carried in preference to governments solely because of their higher net yield. And many bankers, especially those operating smaller institutions, insist that such higher incomes are required for their continued success. Nobody can properly deny that substantial earning power which will permit increases in capital funds is a necessary element in continuing soundness, but ability to pay large dividends is not an essential to soundness. It is suggested, from a patriotic standpoint, that banks with sub-par holdings of governments and substantial

holdings of other securities might well consider letting some portion of these other securities run off, invest the proceeds in governments, and make whatever cut in dividend rates this policy would necessitate.

This discussion of other securities would not be complete without some attention given to holdings of sub-quality obligations. Unwise investment policies of the past have left their imprint in current bond portfolios of a large number of banks. These banks are continuing to hold, in most cases merely for better prices, many bonds which are not currently eligible for new commitments. No figures are available showing the absolute volume of such holdings, but anyone at all familiar with bank investment policies of the past knows that the total can be represented only by a figure of considerable size. Such issues frequently have very high yields on current market prices so that sound procedure in this matter will have additional adverse effects on current income because it calls for the elimination of all these issues without undue delay. Since they cannot be purchased by other commercial banks their sale will mop up purchasing power which otherwise presumably would be used for purposes other than assisting the war financing program. For every million dollars of such bonds which is eliminated from banks' portfolios a million dollars of new governments can be added without increasing the total volume of purchasing power. And it is obvious that the position of individual banks participating in this clean-up will be correspondingly strengthened in every way except that of current income.

Ability to absorb larger quantities of governments may be increased in many individual banks not only through the elimination of certain "other securities," but in two entirely different ways. The first may be of minor importance but it still seems worthy of mention. Reference is to balances carried with correspondent banks. It is entirely praiseworthy for smaller institutions to try to compensate their city correspondents for services rendered by carrying with them substantial balances. It was pointed out in an earlier connection, however, that since the banking holiday banks on the average have been carrying

larger balances with other banks than was customary prior to the depression. This practice is all the more noteworthy since no interest can now be paid on such balances and the need to borrow from correspondents has practically disappeared. Such statistical evidence as is available supports the conclusion that in a great many instances such balances can be materially reduced without eliminating their proportionate character. To the extent that a particular bank can cut down such balances funds are available for the absorption of Treasury bills, notes, and certificates.

It may be argued that adoption on a wide scale of this recommendation would cut down the ability of city banks to carry governments by an amount equal to the increased purchases of the depositor institutions. This contention, however, fails to take into consideration the fact that the city bank must carry reserves of not less than 20 per cent against these balances of other banks. That is, for every $100,000 a country bank withdraws from a city correspondent it can absorb an additional $100,000 of short-term governments while the city bank's ability to carry governments is reduced by only $80,000.

Finding means of payment, however, is not the only factor conditioning the ability to absorb more governments. All government obligations available to banks are readily marketable and are, therefore, subject to the risks of fluctuations in market prices. It will be recalled that this problem was faced when we were trying to determine the maximum volume of securities for the permanent bond portfolio under peaceful conditions. Under war conditions if banks are required to carry securities equal to from nine to twenty times their total capital funds it is obvious that they must concentrate on short- and intermediate-term issues in order to limit the range of possible price fluctuations. After considerable prodding the Treasury finally adopted in 1942 a policy of directing to the commercial banks only those issues maturing within a ten-year period. In that year it increased materially the outstanding volumes of bills and notes and made available a tremendous quantity of certificates of indebtedness. On August 31, 1943, the total of

almost 148 billions of outstanding obligations included these short-term instruments in the following amounts: [4]

Treasury notes	11.9 billions
Certificates of indebtedness	17.5
Treasury bills	12.8
Total	42.2 billions

Of these types of issues both bills and certificates are eligible for the secondary reserve, and the notes meet every requirement for the investment reserve. So far as the capital accounts are concerned a bank can carry practically unlimited quantities of such instruments. Even with the very low yields available large volumes of these obligations should contribute in at least a minor degree to the earning power. But entirely aside from the earnings angle it is important to recognize that absorption of these issues contributes just as much to the whole financing program as does the carrying of longer-term instruments.

Summarizing this discussion, we find that it is impossible to determine any standard maximum limit to government bond holdings under conditions of all-out war. It is the duty of each banker to carry his share of the total burden. Banks that have not participated in the general increase in demand deposits since the inauguration of the defense program may be correspondingly limited in their ability to absorb their pro-rata share. This may be true also of banks whose time deposits are large in relation to demand deposits. But each bank should adopt any available policy which will increase its ability to "do its bit." Certainly large percentages of "other securities" and excessive balances with correspondent banks should not be permitted to impair its capacity for carrying governments. However, the wartime necessity for carrying such large volumes must be counterbalanced by emphasis on shorter maturities. If in the face of total securities far beyond what has been considered conservative in the past our commercial banks can maintain their invulnerability to changing conditions the Treasury should be able to carry its financial problems through to a successful conclusion.

[4] Bulletin of the Treasury Department, October, 1943.

CHAPTER 6

MANAGEMENT OF THE PERMANENT BOND PORTFOLIO

UNDER NORMAL CONDITIONS

Some Considerations in the Formulation of General Policies.—There never was any justification for a haphazard approach to a bank's investment problems. If this was true even before bonds became such an important element in the bank's earning assets, today it is all the more imperative that the bond account be managed in the light of well-considered, long-range investment policies which are formulated in view of the function this asset is expected to perform.

Responsibility for the determination of general investment policies must rest with the board of directors. These general policies must cover questions of standards of quality, and will indicate the official attitude of the bank with respect to marketability, diversification, and maturities. There may be included also instructions regarding bond trading, amortization of premiums, and the purchase or continued holding of issues selling substantially above call prices.

General policies having been laid down by ultimate authority the problem of actually managing the bond account should be formally delegated to some one officer who is definitely charged with the responsibility of acting within the prescribed limits. We are here concerned only with the problems incidental to the formulation of sound general policies and not with the technique of analysis nor the selection of individual issues which fit into the prescribed program.

Characteristics of the deposit liability in a particular bank as reflected in the fluctuations thereof during the most recent complete business cycle were the fundamental elements taken into consideration in determining the size of the investment

reserve. It will be recalled that this reserve consists exclusively of government obligations and Aaa securities possessing ready marketability and with staggered maturities ranging from one year to six years. The combined total of primary, secondary, and investment reserves must be sufficient to provide even for such major loss of deposits as was experienced by the individual bank between 1929 and 1933. For this reason it is not expected that forced recourse to the bond account proper will ever be necessary in order to meet demands of depositors.

In the construction and management of the permanent bond portfolio, therefore, no further attention need be devoted to the varying characteristics of different classes of deposits. In other words, it is unnecessary, except perhaps for legal reasons, to try to correlate individual bond issues with savings deposits as distinct from demand deposits. In our hypothetical bank, for instance, it was decided that the maximum size of this portfolio could not safely exceed $6,000,000, with fifteen years fixed as the maximum maturity. In determining the upper limit the only risk factor taken into consideration was the possibility of market depreciation occasioned by adverse changes in interest rates. This procedure was justified for the purpose of determining the maximum size of this account. It was not the intention, however, to imply that losses in the investment portfolio might not be experienced because of impaired credit standing of certain obligors represented therein. Since investment is an art and not a science it is to be expected that in spite of the most careful and farsighted management occasional losses will be incurred because of mistakes made in the selection of individual risks. Sound investment procedure will hold such losses to a minimum, and those which are actually incurred—if the banker so desires—can be charged to the bond reserve account described in Chapter 8.

Function of the Permanent Bond Portfolio.—No bond account can be managed successfully in the absence of a clear understanding of the ends to be achieved. Its primary function is to furnish an important contribution to the bank's income stream. Even before the outbreak of war every banker knew

that a much greater reliance had to be placed on this source of income than was the case a quarter of a century ago. The decline in commercial loans previously referred to continued right down to the bottom of the depression in 1932 and 1933, and thereafter the extent of the recovery of this demand was disappointingly small. Nobody knows what the future holds in this respect, but even under war conditions prevailing in 1943, and without regard to patriotic motives, banks are forced to depend to a much greater extent than is desirable on their investment account as a source of essential income.

Quality.—Although income is the objective it does not follow that banks are justified, in the selection of individual risks, in sacrificing safety of principal in an attempt to get large income. While all bonds for the investment account need not meet the highest standards of quality laid down for the items comprising the investment reserve, there can be no excuse for making commitments unless there is convincing evidence of the ability of the obligors to continue to meet all liabilities assumed, for speculative bonds have no proper place in a bank's investment portfolio. It seems clear, however, that commitments outside the Aaa bracket should be avoided by banks with inadequate facilities for thoroughgoing analysis.

Marketability.—In spite of the obvious fact that soundness is the basic quality to be sought, ready marketability is also a highly desirable characteristic of any permanent bond portfolio. It is true that adequate asset reserves should provide the bank with an abundance of liquidity to meet whatever demands upon it may materialize. It is likewise true that bonds should be purchased with the intention of holding them to maturity. But while this might have been the original intention circumstances may arise which indicate the desirability of a switch from one issue to some other. It is not impossible that overall conditions may change in some way that makes it appear advantageous to alter the general characteristics of the account in a rather substantial way. Complete freedom of action cannot be assured with issues lacking a ready market; in the event of unfavorable developments the bank may find itself frozen

into a situation, with a substantial loss to face if it attempts to get out. While a small percentage of non-shiftable items may not be particularly objectionable it seems clear that any well-managed portfolio will comprise chiefly issues having ready marketability.

Even from the standpoint of earnings it is important that the permanent bond account have considerable shiftability. Reference is to the fact that the investment reserve should be replenished from year to year with items from the permanent bond portfolio which have approached to within six years of maturity. And the secondary reserve should be supplemented by such issues when within one year of maturity. Only to the extent that this is possible can these asset reserves provide earnings comparable to other earning assets. But since ready marketability is an essential eligibility requirement for these reserves it is apparent that for the best earnings result a high degree of marketability in the permanent bond portfolio is a fundamental necessity.

Diversification.—Since human judgment is fallible each commitment of the bank's funds to a specific block of bonds subjects the bank to the risk that unforeseen developments may make it impossible for the obligor to carry out his promises. When it becomes evident that this situation has been reached or is in prospect the market price of the issue will have declined so that the bank is no longer able to regain possession of the full amount originally paid. Excessively large commitments in any one issue are, therefore, clearly ill advised. Both federal and state laws recognize this factor by specifying maximum percentages of the bank's capital and surplus which may be invested in the obligations of any one creditor. In managing the permanent bond portfolio, therefore, it is important to spread the risk by including issues of a sufficiently large number of obligors so that an occasional error of judgment will not be large enough to cause real embarrassment.

Even in times of peace the heart of any well-managed bond account presumably will be a backlog of direct and guaran-

teed obligations of the federal government. Since the depth of the depression these issues tend to dominate the average bond account to an extent unknown in earlier times. For income reasons, however, few banks found it expedient to confine their commitments to this premier security.[1] Emphasis here should be placed on the phrase "for income reasons." Since government bonds represent a first lien on assets and incomes of all corporations, it is clear that commitments in corporate issues are never justified in the absence of a substantial yield differential after taxes. If no differential existed there would be no reason for the holding of any corporate issues whatsoever. But differential yields are commonly available, and when no patriotic motive is involved it is natural for banks to seek the greater income return made possible by the purchasing of both municipal and corporate issues. By limiting their commitment in each specific issue they acquire whatever additional protection accrues from the spreading of the risk.

Some consideration needs to be given by the banker to the question of the number of different issues it is desirable for him to hold. In this respect it is easily possible to carry to excess the process of spreading the risk. If the permanent bond portfolio is to contain $1,000,000 in corporate and municipal issues, the distribution of this sum might well be limited to fifty different issues as a maximum, and a still smaller number is highly desirable. The reasons in support of this contention are fairly obvious. The costs of making the necessary investigation are just the same whether the block desired is $5,000 or $100,000. And after purchase carrying costs of a particular issue do not vary with the amount actually held. At the end of 1940 one trust company of intermediate size had a bond portfolio slightly in excess of $34,000,000 with only twenty-four issues represented therein. With the number of

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1 In its published statement of condition for December 31, 1940, the First National Bank of Baltimore shows only one item for Bonds: "U. S. Government Securities $140,000,000.00." Before our active participation in the war possibly other large banks also invested exclusively in government obligations, but examination of a large number of statements failed to reveal other examples among metropolitan banks. They will, of course, become more common the longer the war continues.

different issues so strictly limited and the commitment in each one so substantial there exists less temptation to slight the analytical work so essential if the quality of the bond portfolio as a whole is to be maintained at a high level.

Maturity Diversification.—We have seen that a well-constructed secondary reserve contains a list of self-liquidating items which mature gradually over the succeeding twelve months. The investment reserve picks up at this point and provides a stream of maturities over the next five years. Following that six-year period the permanent bond portfolio should be so constructed that annual maturities will furnish the bank with substantial funds which, in the absence of abnormal developments, will be available for reinvestment. A complete program of this kind thus involves three revolving funds, each designated for a specific purpose, which will insure the bank of at least the average rate of interest over an extended period of time. Some bankers will regard the fifteen-year maximum maturity suggested herein as too long, while no doubt others will consider it too short. But whatever limit is decided upon by the individual banker, it is highly desirable to spread maturities as evenly as possible over the period selected. Obviously it would be unwise to adhere to a policy of this kind so strictly that unsatisfactory issues are purchased merely in order to fill in a given maturity schedule. If no security which meets both all quality requirements and desired maturity is available, it is better to forego that particular maturity. This policy may result in concentrating maturities in certain years, but it is far less serious to concentrate maturities than to select issues which do not measure up in some important essential to the desired standard.

Importance of Analysis.—Banks have failed to keep pace internally with the changed character of their business occasioned by the decreasing importance of loans and the growing necessity of making a living out of bond yields. Many are still set up to make loans, not to buy bonds. In the typical metropolitan bank, for instance, it is common to find a large

group of vice-presidents, junior officers, and credit men all devoting their time and energy to the small volume of loans available. On the other hand, the investment department, which invests most of the bank's money, is ordinarily small by comparison. This is understandable only so long as their investments are confined to United States government and highest-grade municipal issues. Investment of one's personal funds without previous adequate investigation is deplorable, but the investment of funds belonging to others without complete knowledge and careful consideration of all the pertinent factors is a policy which cannot be too strongly condemned. Yet a great many bankers buy corporate and municipal issues without the same careful scrutiny that they feel it is necessary to give applications for loans. No outside factor, such as regulation, security ratings, or advisory services, can serve as a substitute for exhaustive investigation by the banker himself into the intrinsic merits of each bond before it is purchased, as well as a careful follow-up of all factors affecting its status so long as it is in the bank's portfolio.

It must be admitted, of course, that to carry out this indicated procedure requires a great deal of time, and in smaller institutions with definitely limited personnel any officer qualified for such analysis is likely to have his time fully taken up with other duties. In banks where this situation exists the only sound policy is to confine commitments to obligations of the federal government. To rely on security ratings or the advice of investment dealers, correspondent banks, or advisory services, and thus to pass over to outsiders effective control over a considerable portion of the bank's assets seems scarcely consonant with any realistic concept of the sanctity of the banker's stewardship. The various services just referred to may be very valuable if used merely as a check on the banker's own conclusions with respect to the intrinsic and relative merits of individual securities or for opinions concerning his bond portfolio as a whole. But in the final analysis the banker cannot justify the delegation to outsiders of his fundamental responsibility for the conversion of his depositors' funds.

The Bond Salesman.—No bond account can be managed to the best advantage unless the banker is able to resist successfully the forcefulness of the bond salesman. It has been truthfully said that far too many bankers do not buy bonds; they merely have bonds sold to them. In many cases the banker feels somewhat obligated to the salesman because he avails himself of certain services which the house offers. Among these services Rowland H. George lists the following:

1. He can tell you what issues of the type you are seeking are available in the market at prices which make them good values in contrast with other investment opportunities.
2. He can keep your list of holdings up to date.
3. He can advise you of redemptions and other matters pertinent to your interest.
4. In general, he can act as a security correspondent in much the same manner that correspondent banks assist you in your banking problems.[2]

There can be no doubt that services of this character may be very valuable at times to the small bank, and yet care must be exercised to insure against the purchase of securities merely because such a house has them for sale.

The General Problem of New Issues.—So far as small banks are concerned there is much to be said for following a policy of buying no new issues whatsoever. New issues which are obviously of high quality usually may be duplicated in the market by bonds of equal excellence in basic security and on a closely corresponding yield basis. One added advantage inheres in the old issues. They are already in the hands of permanent investors and have a seasoning which no new issue, however good, can possibly provide. It is a simple matter gradually to pick up such bonds in the open market when the total block desired is not in excess of $25,000 or even $50,000. It would be much more difficult, if not impossible, for a large bank to follow this policy successfully when issues are desired in units of several hundreds of thousands of dollars as a minimum.

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2 *Bulletin of the American Institute of Banking,* July 1, 1939, p. 402.

It is particularly important to avoid all new issues when interest rates are high. At such times coupon rates on new flotations are necessarily high, but in all issues brought out at such times a call provision is inserted which will protect the obligor when interest rates again decline substantially. Thus the bank purchasing bonds during the stage of distribution is likely to enjoy the high initial rate for only a limited period. At such times the more astute bankers will buy old, seasoned issues which have low coupon rates because they were brought out during some previous period when interest rates were low. Because of these low coupon rates such bonds can be purchased at substantial discounts when interest rates are high. The purchaser is thus assured until maturity of the prevailing high rate of return on the funds he invests, or else of a substantial profit if the bonds are called at an earlier date. In 1920, for instance, outstanding corporations like the Pennsylvania Railroad Company and the New York Telephone Company found it necessary to raise capital. In order to do so their new issues had to carry coupon rates of 6 per cent or 6½ per cent. When interest rates declined substantially these issues were called and replaced with others bearing low coupon rates. But in 1920 there were available a number of high-grade seasoned issues carrying 3 per cent to 3½ per cent coupon rates and selling far enough below par so that the yield basis corresponded with those being currently offered. Many of these issues were brought out in the low interest period of the 1890's, and continued to sell below par until interest rates again reached those earlier levels in 1936 and 1937. It is evident that the differential advantage to be gained from buying old issues in 1920 in preference to new offerings was substantial. It is, of course, impossible to gain this particular advantage when interest rates are low.

The Bond Account in Tabular Form.—If the bond account is to be managed intelligently and within the limits set by the board of directors, it is necessary for the officer in charge to keep constantly in mind the overall picture in terms of diversification, quality, maturities, book values, and market

prices. The preparation at frequent intervals of tables summarizing the essential facts should prove helpful. Table IX is suggested as a form for showing the diversification according to type of security.

TABLE IX. DIVERSIFICATION SUMMARY

	Par	Per Cent	Book Value	Market Value
U. S. Government Direct and Guaranteed				
Municipals				
Utilities				
Rails				
Industrials				
Others				

It is desirable also to prepare a table showing the distribution according to quality. For this purpose the form shown in Table X is suggested.

TABLE X. DISTRIBUTION ACCORDING TO QUALITY

	U. S. Govt.	Municipals	Utilities	Rails	Industrials	Others	Totals	Per Cent
U. S. Government								
AAA								
AA								
A								
BAA								
Below								

From the standpoint of day-to-day management of the bond account possibly even more important than either of the above forms is one which shows the distribution of the various items according to maturities. For this purpose the form shown in Table XI would be appropriate.

Perhaps an explanation is called for concerning the reason for including 1944-1950 maturities. According to the general program for conversion of funds advocated herein maturities

TABLE XI. CALENDAR DISTRIBUTION AS OF JANUARY 1, 1944

	1944–1950	1951	1952	1953	1954	1955	1956	1957	1958	1959
U. S. Government										
AAA										
AA										
A										
BAA										
Others										
Totals										

for the first six years are supposed to be provided by the secondary and investment reserves. In the permanent bond portfolio, however, there are likely to be individual issues which do not qualify for reserve status, because of deficiency in quality or marketability or both. Such issues, if retained, must continue to be considered an integral part of the bond account proper. It seems scarcely necessary to observe that in the management of the investment reserve a table showing the calendar distribution of the items comprising the reserve is also essential.

The Treatment of Bond Premiums.—The great diversity of methods by which banks handle the problem of bond premiums affords an excellent example of the tardiness with which banks in general adopt sound accounting methods in common use by almost all other kinds of business enterprise. Outside of large metropolitan banks one finds all too infrequently the practice of daily amortization and consequently a record of true earnings day by day. In this method income decreases and amortization increases during the life of the bond. Since the mathematically correct method of amortization is somewhat complicated some banks use the straight-line method. R. L. Armstrong described this method as follows:[8]

In the straight line method both amortization and income remain constant. This makes for simpler bookkeeping and in the end the result is the same. The straight line method uses a daily rate of amortization

[8] *Wall Street Journal*, November 27, 1936.

found by the simple process of dividing the premium by the number of days the bond has to run. Similarly, the monthly rate is found by multiplying the daily rate by 30. If $10,000 par value of 5 per cent bonds are purchased at a cost of $10,748.59, the bonds will have 1,440 days to run, making a daily amortization of 51 cents for the unit held, or $15.30 per month. This will result in a difference of $14.19 over the life of the bonds due to the rounding out of fractional cents. To correct this error the practice is to make the adjustment at date of purchase or at the end of the first amortization period, be it monthly or semi-annually.

Proof:	Daily rate, 51¢ × 1,440 days....	$734.40
	Add adjustment	14.19
	Premium	$748.59

Thus it is clear that once the daily and monthly constants are found and the necessary adjustments are made at the first amortization date, it is very simple to ascertain proper amortization at any given date.

For banks not operating on an accrual basis in other respects no valid objection can be offered to the straight-line method of amortization. But this cannot be said for a practice followed by many other banks. The practice referred to is to charge the entire premium off at the time of purchase to the undivided profits account. Two indictments of this policy may be advanced, neither of which, however, holds in the switching operations discussed in Chapter 8.

In the first place subsequent income is overstated so long as the bond is held. This is the obvious result since the entire coupon when received is treated as income instead of as a combination of income and return of capital. It is curious that many bankers who follow this policy think that they are thereby being ultra-conservative. It is difficult to understand how it is possible to see any conservatism in a policy which serves to overstate current income. A number of industrial corporations at the bottom of the depression wrote off large portions of their plant accounts against their capital and thereafter failed to recognize depreciation on these amounts as a cost of doing business. This policy is clearly analogous to the one under discussion for banks. Accumulated profits of the past which have not been definitely allocated to some particular use are carried

as "undivided profits." By charging against this account premium on bonds being currently purchased and treating the entire amount of ensuing coupons as current income the real result is to add to current earnings a component out of the earnings of the past. It seems likely that bankers who regard this policy as conservative have simply failed to consider all the implications involved. It is entirely proper to carry assets on the books at conservative figures so long as this practice is not permitted to magnify the current income figures.

The second objection to this policy is of an entirely different character. The practice of closing the premium on bonds account into the undivided profits account obviously results in a decrease in the latter. When the undivided profits account is not overly large a bank following this practice may be deterred from the purchase of bonds selling at a premium. In order to avoid a decrease in the equity accounts these bankers may be tempted to shop around for issues selling at a discount. This is particularly unfortunate in a period when practically all quality bonds sell at a premium. With yields on quality bonds at the low levels prevailing in 1943 there are enough incentives pointing to subquality issues without adding to them unnecessarily.

It would be clearly unreasonable to insist that small country banks install a costly and complicated accrual system which is designed primarily for purposes of control in larger banks. But the straight-line method of amortization of bond premiums can be used even though the accrual method is used for no other purpose. The arguments in favor of its use are so conclusive that the burden of proof must lie with those bankers who fail to adopt this plan or some modification thereof.

Importance of Adequate Information.—The position taken herein is that no security should be purchased for the permanent bond portfolio which does not appear to be so thoroughly well entrenched that there is every indication that the bank will be justified in carrying it to maturity. In order to satisfy himself on this fundamental matter it is essential that all pertinent information be available to the banker.

For many years rail and utility securities held a preferred position among institutional buyers. The relatively stable character and the homogeneity of these businesses and the uniform accounting practices which prevail are evident reasons for this favoritism, but another of almost equal importance is the availability of complete statistical information. Easy access to all essential information concerning the past is vital but in these industries statistics are available which make it possible to appraise current trends of volume of business and the magnitude of current earnings. These factors combine to make it relatively simple to arrive at an intelligent opinion concerning intrinsic and relative merits of individual issues.

Bonds of industrial enterprises have not been looked upon with much favor by institutional buyers. Among the reasons for this prejudice is the heterogeneity of industrial enterprises which serves to accentuate the difficulties involved in appraising the risk. Other objections are the fluctuating character of business and earnings in many industries and the frequent lack of strong mortgage position. Still another is a deficiency in up-to-date information. The modern tendency is for industrial corporations to furnish quarterly figures of earnings, and many make frequent reports with respect to backlog of orders on hand, the volume of new business being booked, and current sales. Information of this character is clearly essential for any dependable appraisal of risk. It seems obvious, therefore, that securities of corporations reporting only on an annual basis are entirely unsuitable for bank investment purposes.

Most bankers recognize the risks inherent in industrial bonds and yet do not appear to realize that many of the objections which may be cited against them apply with equal force to general municipal obligations. Here there is usually a complete lack of mortgage position, available information is not likely to be sufficiently current, and figures are derived by such diverse methods that appraisal of them on a comparable basis is rendered hazardous. As a class municipal securities constitute a highly desirable type of commitment for the permanent bond portfolio, but selections should be confined to issues for which dependable and up-to-date information is clearly adequate.

Bond Files.—A careful follow-up of each bond after it has been purchased is of equal importance with wise initial selection. Every bond account requires constant supervision in order to insure that wholesomeness of the portfolio as a whole shall be preserved. This process can be expedited by the maintenance of adequate bond files.

The basic material for such files is provided by the data upon which the original selection was based. To this should be added, as a routine process, the outstanding facts from interim reports and subsequent annual statements so long as the bond remains in the portfolio. This procedure serves to insure the early detection of any adverse trends which may develop and which may operate, if continued, to weaken the credit standing of the issuer. In this way the bank is enabled to eliminate a deteriorating issue before the process has continued far enough to entail substantial loss because of market depreciation. For a nominal annual fee banks may now purchase prefabricated bond files covering the great mass of listed eligible issues and thus have more time available for keeping fully informed about developments affecting municipals and corporate issues which may be held and which are not covered by any service similar to the kind to which reference has just been made.

Bond Ratings.—When properly used the ratings assigned to bond issues by the various statistical agencies can be of real value to the bank investment officer. In the construction of ratings emphasis is placed on asset protection and the past record of earnings coverage. Being largely a reflection of present and past conditions, ratings should never be considered a trustworthy guide in the selection of bonds. They are not intended to forecast future price movements and the rating agencies do not hesitate to change ratings in accordance with changed conditions.

The very highest ratings are assigned to bonds which appear to the statistical services to be so thoroughly well entrenched in earnings and by mortgage position that price fluctuations in the future are likely to reflect changing conditions in the money market only. They are commonly known as

money bonds. When the bond buyer is looking for money bonds, therefore, he can concentrate his attention on top rated bonds to the exclusion of issues bearing lower ratings. By the use of ratings the field of inquiry is thus automatically reduced and intensive analysis can be concentrated on those issues for which there is at least a prima-facie case that they are of the very highest quality. But the point to be emphasized is that it is hazardous to omit this most careful analysis of such issues before purchase. In other words, the fact that a bond which turns out badly had the highest rating by all the statistical services should be no valid defense for the investment officer who selected it.

Many bonds, in fact the great majority, do not qualify for this highest rating because appearances indicate that future price movements will depend to some extent upon the future fortunes of the issuer. As we pass from the second classification to the third and fourth this dependence upon conditions in the future tends to increase. Such issues are primarily credit bonds, and future price movements are likely to reflect any substantial changes in the credit standing of the obligors. Although our hypothetical bank is highly liquid, and has clearly sufficient primary, secondary, and investment reserves, it was decided to exclude from the permanent bond portfolio even a sprinkling of the better grade credit bonds in the longer maturities. But for banks following a less conservative policy, ratings are helpful here also in narrowing the field within which intensive analysis may find full scope.

CHAPTER 7

LOAN POLICIES[1]

Discussion of detailed methods of approach in the analysis of individual applications for loans lies outside the scope of this volume. This procedure is in harmony with the plan used in treatment of asset reserves and the permanent bond portfolio. To outline sound analytical methods necessary to determine intrinsic and relative values of individual bond issues would be merely to duplicate unnecessarily the large number of excellent treatises on the subject. Similar repetition would be involved in any attempt to describe in detail sound methods for the appraisal of loan applications. However, in the conversion of funds into advances to customers there are problems of general policy involved which seem to warrant some brief consideration.

One traditional problem of a general character to which considerable attention has been devoted in the past concerns the maximum percentage of depositors' funds which it is wise to lend locally. Whatever importance this phase of the subject may have had in the past vanished with the advent of the great depression of the thirties. Under conditions prevailing since that time, as was pointed out in Chapter 1, banks have had practically no opportunity to exceed reasonably sound maximum limits with respect to loans to customers, whether secured or unsecured. It would appear to be merely academic, therefore, to raise questions connected with proper upper limits for total commercial loans. So far as real estate loans are concerned upper limits are usually prescribed by law.

A problem closely related to the preceding is concerned

[1] For much of the material presented in this chapter the author is indebted to Mr. Gerald F. Dewhirst, Assistant Vice-President, National Bank of Detroit, and Mr. Milton J. Drake, Assistant Vice-President, The Detroit Bank.

with the need for adequate diversification of loans actually placed on the books. Excessive concentration in one or several lines of business activity, or in a few lines dependent upon each other, is obviously unwise. Topmost management can satisfy itself that all is well in this respect by requiring, at regular intervals, aggregate figures showing total loan commitments of the bank in each separate industry.

For a good loan policy to be effective it is necessary that there be not only competent loan officers but also a credit department with enough authority to insist upon satisfactory statement figures and with an adequately trained personnel effective enough to discover any weak spots in the various situations presented. The credit department is usually thought of as merely a service organization, complementary to the loan function. A credit department, however, is likely to be more effective if its opinion in individual cases carries considerable weight.

And, finally, as lines of credit and maximum loan commitments above a minimum figure are passed upon by the Board of Directors or by one of the Board's committees, it is of the greatest importance that this action should never be allowed to become perfunctory. If the loan portfolio is to be kept wholesome there must be wholehearted teamwork by everybody having any relation whatever to the loan process.

Lines of Credit.—Not many years ago it was the custom of banks to extend lines of credit rather freely to all sorts and sizes of businesses. In recent years there has been a very definite change of front by most banks in this respect, and a clarification of the term "line of credit" has taken place. When a bank grants a line of credit today it does so by formal action of one of its committees and in so doing, the bank, in effect, expresses its willingness, based upon the borrower's statement, to lend a certain maximum amount of money at any time during the ensuing year. It is always understood that the funds are to be used for current needs of the business and that all loans are to be completely liquidated for a period of two or three consecutive months. It is understood, further, that if

there should develop any seriously adverse change in the financial standing of the borrower the line of credit will be withdrawn.

Lines of credit should be considered as entirely separate and distinct from maximum loan commitments. In the latter each request for a loan is considered as an individual transaction and is not subject to automatic renewal. Such commitments are made on the basis of financial statements when the funds are to be put to an appropriate use and means of repayment are clearly in sight.

Loan Liquidation Control.—It was formerly quite common for banks to be without any effective means of supervising the collection of loans except those that got into the trouble class for one reason or another. Available evidence points to the fact that many losses which were sustained would never have occurred at all if there had been a routine set-up for following the progress of loans after they had been put on the books, instead of ignoring them until they became troublesome. It seems obvious that a good loan policy should embody a method of loan liquidation or control. Certainly every loan put on a bank's books is good when made—in other words, no loaning officer would knowingly make a bad loan, and a good credit department provides some assurance against such an occurrence. Loans become bad after they are made. Therefore, more and more attention has been devoted in recent years to watching loans after their inception.

When a loan is made it is based on a given set of circumstances, and, as has been pointed out in an earlier connection, means of repayment can be readily foreseen. This means simply that it is possible to predict with a reasonable degree of certainty the time when the borrower should have funds available to repay the loan. The maturity of the note should be made to coincide with this period in the borrower's affairs. Any requests for extensions need to be examined with the greatest care for it is at this point that the first danger signal appears. Of course the bank must adopt an understanding attitude if the original predictions are not fulfilled through no

fault of the borrower. Even then, however, any extension granted should be geared to the time when it appears funds should be available for liquidation of the loan. Without this a steady loan is likely to develop, one which may fall into the trouble class. Even with loans secured by stock market collateral having clearly adequate margins it is desirable to have some orderly plan of repayment for the benefit both of the borrower and the bank.

For an effective loan control policy of the character indicated it is necessary to delegate authority to some individual who is charged with the duty of watching liquidation and whose responsibility it is to bring to light all variations from original liquidation programs.

Unsecured Seasonal Loans.—Lending money on an unsecured basis requires a somewhat rare combination of qualities, including an understanding of people and an ability to judge them, as well as a technical knowledge of accounting and financial statements. Many difficult cases arise where a logical decision is impossible, so that only the broadest type of policies can be laid down, and their effectiveness must be checked from time to time against the actual results obtained.

Of the several types of unsecured loans the most desirable is the seasonal loan to a business enterprise. Loans of this character are based primarily upon analysis of financial statements and examination of the usual credit factors. Such loans are extended for the purpose of financing a seasonal increase in working assets with means of payment to be provided through the normal liquidation of receivables and inventories. An example of this type of business is shown in Figure A. It is especially important that outstanding loans in this classification be followed carefully to see that they are paid off at the end of the season. Exceptions must be made under unusual or difficult circumstances, and the cooperation of the bank is necessary and proper should a semi-frozen condition develop because of sudden and unexpected changes in trade or general business conditions.

Steady or permanent loans should be avoided as a matter

FIGURE A

COMPARATIVE BALANCE SHEETS OF BUSINESS REQUIRING PURELY SEASONAL ACCOMMODATIONS

	12-31	3-31	6-30	9-30	12-31
Cash and Securities	$ 79,000	$ 80,000	$ 74,200	$ 85,500	$133,000
Accounts Receivable	95,100	7,600	237,300	192,300	14,900
Inventories	54,100	161,200	276,800	85,900	80,300
Total Current Assets	$228,200	$249,600	$ 588,300	$363,700	$228,200
Plant and Equipment	414,800	400,700	386,200	374,200	407,400
Other Assets	108,300	94,900	69,000	87,300	98,400
	$751,300	$745,200	$1,043,500	$825,200	$734,000
Notes Payable—Bank	$ -0-	$ -0-	$ 250,000	$ 50,000	$ -0-
Accounts Payable	-0-	56,700	24,700	13,700	-0-
Accruals	51,000	27,400	47,900	45,900	16,800
Total Current Liabilities	$ 51,000	$ 84,100	$ 322,600	$109,600	$ 16,800
Capital and Surplus	700,300	661,100	720,900	715,600	717,200
	$751,300	$745,200	$1,043,500	$825,200	$734,000
Current Assets	$228,200	$249,600	$ 588,300	$363,700	$228,200
Current Liabilities	51,000	84,100	322,600	109,600	16,800
Working Capital	$177,200	$165,500	$ 265,700	$254,100	$211,400
Current Ratio	4.47	2.97	1.82	3.31	13.65

of policy. Many borrowers do not understand why a bank should insist upon payment when they feel that they are perfectly good for the amount involved. It is not a question of whether the borrower is good or whether he is willing to pay. The real objective is to get him to demonstrate his ability to pay. Bank loans which are allowed to become steady get the borrower into a frame of mind where he is likely to consider such loans a part of his capital rather than debt, and this leads him to build his operations on the assumption of continuous availability of the loan. The result is that the bank becomes, in reality, a partner, assuming a partner's risk, but getting only a creditor's return. While arguments may develop a proper loan policy will provide for the education of the borrower so that he can see the bank's viewpoint. A little time and patience exercised in this way may be many times repaid in a period of descending activity when, otherwise, the bank would have had to force the borrower to pay under circumstances most difficult for him. In summary it may be said that unsecured business loans should be processed under a broad general policy which provides for seasonal liquidation, the furnishing of adequate financial statements, and the means of analyzing them.

Working Capital Loans.—There always exist a considerable number of business organizations whose working capital positions are insufficient to permit of seasonal liquidation of bank indebtedness. Borrowings of a large portion of these are of a cyclical nature in that the loans are normally retired only in a period of low business volume. Illustrations of this type include the automobile and personal finance companies as well as equipment manufacturers and certain classes of retailers selling on installment terms. As in the seasonal loan a line of credit may be made available to the customer. In confirming a line to a borrower in this group arrangements are usually made for the retirement of the liability for a period each year through the rotation of the loan to another bank. In this connection two factors are important in determining the degree of liquidity of the credit: first, a confirmation of the amount of

firm lines in relation to borrowing requirements; and, second, calculation of the period of time required to liquidate bank indebtedness upon the discontinuance of its operations. Loans to customers in this classification, as measured by these factors, should show for the individual bank an acceptable degree of liquidity if they are to be considered attractive outlets for depositors' funds.

Secured Loans.—Applications for credit assistance for seasonal purposes are sometimes received from concerns whose credit responsibility does not appear to warrant advances on an unsecured basis. In many cases the subnormal working capital position is the result of operating losses, capital investments, or development expenditures. In these circumstances loans may be granted safely only with adequate security. There are various forms which this security may take. It may consist of assignment of life insurance policies or liens on real property belonging to the principals but not used in the business; or the security may take the form of assignment of receivables on a notification or nonnotification basis, or the pledge of warehouse receipts covering inventory. In these cases the past earning performance and future profit prospects assume greater importance in determining the advisability of approving the loan, for such loans would not ordinarily be considered sound solely on the protection of the collateral. Instead there must be considerable assurance, based upon analysis of past and anticipated profits, that the working capital position can be restored to normal over a reasonable period of time. It is also frequently desirable to schedule liquidation on a monthly basis in accordance with the forecasted working capital improvement.

For other types of secured short-term loans primary concern is with the character of the collateral, although character is, of course, just as important as it is with unsecured loans. Staple commodities represented by warehouse receipts and readily marketable securities with adequate margin constitute the most desirable types of security for such loans. It is essential that records be kept showing aggregate concentration

of collateral for all secured loans so that too much of the loan portfolio will not become dependent upon the market behavior of a single commodity or a single security issue or group of related issues. It is sound policy not to make loans on unlisted securities, and especially local securities, both because of the lack of marketability and also because the borrower may be in control of the company whose stock is offered as collateral. Justifiable exceptions may be made in instances where the borrower has some means of payment and responsibility entirely aside from the collateral itself. In the final analysis it may be said that a bank is never justified in making a secured loan of any kind if at the time the decision is made it appears likely that recourse to the collateral will be necessary in order to prevent a loss.

Term Loans.—Despite the fact that it is contrary to orthodox doctrine for sound commercial banking it has long been the custom for commercial banks to make loans of a relatively fixed character. Such advances are really capital loans but in the past they were evidenced by short-term notes with either a definite or implied understanding that at maturity they would be renewed or reduced only in line with the customer's ability to pay at that time. The demand for loans of this character was greatly intensified during the years following the banking holiday. This development may be ascribed to two causes. It was pointed out above that for many business firms operating losses during the depression served to deplete their working capital, while in the post-depression years increased volume of business indicated the desirability for extensions of plant and also more working capital than had been needed prior to the depression. Another factor was the increased difficulty of smaller businesses in getting into the long-term capital markets at a cost which was not prohibitive.

Because of the tremendous decline in the volume of their ordinary commercial loans banks were quite receptive to capital loans of this character. For such advances the name "term loans" came into general use. However contrary to traditional commercial banking doctrine this development might be one

good purpose was served. It was highly desirable that this type of advance be brought out into the open, its real character as a capital loan be recognized by abandoning the short-term note with renewal privilege, and standardized protective devices be developed.

In contrast with earlier methods used in making capital loans the modern term loan is usually secured, either by a mortgage on the plant or a lien against equipment. The loan is made on the basis of a definite program of amortization with final maturity usually not in excess of five years. Terms of repayment are customarily incorporated in an agreement which also includes various protective clauses such as restrictions on dividend payments and a covenant to maintain working capital in excess of a fixed minimum amount. Periodic financial statements are usually provided for in the agreement.

Term loans may be made to finance the acquisition of additional fixed assets such as plant or machinery, or preferably they may be made simply to increase permanent working capital. In either case funds for their repayment must come from future earnings so that careful analysis of income figures is far more important than for the ordinary short-term seasonal loan. The liquidating ability of the borrower should be estimated by a projection of the cash position into the future for each year during which the loan runs.

One additional observation on term loans seems to be in order. Determination of the maximum volume of loans of this character which an individual bank may wisely hold is a general policy problem for topmost management to solve. For a bank whose capital position is relatively strong, whose liquidity is fully protected with asset reserves, whose solvency cannot be threatened by excessive exposure to market price fluctuations—for such a bank it would seem entirely safe and proper to go in rather heavily for term loans. For another bank weak in any one of these fundamentals it appears wise to invest, if at all, only sparingly in this type of nonliquid asset.

Constructive Loans.—The term "constructive loans" is usually applied to advances to a new enterprise with insufficient

capital. The very fact that the enterprise as an entity is new means that there is no record of success in the past. Thus there is missing one of the basic criteria usually considered significant in credit decisions. This deficiency must be counterbalanced, if a loan is to be justified, by records of successful operations in the past by the principals actively controlling and managing the new business. In addition, judgment by the banker as to prospects for success in the new venture must be fairly optimistic. It has been said that the banker whose business is growing more rapidly than that of competing institutions is usually one who is successful in recognizing opportunities for good constructive loans. Advances of this character which turn out well almost always result in customers who will stay with the bank permanently, who cannot be lured away by wiles of competitors. As their businesses prosper and grow their accounts become more and more profitable to the bank.

It is evident, however, that risks of miscalculation are great. Therefore, it is good general banking policy to limit rigorously total commitments of this character to a volume commensurate with a bank's own strength to absorb losses. It seems advisable also that individual constructive loans of appreciable size should have advance approval by the board of directors.

Postwar Problems.—In the era which will follow the end of the war policy problems in connection with loans may well assume even greater importance than ever before. It is not beyond the realm of possibility that there may develop a tremendous demand for loans of all kinds. Should this happen policy decisions will have to be made as to the desirability of personal loans on any extended scale and the maximum percentage of savings deposits which may be wisely diverted to loans on the security of real estate. Restrictions imposed by statutes on real estate loans are often too liberal for bank managements to look upon as safe or proper for individual institutions. It is not impossible that a new all-time high may be reached in the demand on commercial banks for capital loans to industry. With the advent of the war the importance of ordinary term loans began to decline. Various government

agencies started to furnish capital to suppliers of war materiel, and the V loan was developed. Upon the termination of hostilities commercial banks are going to be faced with a problem of fundamental importance. Are they going to take the initiative in providing whatever finances industry may need to reconvert to a peacetime basis? If they leave this to the federal government it will not speak well for commercial banking. As one banker put the problem in 1943:

> It is quite clear that those who put the dollars out to industry after the war are going to have a lot to say about how these dollars are used . . . If the banking system sits idly by and clips coupons and fails to realize its responsibilities . . . or at least give some real assistance to industries and companies which are entitled to survive the war era, then banks should have little complaint about further inroads in their line of activity. It appears to me that banks will be definitely on trial and that once again—maybe for the last time—they will have an opportunity to demonstrate the right of banks to function as in the past without additional restrictive laws and regulations.[2]

If banks are to meet the challenge, one promising avenue may well be a real expansion of the term loan, with whatever additional refinements and safeguards the traditional ingenuity of bankers may be able to devise.

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2 R. A. Kent, Vice-President, Bank of America National Trust and Savings Association, San Francisco, in a personal letter to the author.

CHAPTER 8

RESERVES ON THE LIABILITIES SIDE

It is quite uncommon to find on the Resources side of bank statements of condition any item specifically labeled as "reserve." Occasionally we find segregated from other assets the item Lawful Reserve with the Reserve Bank. More frequently, however, this item is consolidated with other primary reserves under the heading Cash and Due from Banks. While items properly constituting the secondary and investment reserves are listed individually or in groups, usually it is impossible to reconstruct the statement in terms of the banking concept of "Reserves." In Chapter 3 reference was made to the unique use of this term in banking as applying to certain groups of assets. But in banking it is also the custom to follow the practice common in other lines of business and to give the name to certain items appearing on the other side of the statement. These latter reserves not only have nothing in common with the asset reserves discussed earlier but they also differ fundamentally from each other. Two entirely different kinds of concepts are discernible:

1. Accrued liabilities the exact amounts of which are not yet determinable. Reserves for taxes, interest, wages, and other expenses are good examples of this type of reserve. Use of the label Reserve for these purposes is unfortunate and is not in accord with best accounting practice. It is both better and simpler merely to identify these items as Accrued Liabilities.
2. Actual earnings set aside for some definite purpose. Thus we have reserves for the retirement of preferred stock and reserves for bonds and loans, the latter usually appearing with the label Reserve for Contingencies.

The fundamental purpose of so-called "reserves" of the first type is to provide a device which will guard against an overstatement of current earnings. It is a relatively simple matter to estimate roughly the extent to which expense liabilities not yet due and payable have accrued. The amounts so estimated are charged to the proper expense accounts and identical figures credited to the corresponding reserve accounts. Each accounting period is thus forced to bear the burden involved in earning the gross income of the period. As these expenses actually mature and are paid, the charges are made to the reserve accounts set up specifically for this purpose. It is patent that no managerial policy problems are involved with reserves of this type.

In the other group of reserves, however, there are policy problems involved which are of sufficient importance to warrant more than passing attention. This type of reserve is designed as a means of earmarking for a specific purpose certain portions of earnings actually realized. In banking the fundamental purpose of this type of reserve is to provide for losses not believed to be likely but which may, nevertheless, materialize at some time in the future. In conducting the business of banking it is necessary to acquire a large number of different earning assets. Even in relatively good years it is not to be expected that every individual mortgage, commercial loan, or security will pan out as expected. And hence losses are almost certain to be encountered in the normal course of events. Such losses, being regularly recurring, are quite properly looked upon as current expense and should be charged against the earnings of the period. But always there remains the possibility that at some time in the future they will become so large that current income will be woefully inadequate to offset them. In years of major depression it is not uncommon for such losses, realized and unrealized, to be so large that, if formally recognized on the books, not only would the undivided profits account be wiped out but the surplus would also be impaired. Probably more so than for any other kind of business organization is it important for a bank to be prepared to meet developments of an adverse character in a way which will not disturb public

confidence. In the discussion of asset reserves the contention was set forth that no bank is as conservatively managed as it should be if it cannot meet, without threat to its fundamental soundness and solvency, both sudden and long-drawn-out major losses of deposits without regard to security price levels. To insure against such contingencies adequate asset reserves are essential. In order to be protected similarly against unexpectedly large losses in its loan and mortgage portfolios as well as drastic declines in security price levels it is equally necessary that a cushion be built up in the form of capital reserves adequate to absorb extraordinary losses without affecting in any major way the ordinary capital accounts.

In a very practical sense these ordinary capital accounts—capital stock, surplus, and undivided profits—cannot be used for such purposes by a bank which hopes to continue in business. Surplus in banking has a technical significance not found elsewhere. The combined capital stock and surplus accounts represent the permanent invested capital of the bank. Member banks must subscribe for stock of the Federal Reserve bank an amount equal to exactly 6 per cent of their capital and surplus. Laws setting forth maximum loans and other commitments to one interest always express these maxima in terms of a percentage of capital and surplus. While these two accounts, plus other capital items, provide the actual buffer against losses to depositors it is doubtful that a bank would be able to continue in business should it become necessary to charge substantial losses against its surplus account. Even the undivided profits account, which is more closely akin to the surplus of other corporations, is not readily available for this purpose. Just as with the surplus account of industrial corporations the undivided profits account of a bank should always indicate the volume of recognized accumulated earnings which have not been paid out in dividends and the future disposition of which has not yet been determined. But for a sound, economically justified bank it is expected that this account will grow from year to year, and eventually that some portion of it will be transferred to the more formal surplus account or perhaps directly to the still more formal capital stock account through

the payment of a stock dividend. Utilization of a very large percentage of the undivided profits account for the payment of an unusually large or special dividend would scarcely be in accord with conservative banking practice but this action would not necessarily impair public confidence. It is not so clear, on the other hand, that public confidence could be preserved should current necessary charge-offs be great enough to absorb all current income and also to require substantial recourse to the undivided profit account. Thus while the undivided profit account is also a buffer between the depositor and loss of his funds it is, in practice, not really available for the absorption of large losses. On the other hand, the public will accept with equanimity use of reserves for these purposes because of the very fact that they have been set up in advance for just such contingencies. It seems evident, in the light of these considerations, that adequate contingency reserves are essential for banks if they are to be assured of continued public confidence when, as, and if the going becomes rough.

In the 1930's we had to go through the most serious depression of modern times. In the 1940's we are engaged in an all-out war the repercussions of which nobody can possibly foresee. Their impact may be so severe that private banking can no longer endure. There may be developments against which it is impossible for going institutions to be prepared. Certainly banks cannot be expected to withstand the loss of all their deposits or the uncollectibility of all of their earning assets. Nevertheless, each individual banker should be as well prepared as possible to face whatever conditions the future may hold in store. He wants to make certain that if it is possible for even a minority of banks to weather future storms his institution will be among those that can continue.

Table XII has been prepared to bring into bold relief the character of major contingencies against which banks should aim to fortify themselves as well as possible.

Inspection of this table will bring into focus certain interesting facts. The effects of the war and postwar inflation and deflation did not run their full course until 1923 in the case of securities and not until 1924 with respect to loans.

TABLE XII. CHARGE-OFFS ON LOANS AND INVESTMENTS
ALL NATIONAL BANKS
1918-1942 (years ending June 30)
(000,000 omitted)

Year	Total Loans	Charge-Offs	Charged Off—%	Total Investments	Charge-Offs	Charged Off—%
1918	$10,152	$ 34	.33	$ 3,837	$ 44	1.16
1919	11,013	35	.32	4,811	28	.58
1920	13,621	31	.23	4,050	62	1.53
1921	12,005	76	.63	3,922	76	1.94
1922	11,248	135	1.20	4,518	33	.74
1923	11,818	120	1.02	5,032	22	.44
1924	11,979	103	.86	5,107	25	.48
1925	12,674	96	.75	5,705	25	.44
1926	13,418	94	.70	5,842	24	.41
1927	13,956	87	.62	6,393	28	.43
1928	15,145	92	.61	7,147	29	.41
1929	14,801	87	.59	6,657	43	.65
1930	14,888	104	.70	6,888	61	.89
1931	13,177	187	1.42	7,675	119	1.55
1932	10,282	259	2.52	7,197	201	2.80
1933	8,117	231	2.85	7,372	237	3.21
1934	7,695	379	4.93	9,349	242	2.59
1935	7,365	188	2.56	10,716	137	1.28
1936	7,759	155	2.00	12,483	93	.75
1937	8,808	111	1.26	12,122	94	.78
1938	8,331	66	.79	11,644	103	.90
1939	8,574	85	1.00	12,553	116	.92
1940	9,179	65	.71	12,905	106	.82
1941	10,922	52	.50	15,006	97	.64
1942	10,902	43	.40	18,643	73*	.38

* Year ending December 31, 1942.

Beginning with 1925 and continuing through 1929 necessary charge-offs were never large enough to arouse any fears concerning the soundness of the banking system as a whole. And no doubt any individual banker whose record paralleled the overall national bank record would have found little cause to worry. Nobody could be expected to foresee the depths to which business was destined to sink during the following three or four years. Yet at any time there is always the possibility that losses on earning assets in the relatively near future may

turn out to be of sufficient magnitude to jeopardize the solvency of what is currently considered a thoroughly sound institution. In order to prepare for such contingencies it is the part of wisdom to set aside out of earnings a reserve to serve as a special buffer against such untoward developments. The balance in this reserve at any one time should be considered a part of the capital funds, but a part which has been earmarked definitely for possible unfavorable developments on a large scale. It should not be transferred to undivided profits or surplus and should not be considered as available for dividends. Some bankers consider it unwise to show such reserve on their statements. It is the opinion of the author that this is an unwarranted attitude. But those bankers who entertain doubts in this connection can, so far as their published statements are concerned, merely deduct these reserves from the book values of the assets for the protection of which the reserves have been set up. Departure to this extent from generally accepted principles of sound accounting may be justified by the overwhelming importance in banking of avoiding any practice which might impair public confidence.

During the five-year period ending on June 30, 1929, the net additions to profits for all national banks amounted in total to $1,297,383,000. Of this sum 73 per cent, or $946,569,000, was paid out in dividends. This dividend policy is much more liberal than that of industrial corporations. During the prosperous twenties over 75 per cent of leading industrial corporations paid out in dividends less than 70 per cent of their indicated earnings while approximately half of them disbursed less than 60 per cent in dividends. Over one-third of these leading industrial corporations paid to their stockholders less than 50 per cent of their earnings.[1]

It is a commonly accepted doctrine that banks should be more conservative in all things than corporations engaged in other lines of business activity. The evidence just submitted indicates that so far as dividends are concerned banks have actually been less conservative than have commercial and industrial

[1] O. J. Curry, *Utilization of Corporate Profits*, p. 35.

enterprises. If, during the five-year period ending June 30, 1929, national banks had retained 50 per cent of their earnings they could have built up a contingency reserve of over $300,000,000, a safety measure which would have done much to soften the impact of the extraordinary losses they were destined to suffer during the early thirties.

There is a limit, of course, to the size of contingency reserves which banks can reasonably be expected to accumulate. Certainly it is scarcely conceivable that they could have built up reserves prior to 1930 of sufficient magnitude to take care of the enormous losses suffered from 1930 to 1934, as shown in Table XII. In another connection it was asserted that banking cannot be successfully conducted on a basis which presupposes that the worst is going to happen. But it can and should be conducted on a basis which assumes that an extremely bad succession of years may be encountered at any time in the future, and that losses on earning assets during such periods may be really serious. Unless or until a bank has accumulated a genuinely substantial contingency reserve it is difficult to see the wisdom of paying dividends in excess of 50 per cent of operating earnings.

Differences of opinion exist as to reasonable criteria to be used in determining even approximately what constitutes an adequate reserve for such contingencies. It is suggested here that the procedure to be used by the individual bank should be similar to that used in arriving at minimum figures for the combined asset reserves. It will be recalled that that process entailed a study of the individual bank's own record over a preceding period of years long enough to include all phases of a complete business cycle. In applying a similar procedure to the contingency reserve problem it is necessary to review the bank's record of losses on both loans and discounts and on securities over at least a ten-year period. It would appear that the most appropriate period to be used is one that begins on July 1, 1928, and concludes on June 30, 1938. There will thus be included one year of apparently great prosperity, several years of deep depression, followed by several years which brought a considerable measure of recovery. As a starting point

for this survey it seems worth while to turn again to the record of losses compiled by all national banks for that decade. The figures in Table XIII relate the losses on loans and on securities to the interest actually received.

This table reveals the startling fact that losses on loans for all national banks in the decade under review absorbed 34.5 per cent of all interest and discount received on this class of earning assets. The record was even worse for securities, as

TABLE XIII. INCOME AND LOSSES ON LOANS AND SECURITIES
ALL NATIONAL BANKS

1928-1938 (years ending June 30)
(000 omitted)

Year	Interest and Discount on Loans	Losses on Loans	Loss Percentage	Interest & Div. on Securities	Losses on Securities	Loss Percent
1929	$ 894,032	$ 86,815	9.7	$ 320,416	$ 43,458	13.5
1930	903,858	103,817	11.7	299,042	61,371	20.8
1931	701,889	186,864	26.6	320,076	119,294	37.5
1932	615,357	259,478	42.0	298,841	201,848	67.5
1933	473,696	231,420	48.7	283,568	236,557	83.2
1934	388,064	379,294	98.0	291,901	241,789	90.0
1935	346,995	188,237	54.2	323,491	136,743	42.2
1936	343,110	154,964	45.2	313,982	93,339	29.7
1937	356,732	111,000	31.1	331,666	94,069	28.3
1938	377,076	166,203	44.1	313,403	103,009	32.9
	$5,400,809	$1,868,092	34.5	$3,096,386	$1,331,477	43.0

Compiled from Reports of the Comptroller of the Currency.

losses amounted to 43 per cent of all interest and dividends received. These loss percentages are gross, without any deductions for recoveries. Recoveries on loans previously charged off theoretically do not belong in the current earnings figures and therefore should not be used to offset current losses. Because of current practice this theoretical aspect may be disregarded. For the years 1933 to 1937, inclusive, recoveries on securities are not reported separately from bond profits, but so far as loans are concerned it is possible to revise Table XIII

by omitting the years 1932, 1933, and 1934, and to consider recoveries as offsets to current losses. Results are shown in Table XIV.

With the organization of the Federal Deposit Insurance Corporation in 1934 figures are regularly available covering all insured banks. The figures in Table XV were compiled from the Annual Report for 1941 and bring the data down to our entrance into the war as active belligerents.

TABLE XIV. NET LOSSES ON LOANS OF NATIONAL BANKS
(for Selected Years Ending June 30)
AS A PERCENTAGE OF INTEREST AND DISCOUNT RECEIVED
(000 omitted)

Year	Interest and Discount Received	Charge-Offs	Recoveries	Net Losses	Losses as % of Int. and Disc. Rec.
1929	$894,032	$ 86,815	$18,149	$ 68,666	7.7
1930	903,858	103,817	15,680	88,137	9.7
1931	701,899	186,864	16,636	170,228	24.2
1935	346,995	188,237	32,341	155,896	42.7
1936	343,110	154,964	64,082	90,882	26.5
1937	356,732	111,000	64,243	46,757	13.1
1938	377,076	66,203	38,768	27,435	7.2
1939	377,149	84,897	33,412	51,487	13.7
1940	399,970	65,262	40,164	25,098	6.3
1941	431,014	51,853	37,819	14,034	3.3

Apparently house cleaning of earlier mistakes engaged the major attention of bankers during 1934, 1935, and 1936. The figures in Table XV seem to indicate that this job was pretty well completed by the end of 1936, for in later years the volume of net charge-offs declined toward pre-depression levels. Even so we see that during the great defense-activated year of 1941 it was necessary to charge off one dollar out of every eight dollars earned on loans and discounts.

Against these overall figures the individual bank should compare its own record. The records of some banks, of course,

will be much more favorable while many others will be much less favorable than those indicated in the table for banks in general. For convenience let us assume a bank whose record over the eight-year period between the banking holiday and Pearl Harbor corresponds closely with the overall figures for all insured commercial banks as shown in Table XV. For this hypothetical bank it is suggested that whenever net charge-offs on loans and discounts for any one year fall below 12½ per cent of interest and discount actually received, the difference between 12½ per cent and actual net charge-offs be set up in a reserve for abnormal losses. This policy might be continued

TABLE XV. NET LOSSES ON LOANS OF INSURED COMMERCIAL BANKS
(000 omitted)

Year	Interest and Discount	Charge-Offs	Per Cent	Recoveries	Net Losses	Per Cent
1934	$690,601	$552,857	78.4	$ 52,874	$499,983	72.4
1935	643,217	318,732	49.6	81,812	237,920	37.0
1936	663,195	250,266	37.7	110,595	139,671	21.5
1937	709,962	141,537	20.0	89,860	51,677	7.3
1938	705,037	150,100	21.3	56,405	93,697	13.3
1939	726,922	136,137	18.7	65,581	70,556	9.7
1940	768,770	113,699	14.8	65,887	47,812	6.2
1941	847,832	103,868	12.3	70,947	32,921	4.0

Annual Report, Federal Deposit Insurance Corporation, for year ended December 31, 1941, p. 158.

until the reserve thus built up becomes as large as the net losses actually incurred during the worst year of the preceding major depression.

Let us now turn our attention to the problem of determining a reasonable minimum size for the bond reserve. Reference to Table XIII above reveals the fact that losses written off on securities by all national banks between 1929 and 1938 averaged 43 per cent of all interest and dividends actually received. The percentages reached truly Gargantuan proportions at the bottom of the depression but even in the post-depression years the 28.3 per cent loss in 1937 was the lowest percentage loss for

any one year. The figures in this table do not take into account recoveries on securities, as these figures are not given separately for some of the years in the Reports of the Comptroller of the Currency. For the post-depression overall record, therefore, it is advisable to turn again to data supplied for all insured commercial banks by the Federal Deposit Insurance Corporation. From those figures Table XVI has been constructed.

It appears from this Table that of all interest and dividends received during the five-year period covered 36.7 per cent was absorbed in charge-offs. This figure is before taking

TABLE XVI. INCOME AND LOSSES ON SECURITIES
ALL INSURED COMMERCIAL BANKS
1935-1941
(000 omitted)

Year	Interest and Dividends	Charge-Offs	Per Cent	Recoveries	Net Charge-Offs	Per Cent
1937	$ 572,019	$176,457	30.8	$ 57,919	$118,538	20.7
1938	531,854	221,903	41.7	61,579	160,324	30.1
1939	521,681	215,170	41.2	66,495	148,675	28.5
1940	499,650	193,054	38.8	73,274	119,780	24.0
1941	509,175	161,073	31.6	73,589	87,484	17.2
	$2,634,379	$967,657	36.7	$332,856	$634,801	24.1

account of recoveries. When recoveries are deducted from charge-offs the net figure for charge-offs is in excess of 24 per cent of all interest and dividends received.

It is true that during this period bond profits of great magnitude were realized by banks. In fact, the total combined bond profits realized were in excess of the combined net charge-offs shown for those years in the above table. Bond profits is a subject of sufficient importance to warrant separate treatment. At this point suffice it to say that these bond profits are purely fortuitous, having been made possible by the continued decline of interest rates to unprecedented levels with the concomitant

advance in bond prices to new high levels. The conservative procedure is to consider such profits nonrecurring and to place them in the contingency reserve or in a special bond reserve as a protection against the likelihood sooner or later of interest rates and bond prices returning to more normal levels.

Although the figures in Table XVI indicate a trend toward smaller necessary charge-offs, conservative practice calls for the building up of the bond reserve out of current interest and dividends received. For a bank whose record closely parallels the overall figures for all insured commercial banks it appears that in addition to net realized bond profits 20 to 30 per cent of income from securities would not be excessive annual additions to the contingency reserve.[2] For banks whose own records are definitely superior to the average figures shown in the above tables, amounts set aside out of income need be correspondingly smaller. Other banks with loss records exceeding the average figures need to transfer to the reserve still larger percentages of income. And dividend policy should be determined in the light of operating income remaining after such transfers have been made.

Utilization of Realized Bond Profits

The fundamental source of a bank's earning power is interest on loans and investments. A secondary source is found in the charges made for performing various services for customers. It is common to refer to earnings from these sources as operating earnings. The actual volume of operating earnings naturally tends to fluctuate in accordance with changing interest rates and changes in the effective demand of customers for loan accommodation. Yet for the successful bank it is proper to think of operating earnings as a phenomenon which recurs year after year. Definite proof of the economic justification for an individual bank is supplied by a record of operating earnings ordinarily sufficient to pay reasonable dividends to stockholders and to increase the permanent capital funds in conformity with growing deposits. If a true picture of the bank's normal earn-

[2] Wooster suggests reserve equal to 25 per cent of book value of bond account. *Op. cit.*, p. 122.

ing power is to be presented it is important that nonoperating profits of any magnitude be carefully segregated from operating figures. Since nonoperating profits are likely to be nonrecurring the proper utilization of such profits is a matter of great importance.

Attention was called in Chapter 2 to the factors which have forced banks to depend, to a much greater extent than ever before, on interest on securities instead of interest on advances to customers. Not only did the volume of securities increase tremendously after the banking holiday but there was a concomitant decline in interest rates. The extent of this decline is revealed in Table XVII.

TABLE XVII. AVERAGE ANNUAL BOND YIELDS
(Maturities of 12 Years or more)

Year	U. S. Government	AAA Corporates	Year	U. S. Government	AAA Corporates
1933	3.31%	4.49%	1939	2.36	3.01
1934	3.12	4.00	1940	2.21	2.84
1935	2.79	3.60	1941	1.95	2.77
1936	2.65	3.24	1942	2.02	2.83
1937	2.68	3.26	1943*	1.80	2.69
1938	2.56	3.19			

* Average for week ending September 25, 1943.

Rising bond prices provide the other side of the picture. As interest rates sank to new low levels high-grade bond prices of course advanced to correspondingly new high levels. Between 1933 and the end of 1940, therefore, banks were provided with tremendous capital gains in their bond accounts. During that period it is undoubtedly true that many banks sold bonds for the sole purpose of realizing capital gains which they took into their income accounts. In this manner they sought to offset by what might be called windfall profits the decline in their normal earning power. The argument that such profits were nonrecurring lost much force when bankers discovered that year after year they were able to realize still more profits by the same process. In order to remain in business, reinvestment had to be made on the basis of the new lower rates. In reality,

therefore, the process was one merely of writing up their inventories and then treating the corresponding credit as an addition to normal earnings.

The large minority of bankers who understood clearly the nature of the process found themselves in a peculiar position. Naturally both governmental and corporate borrowers wished to take advantage of the new lower rates. In order to do so they called their outstanding obligations and refunded with lower coupons. This policy was so widespread that realized bond profits in large volume were literally forced on the banks. Sound utilization of such profits thus became a matter of supreme importance.

In the past periods of low interest rates have always been followed by periods of much higher rates. Future patterns in this respect may turn out to be fundamentally different from those experienced in the past, but unless or until it becomes a certainty that the lowest interest rates of modern times are to be a permanent phenomenon the conservative position is to assume that sooner or later they will once again move upward toward former levels. Since rising interest rates depress high-grade bond prices no bank can reasonably expect to escape the painful experience of watching falling quotations on securities held. Under no circumstances can this be considered a pleasant experience, but the misfortune need not be so poignant for those bankers who held in suspense, for a cushion against just such a contingency, bond profits realized during falling interest rate periods.

While almost all banks realized large profits from the sale or call of individual bond issues held during the period 1933 to 1940, during these same years it was not uncommon for banks to experience losses on other issues in their portfolios. Losses actually realized might properly be treated as offsets to corresponding amounts of profits taken. If the depreciated bonds were retained it appears reasonable that they should be written down to current market values, such write-downs also to be considered as offsets against bond profits realized. The concept of realized bond profits, therefore, might well be restricted to *net* realized bond profits. It is to the concept in

this narrower sense that attention needs to be primarily directed.

The position taken here is that, with the exception to be noted later, net realized security profits should be held in suspense exclusively to serve as a protection against future declines in market quotations of securities held. There is a will-o'-the-wisp quality to such profits, and no banker is justified in assuming that he will be able permanently to retain such windfalls. The fact that he was able to do so for a period of over seven years should not lull him into a false sense of security. During 1938 the various supervising agencies agreed upon a revision of standard procedure in bank examinations. With respect to bond profits this ruling reads:

> Until losses have been written off and adequate reserves established the use of profits from the sale of securities for any other purpose will not be approved.

This ruling has the appearance of being in line with conservative practice, and it may be assumed that it has had good results in individual instances. However, it leaves open to innumerable interpretations a definite meaning for the term "adequate," and it does not prohibit the use of bond profits for clearly unsound purposes.

Whatever be the size of bond reserves and notwithstanding the fact that all losses may have been written off, the use of bond profits for the payment of dividends is not good banking practice.[3] Yet this ruling does not prohibit the transfer of bond profits to the undivided profits account even though there may be no bond reserves of any size. Once in the undivided profits account these capital gains become inextricably intermingled with operating profits and in later years may be paid out in dividends. So far as distributions to stockholders are concerned, therefore, the net effect of this ruling is to prohibit the use of current bond profits only for current dividends, and even this only so long as reserves are judged to be inadequate.

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[3] Wooster disagrees with this position, and states that after the reserve equals 25 per cent of the bond account, bond profits might be used for dividends. *Op. cit.*, p. 129. A sounder practice, should the reserve become obviously too large, is to transfer the excess to surplus account.

Neither does this ruling prevent the transfer of such profits to a reserve for the retirement of preferred stock. Suppose, for instance, that in a particular bank, realized bond profits are transferred regularly to this reserve until the reserve becomes as large as the preferred issue outstanding. Let us suppose, further, that the total deposits amount to twelve times the capital accounts, including the preferred. Now if the preferred stock is actually retired it disappears from the capital account and an equal amount of cash or its equivalent comes out of the asset side. But with the preferred actually retired there would be no point in continuing to retain the item of reserve for its retirement. It is likely to be transferred to surplus, or possibly to the capital account itself through the payment of a stock dividend. The end result is that the capital account of the bank is thus depleted and the institution becomes more vulnerable to future losses in its bond portfolio. That this is the case may be shown definitely by means of the following hypothetical example:

SITUATION I:		
Preferred Stock	$100,000	
Common Stock	200,000	
Surplus	150,000	
Undivided Profits	50,000	
Total Capital Funds	$500,000	Deposits $6,000,000

In succeeding periods bond profits are realized and transferred to a reserve for the retirement of preferred stock. Dividends are paid but a portion of operating profits retained. The capital set up then becomes:

SITUATION II:		
Preferred Stock	$100,000	
Common Stock	200,000	
Surplus	150,000	
Undivided Profits	100,000	
Reserve for Retirement of Preferred Stock	100,000	
Total Capital Funds	$650,000	Deposits $7,800,000

Assuming the retirement of the preferred and the transfer of the retirement reserve to surplus we have the following condition:

SITUATION III:		
Common Stock	$200,000	
Surplus	250,000	
Undivided Profits	100,000	
Total Capital Funds	$550,000	Deposits $7,800,000

Realized bond profits, having been used to retire the preferred, are no longer available as a buffer against future bond losses, and the total capital funds now amount to only 7 per cent of total deposits instead of the 8.2 per cent possible through the retention of bond profits in a contingency reserve.

Sound policy requires the permanent segregation of net realized bond profits and ordinary operating profits. Banks following this policy are thereby enabled to increase their operating profits through larger investment holdings. In our hypothetical bank, had the contingency reserve been more substantial, it would have been unnecessary to relegate $657,000 to the already adequate and low-yielding secondary reserve. In other words the larger the contingency reserve the larger the volume of bonds it is safe to hold and, therefore, the larger the amount of interest it is possible to earn.

Net Realized Security Profits and Bond Premiums.—In the management of any bond account there appears, from time to time, to be some advantage in switching from one issue to another. A particular issue may have suffered some deterioration in quality, a development which may or may not have been fully recognized by the market as a whole. Or the market price of a given issue may have risen to such high level that the yield to maturity, based on current market, is below that of other issues that appear to be equally desirable from every standpoint. Suppose, for instance, that a bank holds $10,000 of a certain 3 per cent bond issue bought at par. Suppose sometime later, say in 1943, that this issue is selling on a 2 per cent basis. The advance in market price reflects the combined effects of declining interest rates and shorter maturity. Suppose that

another bond carrying a 3 per cent coupon, with a one year longer maturity, and judged to be approximately as sound, can be purchased to yield 2.5 per cent to maturity. Selling the issue already held means the realization of a profit, and therefore the question of taxation is involved. This may in itself be sufficient to make the switch undesirable in spite of its obvious advantages otherwise. But there must be taken into account, also, the problem of the premium on the issue being considered for purchase. In Chapter 6 it was pointed out that sound practice requires that newly purchased issues be placed on the books at cost and the premium amortized regularly to maturity. In the case under consideration it is evident that this amortization process results in a smaller annual income than if the old issue is retained. As it stands, before the switch is made the entire coupon, or $300, is properly treated as interest income. If the switch is made the interest income will be $300, less the amount of the annual amortization charge. Thus an artificial factor is introduced which may deter the bank from making what we are assuming to be an otherwise desirable alteration in its portfolio. Part of the realized profit will have to be paid out in taxes and the annual interest income thereafter will be smaller. Face to face with this dilemma it appears desirable to relax our standards a bit.[4] Specifically, it is suggested as proper to use whatever portion of the realized profit is necessary in order to write off the premium on an equal par value of the issue it is wished to purchase. If this is done the amount of the annual interest income will remain unchanged at $300. If the issue to be purchased had not yet been decided upon, the net realized profit on the sale, after tax allowance, might be held in suspense pending the selection of another security into which the funds may be placed. In the final analysis this procedure envisages the utilization of net realized bond profits in a given year for the writing off of bond premiums on an equal par value of issues purchased during the same year. An added advantage accrues from the fact that this method does not result in writing up the bond account.

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[4] Wooster argues specifically against this. *Op. cit.*, p. 129.

A policy of this sort is purely pragmatic and runs counter to a strict application of the general principle set forth above that all net realized security profit of a given year should be carried to a contingency reserve. But no hard and fast rule, however sound and proper in and of itself, should be adhered to slavishly if by so doing the bank is restricted in its efforts to maintain the best bond portfolio possible. If the bonds purchased at a premium in a given year are of a quality similar to those sold at a profit, and if there is no great discrepancy in average maturities between those purchased and those sold, there can be neither a material alteration in book value nor in the interest income arising out of such transactions. There can be nothing but captious objection to any method of handling bond premiums which achieves these two fundamental objectives, and which does not permit the commingling of net realized bond profits and operating earnings. And, finally, the carrying of the bond account at a book value which is considerably below market prices constitutes a cushion against future depreciation just as effective as if all such profits are carried in a contingency reserve.

CHAPTER 9

THE CAPITAL ACCOUNT

Assumption of the risk of failure in any business organization properly belongs to those who will profit through the success of the enterprise. Capital furnished by the entrepreneur provides a margin of safety for outside creditors against the possibility that failure instead of success may attend the efforts of the promoters. The stockholders of a corporation which has already achieved some measure of success over a period of years still need to provide capital which appears to be adequate in view of the character of the business.

As applied to banking the implications of these generalizations are fairly obvious. The capital funds of a bank should provide a cushion sufficient to shield depositors against the necessity of participating in any losses experienced by the bank in managing the funds intrusted to its stewardship. Even with all of the depositors' funds invested wisely additional protection against adverse contingencies impossible to foresee should be provided in the form of a substantial stockholders' equity.

Investment of Capital Funds in Fixed Assets

If the investment of the stockholders in a banking institution is to serve as a cushion or margin of safety for the creditors, an excessive percentage of the funds representing this investment must not be committed to fixed assets for which there may be no market at anything corresponding to intrinsic values. For all practical purposes of a going institution funds invested in banking premises and equipment are permanently tied up. Consideration of the fact that stockholders, unlike depositors, cannot demand return of their equity led many bankers in the past to justify the use of those funds in the erection of imposing and costly banking structures, in some

cases large office buildings in which the bank's own quarters constituted a very small percentage of the total space. However profitable such investment may turn out to be, it is unsound banking to allocate to such assets an excessive portion of the stockholders' equity.

For many years the national banking laws provided [1] that a national bank might make investments in real estate "such as shall be necessary for its immediate accommodation in the transaction of its business." The Banking Act of 1933 limits investment in banking premises as follows: [2]

> Hereafter no national bank, without the approval of the Comptroller of the Currency, and no State bank, without the approval of the Federal Reserve Board, shall (1) invest in bank premises, or in the stocks, bonds, debentures, or other such obligations of any corporation holding the premises of such bank, or (2) make loans to or upon the security of the stock of any such corporation, if the aggregate of all such investments and loans will exceed the capital stock of such bank.

It is unfortunate that the legal limitation was not expressed in terms of capital and surplus instead of capital only. Presumably the combined capital and surplus represents the total permanent capital of a bank and the two items are largely interchangeable at the discretion of the bank. A bank with capital of $50,000 and surplus of $50,000 might erect a $50,000 building and remain within the legal limit. Its investment in building would thus amount to 50 per cent of its permanent capital funds. Another bank with the same capital but with only $25,000 surplus is also permitted legally to invest $50,000 in a building, but this second bank would have invested in this fixed form two-thirds of its permanent capital.

At the end of 1942 the capital stock of all insured commercial banks represented about 50.4 per cent of the combined capital and surplus. The law permits, therefore, the investment of 50.4 per cent of the permanent stockholders' funds in banking premises. That informed opinion regards this as markedly excessive is shown by the fact that on December 31, 1942, all

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1 Sec. 29, title 12, U. S. Code (1926).
2 48 Stat. 184, Sec. 14 (1933); U.S.C.A. title 12, Sec. 371 d (1933 Supp.).

insured commercial banks had invested in this form less than 20 per cent of their permanent capital.

So far as the item Other Real Estate is concerned, this is quite commonly recognized by bankers to be an undesirable asset and usually is held only to prevent or to minimize losses on previously extended loans. Such holdings are usually acquired through the foreclosure of mortgages and this is an indication of deficiency in earning power on the part of the borrower and a resulting market value of the property insufficient to cover the face of the mortgage. Therefore it is reasonable to suppose that such other real estate as is actually held at any given time can be disposed of only at a loss to the bank, and this loss is likely to be considerable if it must be disposed of in order to provide additional liquid funds. For these reasons it is necessary to consider it as a portion of stockholders' funds not available as a cushion for the depositors' protection. Whenever possible it should be carried as a nonbook asset.

The stock of Federal Reserve banks which all member banks are required to hold has proved to be a highly desirable type of earning asset in every respect except that of liquidity. It is a nonnegotiable investment and cannot be realized upon at all so long as the bank remains a going concern and a member of the Federal Reserve System. Among other stocks having similar nonliquid characteristics might be mentioned those of safe deposit companies or other affiliated financial institutions.

In order to determine the portion of the capital funds certainly available to meet depositors' demands it is necessary to deduct in addition to all doubtful items and substandard investments the sum of the amounts invested in these fixed forms—banking premises and equipment, other real estate, Federal Reserve bank stock, and other stocks held. The remainder, sometimes called "net capital funds," is the figure of real significance in determining the adequacy of the protection afforded by stockholders' funds.

On December 31, 1942, all insured commercial banks had invested approximately $1,400,000,000, or slightly less than 20 per cent of their total capital funds, in bank premises and equipment and other nonliquid assets. This sum just about

equals their combined undivided profits and reserves, but it is only 33 per cent of all capital items exclusive of capital stock.

Individual banks, of course, vary widely from this average. At the end of 1942, for instance, one fairly large metropolitan bank had almost 40 per cent of its capital funds frozen in these ways. Another bank in the same city employed for these purposes only 12.4 per cent of its capital funds.

Adequacy of Capital Funds[1]

In attempting to measure the adequacy of the capital funds in any individual bank it has been customary in this country to relate the gross capital funds to gross deposits. For a long time there was a rule of thumb that the gross capital funds should equal at least 10 per cent of the gross deposit liability. In the years before the war the Federal Deposit Insurance Corporation had set up this 10 per cent relationship as a sort of norm to which all insured banks should adhere. On this basis banks whose deposits amounted to fifteen or twenty times the capital funds were thus considered to be inadequately capitalized, and there were numerous instances in which such banks were strongly urged to acquire additional capital.

It is not the intention here to minimize the importance of the above capital-gross deposit ratio, nor even to assert that insistence on capital funds equal to 10 per cent of the gross deposit liability is an excessive requirement under normal conditions. The position taken here, rather, is that still greater importance attaches to a sound relationship between the net capital funds and depreciable assets.[3] After all, capital funds equal to 10 per cent or 20 per cent or even 30 per cent of deposits may prove to be entirely insufficient in the face of excessive exposure to risk on the asset side. On the other hand, 5 per cent may be adequate for the bank with minimum com-

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[3] In his Annual Report for 1940 the New York State Superintendent of Banks says: ". . . in determining the adequacy of capital many factors in addition to the ratio to deposits should be considered. Until a formula is evolved which will test capital sufficiency on the basis of the risk attendant to each class of assets, it seems advisable that each case be considered separately with primary regard to the character and condition of loans and investments."

mitments in fixed assets, large excess reserves, substantial secondary and investment reserves, and sound loan and bond portfolios which are not excessive in size.

Substantial support for this position is supplied by the results of certain investigations into the causes of bank failures. In some of these inquiries comparisons were made between banks that failed and those able to continue and a frequent point of attack was the capital-deposit ratio. The evidence unearthed failed to show that banks which succumbed during the thirties had maintained during the twenties capital-deposit ratios which were significantly lower than those which survived. For example, Michigan state banks outside Detroit and not failing before the banking holiday had, on December 31, 1928, capital funds equal to 10.96 per cent of gross deposits.[4] On the same date the 163 banks which failed had capital funds equal to 10.27 per cent of their gross deposits. As a group, therefore, the banks which failed had been maintaining, prior to the depression, capital funds somewhat above the minimum which it has been generally assumed sound banking practice requires. Furthermore, the difference in this respect between the continuing banks and those which failed was not substantial enough to lead to the suspicion that inadequate capital funds was an important factor contributing to their downfall.

Other investigations failed to find inadequate capital funds as the chief culprit in bank failures generally. In fact both Secrist's[5] and Cramer's[6] studies indicated that banks that failed had maintained typically for many years before failure capital-deposit ratios higher than the average for all banks.

Results of these investigations seem to support the proposition that it is the use made of funds coming into the possession of the bank which is the primary factor, not any particular relationship between capital funds and the deposit liability. As Liesy puts it: "It is necessary, therefore, to appraise capital in

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4 R. G. Rodkey, "State Bank Failures in Michigan," *Michigan Business Studies*, Vol. VII, No. 2.

5 Secrist, *National Bank Failures and Non-Failures.*

6 Cramer, *Denver as the Financial Center of the Eastern Rocky Mountain Section.*

the light of the character and quality of the assets rather than merely to measure it in relation to deposits."[7]

The conclusion seems warranted that the most significant of all comparisons is that between free or net capital funds and depreciable assets. Even here, however, there can be little justification for the insistence upon arbitrary standards. The quality of earning assets differs materially from bank to bank, and hence the degree of exposure to risk differs also. It has already been indicated that the risk is negligible in secondary reserve items while the risk incident to investment reserve assets is limited to changing interest rates; and since these assets have an average maturity of only 3½ years, adverse changes in interest rates can have only moderate repercussions on their market prices. Under conditions of total war many banks find it expedient to confine their secondary and investment reserves and their permanent bond portfolios very largely to direct and guaranteed obligations of the federal government and with short maturities properly spaced. On the other hand, some banks go in heavily for municipals and corporate issues, and not always of the highest quality. It is clear, therefore, that the real need for capital funds depends upon a variety of factors which differ from bank to bank and which cannot be reduced to an arbitrary standard relationship between capital funds and deposits.

It seems entirely consistent, however, to recognize the importance of the above considerations and at the same time to insist that under conditions in any way approaching normal the stockholders provide a substantial cushion for the benefit of depositors. If any business should be conducted upon a conservative basis it is surely banking. If a bank is to continue in business it must be able to make at least modest profits, and the chief source of profits must always be income on earning assets. Adequate protection against such losses as may eventuate is certainly one fundamental element in conservative banking policy.

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[7] Liesy, *The Fallacy of a Mandatory Deposit-Capital Ratio.* For a contrary point of view, see W. A. Paton, "Shoestring Banking," *The Certified Public Accountant,* June, 1933.

Conditions prevailing since 1934 have been decidedly unfavorable for the raising of bank equity capital.[8] After the banking holiday bank stocks were in general disrepute among investors for obvious reasons. They became still more unattractive as banks piled up higher and higher excess reserves. If safe and profitable outlets for their depositors' funds could not be found there could be little incentive to offering stock at bargain prices merely to add to already large volumes of unusable funds. The war financing program has tended toward the elimination of excess reserves, but it has also made inadvisable attempts to compete for investors' funds which otherwise might be channeled directly into government bond purchases.

So long as the war lasts the capital-to-loans-and-investments ratio is likely to decline to what in peacetimes would have been considered almost fantastically low levels. The only likely additions to present capital funds will come from retained earnings. If the war continues through 1945, demand deposits may reach the stupendous sum of 150 billions, with loans and investments up to 125 billions. Legal reserve requirements, of course, will have to be cut to make this expansion possible. If banks paid no dividends whatever, net annual addition to capital funds would not exceed $400,000,000. This means that total capital funds cannot be expected to exceed 8 billions. With loans and investments of 125 billions the equity cushion will fall to less than 6¼ per cent.[9]

Even though investments are primarily in governments this is not conservative banking as judged by ordinary standards. But conservative or not it will be necessary should the war not end before late in 1945. Faced with this prospect bankers will have to try to counterbalance the lack of conservatism in their overall position by adopting extra-conservative policies with

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8 The difficulty of raising bank equity capital has been accentuated by the failure of banks to disclose vital information as to their soundness and earning power. See Chapter 10.

9 Banks in the United Kingdom had a capital-deposits ratio of 15.3 in 1897. Thereafter, this ratio tended to decline with considerable regularity, just as it did in this country, and in 1942 reached a new low of 4.7 per cent.

respect to dividends and maturity schedules of their government bond accounts.

It is true that with deposit insurance in force not all depositors are deeply concerned about the solvency of the institution to which they intrust their funds. The Federal Deposit Insurance Corporation reported that during the year ended December 31, 1941, 15 insured banks closed or received assistance from the Corporation. In these 15 banks there were 73,000 depositors all but 241 of whom were fully protected. But these were small banks with average deposits of approximately $2,000,000. Inclusive figures for all banks show that while 98 per cent of all depositors are insured, less than 40 per cent of total deposits are fully covered. Thus corporations and other large depositors still find it desirable to carry balances only with sound banks, and these are the very depositors who, as a group, are best able to arrive at an intelligent conclusion about a bank's soundness. For the duration the getting and retaining of such accounts will be more and more conditioned on dividend and investment policies which are superconservative.

PART IV

PUBLIC RELATIONS

Development of sound public relations is a problem to which bankers have quite properly devoted increased attention in the years since the banking holiday of 1933. No intelligent observer can fail to recognize that a great deal has been accomplished in the way of overcoming the disesteem in which bankers generally were held at that time. This improvement has not come about either automatically or by accident. Bankers who were successful in outriding the storm, perhaps feeling that they were still on trial, have given much thought and devoted a great deal of energy to the problem of rehabilitating their profession in the eyes and minds of the general public. That they have been successful in large measure there can be no doubt.

There is reason to believe, nevertheless, that in certain fields full advantage has not been taken of splendid opportunities to cultivate still sounder public relations. Many bankers, in fact the great majority, have neglected one obvious means by which they might increase the esteem in which they are held by the general public. Reference is to the desirability of more informative statements of condition and clear, unequivocal annual reports made generally available to the public. Others have been remiss in the matter of educating the public not only as to the necessity for adequate service charges but also as to the justice and impartiality of the basis for determining the particular charges actually made. Some have not capitalized fully the possibilities in this direction of a superior body of employees and forward-looking personnel policies. Part IV is devoted to analysis of these three problems.

CHAPTER 10

BANK STATEMENTS AND REPORTS

The Statement of Condition

In banking journals and at bankers' conventions surprisingly little attention has been vouchsafed the character of the reports to public and stockholders which banks commonly make. The term "surprisingly" is used advisedly, because in few if any other lines of business are the affairs of the individual corporation disclosed to so limited an extent. Reports of the Comptroller of the Currency, of the Federal Reserve banks, of the Federal Deposit Insurance Corporation, and of the banking departments of certain states provide a veritable mine of valuable statistical information about banks in the aggregate. These supervisory agencies are all empowered by statute to require from each individual bank under their jurisdiction pertinent information as to the actual condition of the bank, of the sources and amounts of earnings, and of the disposition made of such earnings. Except in certain isolated cases, however, very little of this vital information about the individual bank ever reaches the public—the customers of the bank.[1]

The successful operation of a bank, probably to a greater extent than is true for any other kind of business, is dependent upon the confidence of the public in its soundness. It has already been shown that, despite deposit insurance, at least the sophisticated elements of the general public wish to do business only with those banks on whose soundness they can implicitly rely. From this it follows that not only should the policies pursued by the individual bank be consistent with the best practices of banks generally, but that some regularly recurring proof that such is the case should be supplied to the

[1] In an unpublished monograph Dr. J. Brooke Willis has made an analysis of some phases of the subject discussed in this chapter. Excerpts from this monograph will be found in Appendix B.

public. One obvious means by which a thoroughly sound bank may impress the general public, as distinguished from stockholders, with its complete reliability is the statement of condition which gives really pertinent data. Little information of real value can be found in the so-called statements of condition published by a great majority of banks in the general newspapers and financial journals and made available to depositors in bank lobbies. Frequently only little additional information is given the stockholders.

Regulations of the Comptroller of the Currency require the publication in at least one newspaper of a statement of condition conforming to a prescribed pattern. In most jurisdictions state banks and trust companies must also follow a definite form for the publication of their statements in at least one newspaper. Over such forms, of course, the individual bank can exercise no control whatever. In general these prescribed models leave much to be desired but in some respects at least they are in more detail than the condensed statements of condition prepared for other purposes. It is the practice, however, in at least some of the larger centers, to meet this minimum technical requirement by inserting the prescribed pattern statement in some obscure technical publication or by publishing it in very small type. For the general newspapers having wide circulation locally, and for use in their lobbies, such banks prepare statements which give even less information than that called for in the required model.

Supposedly all condensed statements of condition published by banks are intended as advertising material and obviously the amount of detail to be included is a matter to be determined by the individual banker. Typically such statements purport to give information of real value concerning the bank. The contention here is that they fail to do so. Certainly there could be no valid criticism of a bank which makes no pretense of giving pertinent information in any detail. For such purpose the following form would be sufficient:

Total Resources	$10,000,000
Total Deposits	9,000,000
Total Capital Funds	1,000,000

An advertisement of this sort would serve to bring the name of the bank before the public. In addition it would give some indication of the size of the bank and the extent to which it is trading on the equity.

Compare the above tabulation with the statement of condition given below. It was found in a special receptacle designed for the purpose in the lobby of a small suburban bank in a large eastern metropolitan area:

Resources

Cash and U. S. Government Bonds	$4,330,756.61
Investment Bonds and Securities	1,233,249.98
Loans and Discounts	1,351,059.86
Banking House and Other Real Estate	371,477.54
Income Accrued and Prepaid Expense	34,097.75
	$7,320,641.74

Liabilities

Capital	$ 378,800.00
Surplus	183,500.00
Undivided Profits	106,140.39
Unearned Income and Accrued Expense	41,529.81
Deposits	6,610,671.54
	$7,320,641.74

It is true that there is some information in this statement not contained in the simpler form shown above. We see, for instance, that the Capital account is almost entirely frozen, leaving only the Surplus and Undivided Profits as a margin of safety for the depositor. We see that the book value of the Cash and Governments equals about 65 per cent of gross deposits, a conservative relationship.[2] But government bonds are not synonymous with cash and since these two items are combined we are unable to estimate the exposure to risk from government bonds. We are not informed whether the figures at which all bonds are carried are at, below, or above market prices. If the figures for bonds in the above statement represent

2 This is the only index of liquidity available in typical bank statements of condition. It is purely a makeshift since it does not show the real liquidity, but since bank statements fail to disclose their secondary and investments reserves it is the nearest approach to a measure of liquidity which they provide.

approximate market prices on March 26, 1940, the date of the statement, then two months later it is entirely possible that this bank was insolvent. During that period, when the German armies were overrunning the low countries and northeastern France, there was a drastic decline in the prices of all bonds. It is clear, therefore, that the information in this statement is not sufficient to justify any depositor in carrying a balance with this bank in excess of the $5,000 which is covered by insurance. From personal knowledge the writer has every reason to believe that this bank is in a sound condition. But the point is that this statement does not prove it. As an advertisement, therefore, they might as well use the three-item tabulation given on page 136.

Attention is directed to the following actual statement of condition, dated December 31, 1932, of a national bank which was not permitted to reopen after the banking holiday:

Resources

Cash in Vault and in Banks	$ 4,092,879
U. S. Government Securities	1,580,773
Other Securities	1,377,628
Loans and Discounts	6,280,105
Real Estate Mortgages	1,747,052
Accrued Interest Receivable	149,263
Banking Quarters and Other Real Estate	878,600
Customers' Liability under Acceptances and Letters of Credit	87,494
	$16,193,294

Liabilities

Capital Stock	$ 1,000,000
Surplus	500,000
Undivided Profits	17,331
Reserves	249,876
Liability under Acceptances and Letters of Credit	87,494
Circulation	500,000
Deposits	13,838,592
	$16,193,294

The small Undivided Profits account is the only item in this statement which might lead to suspicion that this was not a thoroughly sound bank, but the rather substantial figure for

Reserves might be assumed to be a partial offset to the small figure for Undivided Profits. Gross Deposits plus Circulation were less than ten times the total capital funds. Its primary reserves were almost 30 per cent of the gross deposit liability while the primary reserves plus government securities amounted to over 40 per cent of gross deposits. Its investment in fixed assets was somewhat excessive but still far below the maximum later authorized by federal statute. Yet the actual condition of this bank was so bad that it was not permitted to reopen after the banking holiday less than three months later. In due course it transpired that this bank had no secondary or investment reserves except for the small portion of government securities which qualified for these reserves. The actual value of its Other Securities turned out to be but little over 50 per cent of the book value shown on the statement. A large percentage of its loans and discounts was represented by overdue paper on which large write-offs were necessary. Its mortgage portfolio was in bad shape. Only a small percentage of the mortgages were on an amortization basis and both interest and taxes were in arrears on many individual items. A mere recital of these facts is sufficient proof that the statement of condition as furnished the general public failed to reveal the true situation.

Reference has already been made to the fact that banks must publish in at least one newspaper a statement of condition in accordance with a pattern prescribed by the regulating authorities, and also to the fact that the pattern currently required by the Comptroller of the Currency calls for pertinent information in more detail in some respects than banks commonly use in their condensed statements to which wider publicity is given. But this required pattern itself is open to serious criticism. Reference to Figure B shows, for instance, that it lumps together real estate mortgages, other loans to customers, open-market commercial paper, bankers' acceptances, and demand loans to brokers in one item called "Loans and Discounts, Including Overdrafts." No statement is required that the figure shown is net after provision for all doubtful items or that the item Reserves on the liability side is sufficient to take care of all

FIGURE B

FORM REQUIRED BY COMPTROLLER FOR STATEMENT OF CONDITION

ASSETS

1. Loans and Discounts (including $..... Overdrafts)....
2. United States Government Obligations, Direct and Guaranteed.....
3. Obligations of States and Political Subdivisions.....
4. Other Bonds, Notes, and Debentures.....
5. Corporate Stocks (including $..... stock of Federal Reserve Bank).....
6. Cash, Balances with Other Banks, including Reserve Balance, and Cash Items in Process of Collection.....
7. Bank Premises Owned $....., Furniture and Fixtures $.....
8. Real Estate Owned Other Than Bank Premises .....
9. Investments and Other Assets Indirectly Representing Bank Premises or Other Real Estate. .....
10. Customers' Liability to This Bank on Acceptances Outstanding .....
11. Other Assets.....
12. Total Assets.....

LIABILITIES

13. Demand Deposits of Individuals, Partnerships, and Corporations.....
14. Time Deposits of Individuals, Partnerships, and Corporations
15. Deposits of United States Government (including postal savings).....
16. Deposits of States and Political Subdivisions.....
17. Deposits of Banks.....
18. Other Deposits (Certified and Cashier's Checks, etc.).....
19. Total Deposits.....
20. Bills Payable, Rediscounts, and Other Liabilities for Borrowed Money.....
21. Mortgages or Other Liens, $..... on Bank Premises and $..... on Other Real Estate.....
22. Acceptances Executed by or for Account of This Bank and Outstanding.....
23. Other Liabilities.....
24. Total Liabilities.....

CAPITAL ACCOUNTS

25. Capital Stock.....
26. Surplus.....
27. Undivided Profits.....
28. Reserves.....
29. Total Capital Accounts.....
30. Total Liabilities and Capital Accounts.....

doubtful items. No breakdown of bond maturities is required, nor any statement indicating that the figure shown for bonds is not in excess of market prices. Savings deposits are not distinguished from other Time Deposits. Much of this information is given in other sections of the form on which banks are required to report to the Comptroller of the Currency, but the omission of these vital details from the form which must be published serves to stymie the analyst and makes it impossible for him to come to any assured opinion as to the soundness of a given individual institution. Maintenance of adequate secondary and investment reserves is an evidence of sound, conservative banking. But information necessary to determine their amount is totally lacking. It is impossible to relate the loans on the security of real estate to savings deposits, the source of funds for such loans. Savings deposits are usually far more stable in character than are other time deposits, a tendency which has been accentuated since interest on demand deposits has been outlawed. But the necessary information is not revealed to the analyst.

Despite the bad example set by the regulating authorities it is not difficult to find samples of bank statements, published ostensibly for advertising purposes, which contain vital information omitted from the official patterns. Loans on the security of real estate were found segregated in statements of several very large banks. Open-Market Commercial Paper is distinguished from other loans in the statement of one bank while another lists the item Call Loans and Acceptances of Other Banks. In its statement of December 31, 1941, published in the *Wall Street Journal,* one important institution carried its United States government bonds at par and divided them into those "Due prior to January 1, 1947," and those "Due after January 1, 1947." Its state and municipal securities and its other bonds and investments were also divided according to maturity before or after January 1, 1947. Furthermore, the all important clause "Not exceeding market value" was inserted with each group.[8] Another large bank

[8] In more recent statements this praiseworthy practice has been discontinued.

published its June 30, 1939, statement in the *Wall Street Journal.* Total Securities were carried at $565,900,013.75, and it is stated that the "market value exceeds this amount" and that the amount itself is "after deduction of reserves" of $5,135,499.89. In one published statement of condition U.S. Government Securities, Securities Called or Maturing within One Year, and Other Marketable Bonds and Stocks are carried at "Cost or Market, whichever is lower." In this same statement there is shown a sizable Reserve for Contingencies as distinct from Accrued Interest, Expenses, Taxes, etc. Evidently this institution wishes to make use of its published statements to give indisputable proof of its soundness. Just why sound banks in general should not wish to take advantage of every opportunity to prove this is not clear.

A statement in the form presented on the opposite page would give to the reader information which is really necessary if he is to come to a reasoned conclusion as to the soundness and liquidity of the bank.

By using a pattern similar to the suggested model a bank would enable the analyst to make deductions of real significance. From it he can determine quickly the primary and secondary reserves separately and make an estimate of the exposure to risk of changing interest rates to which all bonds held are subject. Furthermore real liquidity can be determined as distinct from the makeshift ratio which attempts to measure liquidity by comparing cash and governments with gross deposit liability. He can compare real estate mortgages with savings deposits, other loans to customers with demand deposits, fixed assets with capital account. He knows that bank deposits and public deposits are usually far less dependable in the aggregate than are demand deposits due individuals, partnerships, and corporations, and is therefore interested in these figures as separate items. Because he knows that savings deposits are likely to be far steadier than other time deposits it is important for him to have separate figures for these items. He knows that the bank has estimated its probable losses and has set up a contingency reserve ample to take care of them. He is not interested in separate figures for overdrafts, prepaid expense,

Model Statement of Condition

Resources

Cash and Due from Banks .....

Call Loans, Acceptances of Other Banks, and Commercial Paper (if any) .....

U. S. Government Securities*

Due within 1 year .....

Due 1 to 6 years .....

Due after 6 years .....

Total Government Securities .....

Municipal Securities (Average Maturity years).....

Other Securities (Average Maturity years).....

Real Estate Mortgages .....

Other Loans to Customers .....

Bank Premises, Equipment, and Other Real Estate.....

Other Assets .....

Total Resources .....

Liabilities

Due Depositors

Bank Deposits .....

Public Deposits .....

Other Demand Deposits .....

Total Demand Deposits .....

Savings Demand Deposits .....

Other Time Deposits .....

Total Time Deposits .....

Total Due Depositors .....

Other Liabilities .....

Capital Account

Common Stock .....

Preferred Stock .....

Surplus .....

Undivided Profits .....

Contingency Reserve† .....

Total Capital .....

Total Liabilities and Capital .....

* Market value of each class of securities equals or exceeds figures shown.
† Reserve for Contingencies exceeds all probable losses.

income accrued but not collected, income collected but not earned, accrued expenses and taxes, nor in the offsetting items covering acceptances and letters of credit. It is rather common to include these relatively unimportant items in published statements of condition, but except for large metropolitan institutions they can well be grouped under the headings Other Assets and Other Liabilities. Thus the really significant items stand out in bold relief.

Advertising the bank would seem to be the primary objective in the publication of all statements of condition except those which are required by the regulating authorities. It seems obvious that sound, conservatively managed banks would derive much greater returns from this advertising if the statements were prepared in such manner that soundness and conservatism would be clearly defined. The pattern presented is intended to be merely suggestive of the means by which the real character of the institution may be made known, and public relations correspondingly improved.

The condensed general statement of the Bank of Nova Scotia was published in the *Wall Street Journal* in January, 1943. Since it is typical of Canadian bank statements as published in newspapers and banking journals its listing of assets is presented herewith:

Cash, clearings, and due from banks	$ 89,102,723.02
Government and other public securities, not exceeding market value	105,039,341.73
Other bonds and stocks, not exceeding market value	10,482,058.64
Call loans (secured)	4,538,836.37
Other loans and discounts (after full provision for bad and doubtful debts)	126,777,447.39
Liabilities of customers under letters of credit and acceptances (as per contra)	21,244,614.62
Bank premises	5,607,060.44
Shares of and loans to controlled companies	2,050,000.00
Other assets	624,972.79
Total assets	$410,467,055.00

It is obvious that this statement is much more informative than typical statements of American banks. Government and

other public securities and Other bonds and stocks are carried at figures "not exceeding market values." Call loans are segregated and "Other loans and discounts" are "after full provision for bad and doubtful debts." In other words, the Bank of Nova Scotia is a thoroughly sound institution, and it, like other Canadian banks, believes that it is worth while proving that fundamental fact in its published statements of condition.

That American banking statements *can* be just as informative as the Canadian is demonstrated by the June 30, 1943, statement of a very old American banking institution, also published in the *Wall Street Journal.* It lists its assets as follows:

Assets

Cash on Hand and Due from Banks	$ 32,583,398.67
United States Government Securities *Valued at Cost or Market whichever lower*	66,446,329.93
Call Loans and Acceptances of Other Banks	7,893,346.52
Securities Called or Maturing within One Year *Valued at Cost or Market whichever lower*	7,926,759.97
Loans and Advances	27,551,987.08
Marketable Bonds and Stocks *Valued at Cost or Market whichever lower*	16,087,037.54
Customers' Liability on Acceptances	6,691,365.92
Other Assets	486,376.55
	$165,666,602.18

The Annual Report

A statement of condition, even though prepared for the purpose of giving full information, necessarily supplies a picture of a bank at a given moment of time—"At the close of business"—on the specified date. It can throw no light on the road traversed in reaching that particular destination. A comparison of successive statements over a period of years is somewhat helpful. From this comparison trends may be observed and some tentative conclusion reached about the extent of progress achieved. But the information is incomplete without an income statement or at least without information concerning the sources of income and its disposition. Banks quite properly insist on having such details from their borrowing customers.

With few notable exceptions, however, they have failed to make available to the general public similar information about themselves.

Over a long period of years prior to the securities regulation acts of the Roosevelt Administration there had been a growing tendency on the part of the rank and file of leading publicly owned American corporations in all lines of activity except banking to improve the quality of their reports to stockholders and the public generally. Additional impetus was given this tendency by the requirements of the Securities Act and the Securities and Exchange Control Act. In fact a number of students of the subject feel that the principal justification for these acts lies in the requirements for a complete disclosure of all pertinent facts. Even under securities regulation, however, some conservative investors avoid the securities of certain large well-known companies because they feel that certain relevant information is withheld. On the other hand, a few corporations have received much favorable attention because of the complete disclosure of details essential to determination of their investment quality.

In spite of their progressiveness in most directions bankers have lagged far behind the procession in this respect. We have already seen that the typical statement of condition which is used for publicity purposes actually advertises little except size, a detail about which bankers themselves are more interested than is the general public. So far as income figures are concerned it will be shown shortly that only a small minority of even leading American banks furnish information at all comparable with that supplied by most corporations in other lines of business. In January, 1941, in an editorial *Barron's* summed up the case as follows:

> At present the widely-varying ways in which [bank] reports are made seem incredible in an era of "truth-in-securities." The majority of publicly-owned corporations have been reporting earnings in a definite, easily understood manner for many years. And while there are variations in their methods of accounting for certain items—such as, in the oil industry, the cost of drilling new wells—the reported figures do generally permit intelligent analysis.

But in the case of banks, which also are owned by numerous stockholders, the situation approaches chaos. On page 7 is a table of *indicated* earnings of New York banks in 1940. *Indicated* earnings are those derived from a comparison of annual statements. You take the surplus at the end of the latest period and deduct from it the previous surplus, add dividends paid during the period, and divide the net result by the number of shares outstanding. In some cases the figure thus obtained represents actual net earnings, but in other cases various adjustments, which need to be allowed for, are not shown, and real earnings are quite different.[4]

In recent years, however, there has been more evidence of an awakening interest in the quality of their annual reports than there has been in their published statements of condition. Both the American Bankers Association and the New York State Bankers Association have interested themselves in this problem. They have aimed to formulate a simple, standard Earnings and Expense Report for use in providing information for "stockholders, reporting services, financial departments of insurance companies and treasurers of other large corporations who are evidencing increased interest in the receipt of such information from banks."[5] The form which has been suggested is presented herewith.

If it were the common practice for all banks to issue annual reports even in this condensed form, and if the report included also an informative statement of condition such as has been suggested herein, there would exist less reason for accusing banks of concealing vital information. The wording in the suggested form indicates, moreover, that the American Bankers Association Committee had definitely in mind the idea that such reports would be printed and made generally available to those interested. Not only present and potential stockholders are interested but also all depositors whose balances exceed the $5,000 protected by deposit insurance.

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[4] In a letter from the president of a large metropolitan trust company the following statement appears: "We own a number of different [bank] stocks in trust, and an effort to decide which one would seem to be an attractive purchase, and which ones would seem to be a proper sale, brings one squarely up with the fact that the information at hand is not adequate."

[5] G. Fred Berger in "Report of Committee on Bank Report Form Simplification," as quoted in *Banking*, February, 1943, p. 54.

CONDENSED REPORT OF EARNINGS FOR SHAREHOLDERS AND OTHERS

(For year ending December 31, 1942)

CURRENT OPERATING EARNINGS	
Interest on Loans	
Interest and Dividends on Securities	
Other Current Operating Earnings	
Total	
CURRENT OPERATING EXPENSES	
Interest Paid	
Salaries and Wages	
Other Current Operating Expenses	
Total	
NET CURRENT OPERATING EARNINGS	
Reconcilement of Surplus and Undivided Profits	
Surplus and Undivided Profits at beginning of year	
Net Current Operating Earnings (as above)	
Miscellaneous Additions (Net)*	
Less:	
Dividends Declared	
Other Deductions†	
Surplus and Undivided Profits at end of year	

* Any large items could be detailed in the publication.

† The actual published caption will be a specification of the deduction in each particular case.

So long, however, as really informative statements of condition are not to be published it seems that once a year, through the medium of a printed annual report, banks would be well advised to make a complete disclosure of their affairs. Examination of a few annual reports indicated the existence of wide differences among banks in this respect. This condition suggested the desirability of making a more comprehensive survey of current practice. For the purpose of this survey, requests for annual reports were sent to forty-four large and widely known representative banks in all parts of the country. Of these forty-four banks eight reported that they made no printed report whatever, but that the chairman or president read certain figures at the annual stockholders' meetings. One other insti-

tution reported that its annual report was intended for stockholders only. One bank sent merely its year-end statement of condition, with no comments. So far as these ten institutions are concerned the implication is that their depositors are not interested in the soundness of the banks with which they do business and that present stockholders are not concerned about the market price of their stocks.

Examination of the thirty-four annual reports actually received reveals that six follow faithfully the earnings and expense form recommended by the American Bankers Association and include in their reports their year-end statements of condition. Four of these six also give the average maturity of their government bond accounts. One shows its profits on sales of securities and recoveries, both of which are excluded from the income figures, and states that they are transferred directly to reserves.

For three other banks the operating figures are somewhat less detailed than in the recommended form but in other directions their reports include significant information. One gives an analysis of its various reserve accounts. Another shows its security profits (after taxes) and indicates the transfer of this item to Deferred Income. This particular institution also shows average maturities and says that:

> United States Government Securities are stated at amortized cost; all other readily marketable securities at not more than the lower of amortized cost or market; other securities at not more than the lower of cost or fair valuation; and loans and discounts, first mortgages on real estate, headquarters building and other real estate after deduction of valuation reserves.

The report of the third of these banks is unique in that while it gives no breakdown of its Gross Income it supplies other information of real significance. Its securities are divided into four classes with both market and book values for each class. While a breakdown of the gross income into its principal component elements is desirable it certainly is not as important as this proof of the soundness of the bank on the basis of current

values. Other commendable features of this report might be mentioned:

Breakdown of expenses into six divisions
A full explanation of its Reserves account as shown on the statement of condition
For the past ten years a year-by-year comparison of average resources, earnings, and percentage realized
Analysis of its deposits, as follows:
  Interest Bearing
    Savings (Thrift) Accounts
    Certificates of Deposits and Special Time Amounts
  Non-Interest Bearing
    Commercial:
      Commercial Checking Accounts
      Checking Accounts of Other Banks
      Cashier's Checks, etc.
    Public Funds
    Trust Deposits

Among twenty-one other annual reports which did not give all the information about their operations which is called for in the American Bankers Association form a few gave other valuable data. One segregated its trust income and two others indicated their net security profits. Only one of these stated, however, that these profits had been carried to a bond reserve account. One reported that "recoveries on charged-off items during the year have not been taken into consideration in the income account presented herewith, but have been used, together with other additions from current earnings, to build up interior reserves of the bank against possible future losses." As a matter of fact, however, this particular bank supplied no income account whatever. The only income item given is the figure of "net profits for the year after all bad and doubtful debts have been charged off." Three of these twenty-one annual reports gave the average maturity of their government bond portfolios and three stated that their securities as a whole were carried at below market values. One reported that government bonds were carried at par or less and that all bond

premiums had been charged to profit and loss. Still another gave an analysis of its reserve accounts in two-year comparative form.

The remaining four reports gave not only more than the minimum operating data but also other pertinent information. One of these follows the American Bankers Association form exactly but adds an analysis of its securities profits and their allocation. It also analyzes its Amortization Fund, gives the maturities of its government securities, and its statement of condition in comparative form for two years.

In another report we find a five-item breakdown of earnings and under current operating expenses twenty-seven different items. There is also an analysis of charges and credits to valuation reserves. Even more important, we find that the entire investment portfolio had a market value exceeding book value by over 8 per cent. Approximately 97 per cent of the governments mature within five years and 75 per cent of all other securities within three years.

Each of the remaining two reports gives a four-item breakdown of earnings. One lists operating expenses under five headings, the other under six. In both, depreciation of building and equipment is included, as it should be, in determining total operating expenses. One treats as nonoperating income both net profits on sale of securities and recoveries and miscellaneous credits. From the sum of these the following deductions are made:

Advanced amortization on government securities
Reserve for securities
Losses, charge-offs, and write-downs

The remainder is carried to Reserve for Contingencies.

The other bank makes no mention of bond profits but net recoveries are carried directly to Undivided Profits. This bank gave both its statement of condition and its operating statement in two-year comparative form. Both reports give average bond maturities but only one states that "the market value of all securities owned is at present substantially greater than book value."

An annual report which contained all the best features of the thirty-four reports surveyed would supply all the information necessary to determine both the soundness of the institution and the investment merits of its stock. Large depositors are primarily interested in data which will enable them to determine its soundness. Both present and prospective stockholders are concerned with facts which will permit an intelligent appraisal of the investment merits of the stock in relation to market price.

The statement of condition in every annual report surveyed shows cash and its equivalent plus direct and fully guaranteed governments as a substantial percentage of total deposits. As a matter of fact these percentages ranged from about 50 per cent to over 85 per cent. This fact alone, however, is not sufficient to prove the institution sound. The analyst needs to know something about the extent of exposure to risk of market price fluctuations, and in order even to approximate that the minimum information required is the average of maturities. So far as carrying values are concerned, the minimum information necessary is the statement that these values do not exceed market quotations. A classification of deposits such as that included in the annual report mentioned on page 150 adds to the value of the report as a whole.

The three-item breakdown of current operating earnings as suggested by the American Bankers Association's Committee would seem to be a minimum. If the figure for Other Current Operating Earnings is relatively large it would seem desirable to deduct from it and report separately any source of revenue which represents a sizable percentage of the total. In several reports, for instance, trust income is reported separately. One bank with substantial rental income is careful to segregate that item. In only one report is income from service charges on deposit accounts reported separately, and in that particular instance these charges amounted to less than 3 per cent of operating earnings. The principal executive of one large bank reported that he did not like to show this item separately because it was so large he feared criticism from depositors. How much validity attaches to that view this writer does not

pretend to know. It seems not unreasonable to suppose, however, that the good will engendered by frank and complete disclosure of the overall affairs of a bank would be more than adequate compensation for any such criticism as might arise over the size of service charges.

In principle the foregoing remarks about Other Current Operating Earnings apply with equal force to Other Current Operating Expenses. That is, it is desirable to segregate any relatively large item or any item without regard to size the treatment for which no universal banking practice prevails. Thus in one earnings statement the first item under expenses is Amortization of Premiums on Securities. The figure here represents about 14 per cent of total operating expenses. If premium amortization is to be handled in this way it is certainly desirable to show the item separately, especially if the amount involved is large. In another statement we find Current Premium Amortization, with no amount stated, used as a deduction from income on securities. In this same statement, Advance Amortization on Government Securities, with the amount stated, is included with other items as deductions from nonoperating income.

Other expense items segregated in various statements are Federal Deposit Insurance, Taxes, Depreciation, Rent, and Insurance. In only one statement is the figure for depreciation shown as a single item under operating expenses, but in several operating earnings are derived only after clearly including in operating expenses a charge for depreciation, although in combination with certain other items.

A few of the better annual reports show clearly the treatment accorded to profits realized on the sale of securities, recoveries, losses, and charge-offs and write-downs. There can be little doubt that such facts add materially to the value of the annual report both for depositors and stockholders and increase the public esteem in which the bank is held.

For a number of years one of the banks included in the survey followed the custom of publishing in the general newspapers of its city both its statement of condition and its income statement "because it is felt that depositors, customers, and

prospective customers will be interested." From the report dated December 30, 1939, the following abstracts are presented:

The net amount carried to Undivided Profits December 30, 1939, as shown in our Profit and Loss Account report below, amounts to $839,780.14, equal to $14 a share on our $50 par stock, or 14 per cent on our Capital and Surplus:

Undivided Profits at Beginning of Year....		$1,040,000.00
Net Interest Income on Loans	$1,055,486.80	
Net Interest Income on Securities	728,363.23	
Net Profit on Sale of Securities.....	429,748.01	
All Other Income	450,636.50	
Total Gross Income	$2,664,234.54	
Total Operating Expenses, including Salaries, Interest on Time Deposits, Taxes, Federal Deposit Insurance, Depreciation, Transfers to Reserves, etc.	$1,824,454.40	
Net Addition to Undivided Profits.....		839,780.14
Undivided Profits End of Year.....		$1,879,780.14

Total Reserves for possible losses, depreciation on bonds, stockholders' taxes, and other contingencies, amount to $452,146.04, and are adequate in the opinion of your directors and officers.

Our policy of confining our investments to readily marketable, short and intermediate term securities has been continued. The market value of our securities at present is substantially above the figure at which these are carried on the books.

Particular attention is called to the fact that while net profit on sale of securities is improperly included with other items of operating income its exact amount is stated openly. This procedure at least makes it possible for the analyst to eliminate it in order to compute the operating earnings with some measure of exactness. Furthermore, the size of the contingency reserve is separately given, with a statement to the effect that it is considered adequate. It will be noted, also, that depreciation appears where it belongs, among the other operating expenses. Although unfortunately the main items of expense are not segregated, the breakdown of Gross Income into its chief constituent elements is praiseworthy and in line with sound corporate reporting in nonfinancial institutions.

It is to be regretted, therefore, that later annual reports to stockholders discontinued this forward-looking practice. In its annual report for 1942 the operating figures begin with "Gross Earnings, including Interest from Loans and Securities, and Other Income."

The survey was confined to relatively large metropolitan banks. A few isolated examples suggest that among smaller institutions a few may be found following the practice of making complete disclosure of vital facts. For instance, in its annual report dated April 30, 1940, the Equitable Trust Company of Wilmington, Delaware, publishes a five-year balance sheet comparison and a two-year comparative income and expense statement. For illustrative purposes it seems worth while to present these statements in full.

In the balance sheet comparison it will be noted that both "short-term securities" and "short-term commercial paper" are listed separately. Also praiseworthy is the footnote indicating that the market value of securities was 1.6 per cent higher than the figures shown in the statement. In addition to this there is a sizable reserve for contingencies. In the comparative income and expense statement attention is called to the fact that profits and recoveries on securities and real estate are used exclusively for write-downs and reserves. A table of bond maturities is also given and the distribution of securities according to classes.

In spite of the obvious merits of this annual report there are two serious omissions. Reference is to the lack of detail concerning the sources of the operating income and the absence of a breakdown of total expense into its principal subdivisions. With the addition of these details this report might well serve as a model for other banks regardless of size.

The New Milford Savings Bank of New Milford, Connecticut, is a small institution which gives a really complete statement of operations in its annual report. In its report for the fiscal year ending June 30, 1943, it also gives a detailed list of all bonds at par value, followed by a recapitulation by classes of securities, showing total par value, total book value and total market value for each class. For each group, market

TABLE XVIII. EQUITABLE TRUST COMPANY

Wilmington, Delaware

FIVE-YEAR BALANCE SHEET COMPARISON

	April 30, 1940		April 30, 1935	
Resources				
Cash and Due from Banks	$ 8,972,524.95		$ 3,448,121.68	
* U. S. Government Securities	4,722,868.26		2,528,720.61	
* Short Term Securities	1,649,298.95		1,974,568.36	
* All Other Securities	712,461.87	$16,057,154.03	1,362,293.40	$ 9,313,704.05
Short Term Commercial Paper	$ 720,000.00		$ 1,195,000.00	
Loans Due on Demand	4,323,952.99		4,236,228.36	
Loans Due within 90 Days	2,551,695.01		723,551.25	
Loans Due after 90 Days	473,824.96		381,510.57	
Construction Mortgage Loans	270,800.00		59,500.00	
Mortgage Loans	500,273.04	8,840,546.00	345,529.94	6,941,320.12
Banking House		213,000.00		239,748.56
Furniture and Fixtures		49,943.60		65,866.54
All Other Real Estate Owned		53,756.65		110,116.73
All Other Assets		68,512.29		84,054.75
Total Resources		$25,282,912.57		$16,754,810.75
Liabilities				
Demand Deposits	$19,753,049.42		$11,654,708.41	
Special Time Deposits	915,000.00	20,668,049.42	570,581.31	12,225,289.72
Dividends Payable May 1		60,000.00		75,000.00
All Other Liabilities		35,046.23		54,648.85
Reserves for Contingencies		236,119.77		392,510.44
Capital Stock	$ 1,500,000.00		$ 1,500,000.00	
Surplus	2,500,000.00		2,100,000.00	
Undivided Profits	283,697.15	4,283,697.15	407,361.74	4,007,361.74
Total Liabilities		$25,282,912.57		$16,754,810.75

* Net Market Value of Securities—1940 1.6 per cent higher.
1935 .2 per cent higher.

TABLE XIX. EQUITABLE TRUST COMPANY

Wilmington, Delaware

COMPARATIVE INCOME AND EXPENSE STATEMENT

	1940		1939	
Operating Income		$718,676.59		$704,371.29
Operating Expense, Including Normal Amortization, Depreciation, Reserves, Merit Bonus, and Taxes		$480,396.90		$461,549.43
Net Operating Earnings		$238,279.69		$242,821.86
At the Rate of		$3.97 a share		$4.05 a share
Plus:				
Profits and Recoveries (Securities and Real Estate)	$77,888.27		$26,293.14	
Less:				
Transfers to Reserves and Write-downs	$77,888.27		$21,242.79	
Net Nonoperating Income		$ 0.00		$ 5,050.35
Net Profits		$238,279.69		$247,872.21
At the Rate of		$3.97 a share		$4.13 a share
Dividends Paid—$3.25		$195,000.00		$195,000.00
Net Addition to Undivided Profits		$ 43,279.69		$ 52,872.21

value exceeds book value. The bonds are listed by maturity dates, with a total for each year. Moody's rating is given for each item. The Merchandise National Bank of Chicago is yet another institution which publishes a thoroughly complete and adequate report, including in it in comparative form both statements of condition and income and expense statements. In this statement securities are carried at market value.

Examples might be multiplied but those given are sufficient to indicate the extent to which a minority of progressive banks, both large and small, make available to the general public information essential for the competent outsider to appraise the soundness both of their actual condition and the policies being followed.

The observation was made earlier that the pattern prescribed for "Bank Call" statements of condition by the regulating authorities leaves much to be desired. A bad example is set also in the form of the reports required from banks by the Federal Reserve bank covering earnings, expenses, and dividends. After a figure called "net earnings" has been determined the following items appear:

Recoveries, profits on securities sold, etc.:
  Recoveries on loans
  Recoveries on bonds, stocks, and other securities
  Profits on securities sold
  All other
    Total
    Total net earnings, recoveries, etc.

Losses and depreciation:
  On loans
  On bonds, stocks, and other securities
  On banking house, furniture, and fixtures
  Other losses and depreciation
    Total
Net addition to profits

Depreciation on banking house and furniture and fixtures is just a plain ordinary, every-day operating expense and there can be no justification for failure to include it with the other

items of expense before arriving at any net figure of any kind. This practice is universally followed by nonbanking enterprises and also by the Federal Deposit Insurance Corporation.

In November, 1942, the Comptroller of the Currency revised the form calling for Report of Earnings and Dividends and included as one item under Current Operating Expenses "Recurring depreciation on banking house, furniture and fixtures." Much is to be said, also, for including among operating expenses, as clearly designated items, normal losses on loans and securities, since these are regularly recurring phenomena in the operation of banks. Equally sound arguments exist for inclusion among earnings, also as clearly designated items, recoveries on loans and securities. Nevertheless the practice of showing profits, losses, and recoveries in a separate section need not be condemned. This procedure simplifies the determination of net earnings from current operations, which is an exceedingly important figure for comparative purposes. It is important, however, to label this item correctly as is done in the revised form of the Comptroller of the Currency. Even at this late date it is encouraging to find the regulating authorities catching up with sound practice in other lines of business. Section 1 of this revised report form is shown in Figure C.

It is true that the general public is not sufficiently well informed to appraise the soundness of a bank however complete the nature of the information which is supplied. But it is the sophisticated element of the general public whom it is important to impress with the soundness of the institution and the quality of its management. Pursuit of a policy which aims to give information of real significance to the general public is a first-class generator of confidence and goodwill. By placing its cards on the table the bank having nothing to conceal, however, gains not only public confidence and respect. The mere fact that vital information is to be given regularly provides an additional incentive to bankers to keep their houses in order, their institutions in a condition which competent outsiders will not be able to criticize.

In investment analysis in general it is difficult to place too much emphasis on the quality of the management. But because

FIGURE C

SECTION 1. SOURCES AND DISPOSITION OF EARNINGS

	Six Months Ended December 31	Year Ended December 31
1. EARNINGS FROM CURRENT OPERATIONS:		
(a) Interest and dividends on securities....	$	$
(b) Interest and discount on loans..		
(c) Service charges and other fees on bank's loans.....		
(d) Service charges on deposit accounts....		
(e) Other service charges, commissions, fees, and collection and exchange charges...		
(f) Trust department.....		
(g) Other current earnings (itemize large amounts).....		
.....		
.....		
(h) Total earnings from current operations.....		1h
2. CURRENT OPERATING EXPENSES:		
(a) Salaries—officers (Number on pay roll at end of year_____).....		
(b) Salaries and wages—employees (Number on pay roll at end of year_____)		
(c) Fees paid to directors and members of executive, discount, and advisory committees.		
(d) Interest on time deposits (including savings deposits)		
(e) Interest and discount on borrowed money.....		
(f) Taxes other than on net income.....		
(g) Recurring depreciation on banking house, furniture, and fixtures.....		
(h) Other current operating expenses (itemize large amounts).....		
.....		
.....		
(i) Total current operating expenses..		2i
3. NET EARNINGS FROM CURRENT OPERATIONS (Item 1h minus Item 2i)		
4. RECOVERIES AND PROFITS:		
(a) Recoveries on securities.....		
(b) Profits on securities sold or redeemed..		
(c) Recoveries on loans.....		
(d) All other (itemize large amounts).....		
.....		
.....		
(e) Total recoveries and profits.....		4e

5. LOSSES AND CHARGE-OFFS:		
(a) On securities.....		
(b) On loans..		
(c) All other (itemize large amounts).....		
....		
.....		
(d) Total losses and charge-offs.....		5d
6. PROFITS BEFORE INCOME TAXES.. ..... (Item 3 plus Item 4e minus Item 5d)		6
7. TAXES ON NET INCOME: Federal $_____; State $_____		7
8. NET PROFITS .. .. (Item 6 minus Item 7; if a loss, show in red)		8

of its intangible character it is the most perplexing of all qualities to evaluate. In no field is it more important than in banking for the management to offer periodic evidence of its conservative character and superior ability. Since it is not customary currently in this country for banks to make full disclosure of all pertinent facts, it appears that there exists a real opportunity for able and progressive bankers not only to improve the competitive positions of their own institutions but also to set a good example for others by publishing statements of condition somewhat along the lines indicated in the suggested form presented above and to make available to the general public full details of their operating results in printed annual reports.

One peculiar aspect of the traditional secrecy regarding the fundamental condition of banks is that this policy is rather generally encouraged by statute. There exists, of course, no statutory provision which forbids the individual bank from divulging whatever facts it cares to make public concerning its business. But in the great majority of jurisdictions the public regulating agencies having power to examine banks and to require reports from them from time to time operate under statutes which prohibit them from giving information relative to the soundness of any individual bank to anybody outside such agency. The situation in California is fairly typical in this respect. Section 142, Bank Act of California, as amended 1935,

provides: "None of the records of the state banking department shall be deemed to be public documents, nor shall any of such records be open to inspection of the public." In a letter in 1941 from William J. Murphy, Chief Deputy of the State Banking Department, he says:

> Anyone inquiring about a bank operating under the jurisdiction of this office will be told that as long as the bank carries the license of this department it is in a solvent condition and worthy of the patronage of the public. Our banks are very closely supervised and you may be very sure that any bank which is operating under the license of this department is one which is worthy of public patronage.

Presumably similar answers would have been given to inquirers during 1931, 1932, and January and February of 1933. Yet during that period no fewer than forty state banks in California were forced to suspend operations.[6]

Much of the necessary information an interested person may be able to get from the bank itself, if he is a sufficiently important depositor. But he may believe the safety of his deposits is important enough for him to check any data supplied by the bank. Such checking by the banks themselves is not entirely unknown when they are analyzing the credit responsibility of borrowing customers.

It is obvious, of course, that details of the relationships of a bank to its individual customers quite properly should not be divulged by any regulating agency. The confidential relationship between the bank and its customers is one of the finest traditions in American banking. Every good banker would consider it utterly reprehensible for him to violate the confidence of his customers who provide him with intimate details of their own private affairs or of the affairs of the business enterprises they represent. No responsible person would think of suggesting any change in this tradition, either by bankers themselves or by the regulating agencies. But it does not follow from this that overall data essential for the analysis of the soundness of particular individual banks should be kept secret. All essential

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[6] *Federal Reserve Bulletin*, February, 1932, p. 134; February, 1933, p. 105; and March, 1933, pp. 200-201.

facts are generally available in the examiner's summary of sound assets and liabilities and his computation of the bank's net sound capital. Instead of enjoining secrecy the statutes should require the regulating authorities to make this information available to anybody requesting it. It is clear that no thoroughly sound bank could be injured in any way by this procedure.

Perhaps banks managed on a fair-weather basis would object. As the national economy passes from the clear skies of prosperity to the deepening shadows of a major depression the vulnerable position of such banks could no longer be shrouded in secrecy. People who are lending money to such institutions on an unsecured basis—in other words, the general run of depositors—would have access to the facts. Those depositors who are energetic enough to obtain the facts and sophisticated enough to appraise them intelligently would have due warning of the deterioration of institutions in which they carry accounts. All other depositors would either be protected by insurance or have only themselves to blame for any losses incurred.

With this policy of enforced statutory publicity in effect it is entirely possible, perhaps even probable, that in periods of major depressions more banks would fail than would fail under the present system of secrecy. But it is easy to overestimate this increased tendency to failure. Mere knowledge that an unsound condition could not be kept secret from the general public would in itself provide a powerful additional incentive for bankers to conduct sound institutions. Fair-weather banking would tend to disappear, with the result that our banking system as a whole would gradually become as impregnable to the vagaries of changing business conditions as has long been true of banking systems in other countries.

CHAPTER 11

SERVICE CHARGES

One unique characteristic of the internal routine operations of banks is the necessity for a daily proof which serves as evidence that the bank as a whole is in balance. Partly because of this characteristic banks have achieved a high reputation for accuracy with respect to their accounts with customers. This reputation is deserved in spite of the fact that, as all experienced bankers know, many errors do actually creep in from time to time. Recognition of this efficiency on the part of banks is so widespread that when depositors' records fail to check with those of the bank it is customary for them to assume that the bank is right and that the discrepancy arises out of some error on the part of the depositor himself.

Notwithstanding this evidence of efficiency banks on the whole had lagged behind the procession of well-managed corporations in general in the matter of accounting procedure and particularly with reference to a knowledge of their own costs. With the advent of the great depression of the thirties banks were forced to adopt more businesslike methods as a means of self-preservation. Expenses had been increasing, many customers were failing, and interest rates were declining. It then became clearly necessary for bankers to analyze their own business, something they should have done before, but a practice which only a small minority of the more progressive had seen fit to adopt.

During the first three decades of the present century interest rates on the whole were quite satisfactory, and the industrial development of the country proceeded at a pace sufficiently rapid to bring into the banks an ever-increasing volume of business. Critical self-analysis is not likely to be a common characteristic in any business during periods of expansion and high rates of

overall income. Yet even before World War I there were isolated instances of bankers who felt it desirable to get beneath the surface in an attempt to discover whether any portions of their business were failing to contribute properly to the total earning power.

It was not until the early twenties, however, that there began to appear in banking journals frequent articles calling attention to the importance of careful analysis of relationships between costs and revenues of all kinds of business commonly handled by banks. The general purport of these articles was that in spite of satisfactory overall profits many banks were doing a considerable part of their business at no profit at all and in some instances at an actual loss. In 1928 one banker reported that if 72 per cent of the banks in Illinois had gone out of business as banks and had invested all their capital funds—capital, surplus, and undivided profits—in high-grade securities, thereafter merely clipping coupons, they would have made more money.[1] The manufacture and sale of refrigerators constitutes a minute fraction of the total business of General Motors, but it is a safe assumption that the management of that corporation has had specific knowledge all along concerning the net results of its expansion into that field. It seems also safe to assume that if they found that they could make no money with that product they would have withdrawn from the experiment. It is surely as important for the bank to know whether each class of business handled contributes satisfactorily to the total net income.

As more bankers came to realize that a large percentage of their checking accounts were not only earning nothing but were actually being carried at a loss they were brought face to face with the problem of what to do about it. It was clearly inadvisable to insist on either of the two obvious alternatives: withdrawal of the unprofitable accounts, or increasing the balances to a satisfactory level. Such highhanded procedure could engender much ill will. Furthermore, it seemed much more desirable to keep this business but to try to make it contribute

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[1] Walter E. Devlin, *The Financial Age*, May 29, 1928, p. 546.

its share to the bank's earning power. A campaign of public education seemed to be called for. If there were a number of banks in the community it was clearly appropriate that this campaign be conducted by the local clearing house association. An entirely successful campaign of this kind was carried out by the St. Louis Clearing House Association in 1925. The procedure in detail was described by Dale Graham in the *Journal* of the American Bankers Association in January, 1926. Among other interesting "lessons" was the one called "How a Bank Makes Money." Graham quotes from this leaflet as follows:

> Many people imagine a bank has magic ways of making money—almost literally coining it. Somehow they think that one hundred dollars deposited on Monday means about one hundred dollars profit for the bank even if the money is withdrawn on Friday. Yet, if they stopped to think about it they would realize . . .

There follows a simple analysis:

Amount of deposit	$100.00
Legal and cash reserves	15.00
Loanable funds	$ 85.00
Income at 6% (which is higher than average rate of income)	$ .42

Then the booklet pointed out the other side of the story, the expense side. And the whole thing required only one minute and fifteen seconds to read.

Another leaflet in the same series was called "The World's Cheapest Bookkeeper" and required one minute and thirty-six seconds to read. It started out as follows:

> WANTED—Bookkeeper and Treasurer; must be capable of handling funds and rendering monthly statements; must furnish own safe and guarantee safety of money; must furnish necessary books, stationery, etc. Salary to start, forty-two cents a month; possible opportunity for advancement. Box J 72.

The leaflet then called attention to the similarity between the above offer of a job and the offer made by a depositor when he comes into the bank and opens an account with one hundred

dollars. It then continued with arguments about the amount of service a depositor gets from a banking institution, whereas the best a bank can earn—gross—on a hundred dollar account is forty-two cents a month. Graham reports that the campaign was surprisingly successful. The citizens of the city were convinced of not only the real value of checking accounts to them, but also the importance of maintaining balances sufficiently large to enable the bank to service them at least without loss. This was preliminary, of course, to the installation by all the banks of the city of flat service charges on all small accounts.

The successful installation of a flat service charge system as early as 1925 is evidence that the St. Louis banks were fully abreast of the times. They had made a step in the right direction, one which could not fail to be reflected in increased earning power. The flat charge is a simple method to operate, and prior to 1930 was the system most commonly used by banks which had installed service charges.

But a flat service charge applied to accounts falling below a certain specified minimum average balance left much to be desired. It was not equitable even among the small accounts themselves because it failed to take into consideration variations in activity. The same charge is made regardless of whether many checks are drawn or deposited, or only a few. Nevertheless, in its Service Charge Survey 1938, Bulletin 77, the Bank Management Commission of the American Bankers Association reports that one hundred clearing house associations were still using this method exclusively.

The Measured Service Charge

The measured service charge plan was developed to meet the inequities of the flat charge and to secure more general application of charges. It contains a basic charge on accounts falling below a specific minimum with a certain number of "free" checks and a definite charge for each item in excess of this specified maximum number of "free" checks. According to the Bulletin referred to above, the rules of seventy-seven clearing houses permitted five free checks on a $50 balance and ninety-

eight permitted ten free checks on a $100 balance.[2] Thus about one-half of the clearing houses using this method allow one free check for each $10 of collected average balance.[3]

Not only did development of the measured service charge plan serve to eliminate many of the inequities of the flat service charge plan. It also is applicable to all accounts without regard to size. Even among the wide-awake and progressive bankers who led the way in the adoption of flat service charges on small accounts, it was formerly the common assumption that large accounts were automatically profitable. The analysis method will be discussed presently, but at this point the observation should be made that it was later discovered that many large accounts have so much activity that the cost of servicing them exceeds their revenue producing possibilities. Since the measured service charge plan can be applied to all accounts, its use insures that every account, both large and small, shall contribute to the cost of handling it. The popularity of this plan is attested by the fact that in 1938 it was in use by over 350 clearing house associations.

The Complete Analysis Method

The measured service charge plan is clearly a marked advance over the flat charge system. It is found to be deficient, however, because charges resulting from its application fail to check with charges determined by complete analysis of individual accounts. When results deviate substantially from those obtained through 100 per cent analysis there exists conclusive evidence that inequities prevail. Each customer should pay for those services that he requires for which the bank cannot be reimbursed through the use of his free average balances. There is only one way to determine whether the individual depositor's funds are adequate to compensate the bank fully for the services rendered. This method is to subject every account to complete individual analysis according to a carefully devised

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2 See E. S. Wooley, *Bank Management Control*, p. 90. He claims this comes nowhere near covering costs.

3 Attention is called to the fact that this takes no account of deposits made.

formula. Only in this way can even a fair approximation of accuracy be obtained.

Any defensible service charge system must avoid unjust discrimination between individual depositors and between different classes of depositors. To insure this result it must be based on knowledge of the actual costs involved in handling the different kinds of services rendered to customers. It is obvious that this is essential if the charges are to be equitable to each customer regardless of the peculiar characteristics of his account. The charge not only must cover the cost of each type of service but also must include a reasonable profit margin. The extension of credit to customers is only one service to depositors which banks stand ready to provide. Even before the effective demand for credit fell to the low levels of the thirties and forties, a large majority of depositors were non-borrowing. They merely carried their cash assets in the bank, requiring the bank to collect their out-of-town checks and pay not only their own checks given to other members of the home community but also those checks which they found it convenient to dispatch to other parts of the country. In order to render this service it was necessary for the bank to act as general bookkeeper for the community. If banks are to be the sound institutions the public requires, they cannot be expected to render a major and costly service with no profit component. In other words, the bank should expect each individual account, without regard to size, to contribute proportionately to its total earning power.[4]

In cities and towns enjoying the services of more than one bank, uniformity of charge is a second basic requirement. Since both actual costs and rates of earnings are likely to vary slightly from bank to bank, it is necessary, if uniformity is to be achieved, for the individual banks to work out compromise

4 Ernest S. Wooley, before the 1940 annual convention of the South Dakota Bankers Association, said: "Actually no bank makes service charges. All that a bank does is to ask that depositors pay for the services which they themselves request, and leaves with each depositor the option of two ways of paying. The depositor may either leave with the bank sufficient funds to earn the price of the services he uses; or, if that is not convenient, he may make up any deficiency between the price of the services and the earnings on his balance with a specific payment. . . . It is only right that such important services should be priced at cost plus a reasonable profit."

charges for maintenance and activity as well as a compromise figure for rate of earnings to be applied to average collected balances. Sound compromise figures for all the banks in a given community entail no injustice to the citizens as a whole. For it means, simply, that average costs and average rates of earnings for all the banks in the community are used as a basis for the analysis within each individual bank. Furthermore, the advantages of uniformity are so obvious that minor deviations from actual costs and earnings figures cannot be a matter of real consequence to the public at large. Unfortunately here and there some misguided banker may refuse to cooperate in order to achieve this desirable end.

Banks gain in public esteem by regularly supplying evidence of their candor and fair dealing. It is important, therefore, as a third essential, that there shall be supplied to each depositor the means of checking the charge against his account. Much is to be said for the practice of furnishing the detailed computation in each case. A somewhat less expensive alternative is to furnish the depositor all the information necessary for computing his own service charge. It is reported in *Bankers Monthly*[5] that the latter practice is followed by the Iowa-Des Moines National Bank and Trust Company. That bank has printed the following statement on the face of the debit ticket going to the customer:

Your service charge has been figured by the following schedule of rates which was adopted by this bank effective November 1, 1942:

COST OF ACCOUNT TRANSACTION

Maintenance cost	$1.00 per month
Local checks	1½ cents each
Other checks and deposits	3 cents each

CREDIT ALLOWED AS OFFSET

2% on loanable balance

If there is any charge you do not understand, or in the event of error, please return for adjustment.

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[5] March, 1943, p. 162.

In addition the new uniform analysis schedule adopted by that bank in 1942 was explained to customers in full detail in a special folder which was sent out to all customers some time prior to the date they were to become effective.

The public in general may evince no interest in the method used in computing service charges. Some banks that supply no means for auditing the charge report surprisingly few complaints from their depositors. Despite any general apathy, however, there are always some individuals who wish to be shown and others who suspect that the bank is getting rich at their expense. Furthermore, the practice of supplying the necessary data makes a good impression even on those customers who are entirely uninterested in auditing their own particular charges, and good public relations are thus furthered. In the light of such considerations there seems to be good reason for believing that banks are poorly advised if they follow a policy of furnishing each depositor merely with the single figure showing the amount with which his account has been charged for service rendered.

Analysis Procedure

The procedure involved in account analysis begins with the depositor's average daily balance. From this balance two deductions are necessary. The first deduction is the float, in order to obtain the average collected balance. The second deduction is for all legal and cash reserves, in order to determine the amount of the depositor's funds which the bank is actually able to convert into earning assets. To the resulting figure is applied the bank's average rate of return on loans and investments after making proper reduction for normal losses. There emerges from the procedure just described the gross income realized on the account. In order to get net income it is necessary, of course, to deduct from this figure of gross income all items of expense involved in handling the account.

These expenses may be grouped under four main headings:

A. *Maintenance.* Cost of maintaining an account without reference to size or activity. Whether or not there is any

activity in a given month the ledger card must be handled a great many times and the balance in the account must be included with all other balances in arriving at a daily proof. The only circumstance which can justify the elimination of this charge is notification in advance that over an extended period there will be absolutely no activity. When this is done the account can be transferred to an inactive ledger.

B. *Administration.* Administration expenses include both the cost of investing the depositor's funds and the cost of safeguarding them. It is evident that these expenses vary directly with the size of the account. Since it costs less to invest and safeguard $1,000 than it does $100,000, the lumping of administration and maintenance expense penalizes the small depositor and favors the depositor with a balance of substantial size.

C. *Activity.*

1. Credits—Cost of crediting to deposit accounts each deposit made
2. Debits—
   (a) Cost of debiting to deposit accounts all checks drawn
   (b) Cost of collecting items drawn on other banks
      (1) Clearing house banks
      (2) Out-of-town banks

D. *Special Services.*

1. Collection service, including coupons
2. Certifications
3. Cashiers' checks
4. Mail or telegraphic transfer of funds
5. Return items
6. Special cash service, etc.
7. Special service check books

For the analysis of active checking accounts the Committee on Standardization of Analysis Methods of the New York State Bankers Association set up Formula "A," which is shown herewith:

FORMULA "A". FOR THE ANALYSIS OF ACTIVE CHECKING ACCOUNTS

1. Depositor's Average Daily Ledger Balance	$
2. Less Average Daily Float (deposited checks in process of collection)	$
3. Average Net Collected Balance	$
4. Less Uninvested Portion of Net Collected Balance, including legal and cash reserves .....%	$
5. Portion of Depositor's Balance which was invested	$
6. Gross Earnings on Invested Portion of Balance at .....% per annum, (percentage to be determined as recommended)	$
7. Less Administration Expense (cost of insuring and otherwise protecting the depositor's funds; and cost of investing the invested portion of his average balance at .....¢ per $100 or per $1,000 of invested portion of balance)	$
8. Balance of earnings available to pay for service	$

Services Rendered

9. Account maintenance at .....¢ (per account per month).	
10. ..... Deposits Handled at .....¢ each	
11. ..... Cash Handled (at a percentage of the amount involved for normal amounts; or at .....¢ per minute of handling time for substantial amounts in varying denominations)	
12. ..... Coupons Collected at .....¢ per envelope	
13. ..... Checks on other local banks collected at .....¢	
14. ..... Checks on out-of-town banks collected at .....¢	
15. ..... Items debited (checks paid for the depositor, notes and other charges to the account except service charges) at .....¢ each	
16. ..... Checks Cashed at .....¢ each (to be used in certain cases only)	
17. ..... Returned Items at .....¢ each (if not otherwise charged for)	
18. Other Special Services (if not otherwise charged for. These would include collections handled; remittances; money transfers; night depository, etc., at the price determined for each; also a charge for overdraft, if any)	$
19. Total Value of services rendered	$
20. Less balance of earnings available to pay for service (Item 8 above)	$
21. Net service charge (or excess profit)	$

An alternative formula was devised for the analysis of active checking accounts in which reserves, uninvested funds, and administrative expenses are reflected in a lower rate allowed the depositor, instead of being treated separately.

FORMULA "B". AN ALTERNATIVE FORMULA FOR THE ANALYSIS OF ACTIVE CHECKING ACCOUNTS IN WHICH RESERVES, UNINVESTED FUNDS, INVESTMENT COST, AND PROTECTIVE COST ARE REFLECTED IN A LOWER RATE ALLOWED THE DEPOSITOR INSTEAD OF BEING TREATED SEPARATELY

1. Depositor's Average Daily Ledger Balance	$
2. Less Average Daily Float	$
3. Average Net Collected Balance	$
4. Earnings Available to pay for service at .....% per annum on net collected balance	$

Services Rendered

5. Account maintenance at .....¢ (per account per month)	
6. ..... Deposits Handled at .....¢ each	
7. ..... Cash Handled (at a percentage of the amount involved for normal amounts; or at .....¢ per minute of handling time for substantial amounts in varying denominations)	
8. ..... Coupons Collected at .....¢ per envelope	
9. ..... Checks on other local banks collected at .....¢ each	
10. ..... Checks on out-of-town banks collected at .....¢ each	
11. ..... Items debited (checks paid for the depositor, notes and other charges to the account except service charges) at .....¢ each	
12. ..... Checks Cashed at .....¢ each (to be used in certain cases only)	
13. ..... Returned Items at .....¢ each (if not otherwise charged for)	
14. Other Special Services (if not otherwise charged for. These would include collections handled; remittances; money transfers; night depository, etc., at the prices determined for each; also a charge for overdraft, if any)	$
15. Total Value of services rendered	$
16. Less earnings available to pay for service (Item 4 above)	$
17. Net service charge (or excess profit)	$

Note: The parenthetical comments are solely for the purpose of clarifying this formula for the reader and, except for that concerning float, should not be included in an analysis exhibited to a depositor.

The method of analysis described and illustrated is intended to be merely suggestive, and it seems appropriate at this point to consider rather obvious objections which may be advanced against certain features as well as against the plan in its entirety.

In arriving at the figure for expenses to be used in determining the charges for the different services there is included a profit loading. Failure to do this would be tantamount to selling its services at cost, a procedure which no other kind of business organization in the world would think of following intentionally.

But it is not quite so obvious that there is equal justification for the inclusion of provision for normal losses when determining the earnings rate on earning assets to be applied to the average collected balance. A combination of these two practices might seem to guarantee a profit to the bank in servicing its customers' accounts.

Losses on loans and investments of all member banks in 1939, for instance, amounted to approximately $288,000,000,[6] or about 28 per cent of gross revenue from interest and discount on loans plus interest and dividends on investments. This figure for losses undoubtedly includes losses which might be considered abnormal, but information is not available which would make it possible to separate normal from abnormal losses. If we assume that one-quarter could justly be characterized as abnormal, then normal losses would still be in excess of 20 per cent of gross earnings on loans and investments.

A distinction between normal and abnormal losses may be difficult to apply in individual cases, but an attempt should be made to do so nevertheless. The possibility of incurring abnormal losses is one of the risks of doing business and is a hazard the full repercussions of which should be a burden for the stockholders to bear. Any loss on an individual earning asset which is large in relation either to the gross income from loans and investments or to the total invested capital might be con-

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[6] *Federal Reserve Bulletin*, June, 1940, p. 719.

sidered abnormal and nonrecurring. But in years like 1931 and 1932 it is conceivable that the loss on no individual item could be considered abnormal from this standpoint and yet the greatly increased number of small losses might have made the total loss abnormally great. To include the total volume of such depression losses as an expense in determining the average earning rate to be applied to average collected balances would have been equivalent to assessing such nonrecurring losses against depositors. And service charges would have become prohibitively high.

In order to guard against this impossible situation certain limitations are essential. Certainly the load factor should never be larger than is necessary to reflect the loss experience of the year immediately preceding the analysis. Nor should it be larger than that indicated by the smallest loss experience during any one of the last preceding five years. In other words, whichever of these two loss experiences is the lower should be the base currently used. Thus, in 1931, 1932, or 1933 the loading would actually have expressed the normal loss experience of 1928 or 1929 and not the abnormally heavy losses with which banks were forced to contend at the bottom of the depression. With loading limited by some such arbitrary standard the program as a whole would be defensible against the charge that the bank was attempting to guarantee itself against loss by passing over to depositors the entire burden of losses arising out of bad general business conditions or out of unsound loan and investment policies on the part of the management.

A second major objection to the complete analysis method of arriving at service charges is the expense involved in deriving costs in the first place and in actually carrying through the detailed analyses of each account twelve times each year. This objection comes primarily from country banks having limited personnel.

So far as costs are concerned it must be admitted that in very small banks the personnel may not be competent to derive even approximately accurate cost figures. Furthermore, many of these banks are so small and have such limited earning power

that the expense of hiring outside experts to determine their costs may seem prohibitive. With respect to cost two alternatives are open to institutions of this character. The first is to use the service charge schedules of neighboring banks which are large enough to bear the expense of obtaining their costs. Even though they may have good reason to believe that their own costs are higher than those of their larger neighbors it may be good policy to charge no more, for there is much to be said for uniformity in service charge schedules in a given region. Another alternative is to try to induce a group of neighboring small banks whose costs are not likely to differ from each other in any marked degree to join in hiring outside experts to come in and determine their costs for them.

After costs have once been ascertained the carrying out of the analyses involves no excessive burden for any bank with modern machine equipment and with an internal routine developed in accordance with present-day standards. Analyses, however, can be still further simplified for small banks the great majority of whose accounts are personal or otherwise relatively inactive and in which the float factor is negligible. Even in larger banks such accounts may warrant simplified analysis and can be segregated for that purpose. Theodore Rokahr, Chairman of the New York State Bankers Association Committee on Standardization of Analysis Methods, makes the following comments in this connection:[7]

> Small personal checking accounts rarely require the multiplicity of services of larger and more active accounts, and float is usually negligible or nonexistent. Hence the analysis form need not be quite so detailed, and in most instances the daily average ledger balance may be considered the net collected balance. So the bank can safely use for most such accounts a flat allowance of a determined number of cents per $100 of average ledger balance as a credit offset against the value of the services rendered. If the actual earning rate, after taking into consideration uninvested funds and administration expenses, was 2 per cent per annum, the figure for monthly analysis would be 17 cents per

[7] *The Burroughs Clearing House*, October, 1939, pp. 30-31.

$100. A form suggested for use in small accounts—except those to which unusual factors apply, is shown as Formula "C."

FORMULA "C"

Depositor's Average Daily Ledger Balance	$180.00
Services Rendered:	
Account maintenance at 30¢ (per account per month)	.30
2 Deposits Handled at 5¢ each	.10
6 Checks on other local banks collected at 1¢ each	.06
1 Check(s) on out-of-town banks collected at 2¢ each	.02
12 Items Debited (depositor's checks paid) at 3¾¢ each	.45
Other Services (which would include an occasional return item, coupon, collection, remittance, etc., if not otherwise charged for)	None
	$ 0.93
Less Earning value of balance at 17¢ per $100	.31
Service Charge	$ 0.62

Note: The rates used above are purely arbitrary and for the purpose of illustration only. They are not to be considered as standard.

This method, if properly used for small accounts, will produce the same ultimate charge, hence the same ultimate revenue to the bank, as if either of the longer formulae were used. Its advantage, of course, is that it omits many separate steps which are comparatively unimportant in small accounts and lumps them in single entries on the analysis. But it is still an analysis and varies not in the slightest degree in principle from the longer analysis forms used for larger and more active checking accounts.

CHAPTER 12

CERTAIN PROBLEMS RELATING TO PERSONNEL

Under conditions of total war, banks, in common with many other kinds of institutions which have not been classified as essential, have been hard put to it to maintain sufficient personnel even of highly uncertain quality. To a more limited extent this situation also confronted bankers during World War I. At that time the practice by banks of employing women on an extensive scale made its initial appearance. Many bankers rather assumed that at the end of that war these women would be largely displaced by men. For many kinds of routine work, however, women demonstrated such real aptitude that after the war was over their numbers continued to increase. The exigencies of the situation in the present war have compelled bankers to turn to women on a far greater scale than ever before and for positions which even in the recent past were reserved exclusively for men. It is not at all unlikely that in many of the new positions they are now filling they will continue even after the war emergency is over. It seems justifiable to assume, however, that other makeshift devices necessarily resorted to in time of war may be discarded when conditions no longer require them. The discussion of various personnel problems in this chapter, therefore, is concerned primarily with normal peacetime conditions, when once again bankers will be in a position to return to the prewar flexibility in handling these problems.

In the whole realm of bank management no problem is more fundamental than the selection, training, and development of a superior personnel. It has been estimated that in the ordinary bank over 90 per cent of the customers never come into contact with an officer. Their business with the bank is conducted solely with employees, and the impression made upon them in

their daily contacts by these employees is, therefore, of the utmost importance to the welfare of the institution. To these customers the employees with whom they do business *are* the bank in a very real sense. The tone or atmosphere of the institution, something that is felt and appreciated by customers without being analyzed by them, may be either good or bad. It is good if the employees combine courtesy, friendliness, and efficiency with utmost loyalty to the bank. Outside the bank, among their friends and acquaintances, they also represent the institution they serve. In their respective neighborhoods they are, accordingly, in a position to build up or to impair the good repute of the bank. In the final analysis the real personnel problem is to develop a banking staff which will build public relationships of a character that will insure the retention of old customers and the regular attraction of additional clientele.

It is true that the larger the institution the smaller the percentage of employees who actually come into contact with the general public. Yet every boy who is added to the staff is a potential contact man at some time in the future. The cornerstone of any sound personnel policy must be promotion from within. Therefore, the selection of an individual for a messenger, adding-machine operator, ledger clerk, or any other routine job must be made with an eye to the possibility that later he may be a teller who comes into daily contact with the bank's customers. For this reason banks are justified in placing the traditional emphasis which they have laid on personality and neatness in the selection of their male employees.

Initial Selection and Placement

The process of initial selection can be carried out intelligently only in the light of a full understanding of the fundamental character of the bank's routine operations plus a realization of the limited number of opportunities for advancement to official status. It cannot be denied that, in the larger institutions at any rate, an overwhelming majority of all jobs are routine and technical in character. Accuracy, speed, and dependability are the prime requisites for successful work. However, since vacancies in the ranks of tellers and other contact

men must be filled from younger men in these routine jobs good personality is desirable in an adequate number of routine male workers to provide reserves for promotion to contact jobs. Educational requirements for these positions are modest and nothing is needed in the way of inherent executive ability. At best, furthermore, only a small percentage of those engaged in these routine technical operations will ever be needed for contact jobs. For this reason it is of considerable importance that new employees shall consist in large measure of individuals of limited potentialities who are likely to be satisfied to continue year after year in routine positions. If additions to the staff include too many of superior ability there is danger that dissatisfaction will become general and turnover may reach excessive proportions. The practice of employing more and more women already referred to serves to simplify this problem somewhat, since it is taken for granted that the average girl does not look on business as a long-run career but merely as a stop-gap between high school or college and marriage. Nevertheless, under normal conditions any well-organized staff must include enough young men among the new employees to provide sufficient material from which men for contact work and executive positions may be selected.

The observation was made above that promotion from within the ranks is the basic requirement in any sound personnel policy. Few things can be more damaging to the *esprit de corps* of any working force than a general realization that only an insignificant percentage of the officers came up from the ranks of the institution itself. One young man of superior ability and excellent technical preparation was given a job with a large metropolitan trust company. His initial assignment was the analysis of electric light and power company bonds. His work was entirely satisfactory and he received a substantial increase in salary at the end of the first six months. But before he had completed one full year of service he resigned because he had discovered that every senior officer in the institution had been brought in from the outside. He preferred a connection where the path to a vice-presidency was not absolutely barred to a per-

son of superior ability who happened to be a member of the institution's own staff.

For a bank that prefers to avoid the necessity of bringing in most of its vice-presidents from outside a long-range policy of initial selection is essential. This policy must provide for the addition to the staff from time to time of a limited number of young men of distinctly superior qualifications. These qualifications should include a thorough training in accounting, corporation finance, and credit and investment analysis such as can be obtained at a few of the collegiate schools of business administration. In order to obtain such men it is necessary to compete in the open market on a salary basis with all other kinds of business enterprise. Whatever glamour banking may at one time have held has long since disappeared, and young men with superior native ability and with technical preparation of the kind here referred to cannot be expected to make any initial financial sacrifice in order to get into a bank. They are probably aware of the fact that advancement in a bank during the early years is likely to be somewhat less rapid than might be expected in other lines of business enterprise. A knowledge of this condition is sufficient to discourage anyone who does not definitely prefer to follow banking as a career. But if an initial financial sacrifice is also involved banks will merely be diverting to competing opportunities the very best young men available.

It is obvious that the number of such young men that it is desirable to add to the staff is strictly limited. The actual number needed by any individual institution depends upon its size, its previous experience in recruiting official personnel, and the age distribution of its present officers. If the number employed is excessive in relation to avenues of possible advancement dissatisfaction will develop and turnover will tend to increase.

Some metropolitan banks which attempt to follow in a general way the policy suggested above make the mistake of failing to distinguish sharply enough between the graduate of collegiate schools of business administration and the ordinary liberal arts college alumnus. Despite superior native ability,

good intellectual development, and cultural training the latter is likely to be entirely innocent of any familiarity with the fundamentals of business. The chances are that he has had no training in accounting and corporation finance and therefore knows nothing of the technical procedures involved in credit and security analysis. Because of his greater maturity and intellectual development he should be able to pick these things up with much greater facility than the superior high school graduate. But he is at a serious initial disadvantage in competition with the young man who in addition to his college education acquired definite technical preparation for business.

When college graduates without any technical business preparation are taken on it is the custom of some large banks to start them on the messenger force or possibly in one of the routine operating divisions. Some bankers report that their experience with these men has been, on the whole, quite satisfactory. But there is little evidence to support the belief that this is a wise practice so far as graduates of collegiate schools of business are concerned. It is the exception rather than the rule for them ever to become expert operating men. If these men are ever to be of real value to the bank it is quite likely to be in such specialized departments as credit, investment, trust, foreign exchange, or new business. It is difficult to see how a year or two on machine operation or other routine jobs can provide any worthwhile background for work in these lines. There is much to be said for placing them immediately—at the bottom—in some department in which at the earliest possible moment they can begin to capitalize on their educational background and be of real value to the bank. An actual case may serve to illustrate this point.

Shortly after the World War I a large metropolitan bank adopted the policy of adding to its staff each spring three or four graduates of collegiate schools of business. The initial salary paid these men was considerably above the starting wage for ordinary high school graduates and the general policy was to assign them directly to work in credit, investments, trust, or foreign exchange. They were told that while they were being paid considerably more than other beginners the only way by

which they could secure promotion was by proving their superiority over their competitors who were also seeking better jobs. One young man who had had a lot of special training in accounting held out for assignment to the auditing department. Although it was contrary to its better judgment the personnel department acceded to his wishes. After about eight months he came in to see the personnel manager. He said he had no quarrel with the policy of basing promotion on superior work. On the contrary, he approved it. "But," he said, "on that basis I can never get a promotion. Not only am I not better than the other fellows—I am not nearly as good. They can throw figures all around me. They can do much more work than I can, and do it more accurately. If I have to prove I'm better than they are to get ahead I'll be there all my life." During his four or five years in college and business school his competitors of the same age, who had entered the bank directly from high school, had been acquiring dexterity in the handling of figures quickly and accurately. It is much easier to acquire facility along such lines between the ages of eighteen and twenty-three than it is thereafter. So the chances were that in that type of work he would never even be able to catch up with them. Accordingly he was transferred to the credit department, a field in which his auditing competitors were not qualified and in which he was soon able to capitalize on his education and background. Within twelve years he was a vice-president of that institution, a position which he holds to this day.

Even if the desirability of a sprinkling of especially trained college men be admitted, it is obviously difficult for the relatively small bank to attract them. The smaller the bank the less the extent to which it is possible or desirable to carry the division of labor; and the more important it becomes, therefore, for the officers to be thoroughly experienced in the technical, routine operations. But banks with resources as low as $10,000,000 are well advised to give real thought to the development of future investment and credit officers. For the still smaller bank with total personnel of a dozen or even fewer perhaps the problem may be solved by encouragement of adult

education in the way of technical evening or correspondence courses.

In none of the foregoing is there intended any implication that the high school graduate may not attain to a specialized department and eventually prove to be of senior office calibre. There are today far too many outstanding senior officers with limited formal education to warrant any such implication. With the increasing use of machines and the increased tendency to hire girls to operate them, however, operating departments of the future may not be as productive of executive material as has been the case in the past.

Basic Salary Level and Salary Adjustments

According to figures prepared by the Comptroller of the Currency, for all national banks salaries and wages in 1942 absorbed over 30 per cent of total current operating earnings and over 43 per cent total current operating expense. This represented by far the largest single item of operating expenses. It is difficult to overestimate, therefore, the importance of maintaining reasonable basic wage levels. Salaries must, of course, be carefully administered as costs. But salaries must be viewed also as important factors in providing incentive for employee effort, self-improvement, and satisfaction. Employee satisfaction depends not only upon the basic salary level but also upon salary differentials which recognize in clear-cut fashion the difficulty, importance, and responsibilities of different kinds of work and the degree of competence attained by the individual worker. Nothing can be more discouraging to a clerk than to have his hard, conscientious work and improving competence go unrecognized through lack of reasonable salary adjustments.

Over a long period of years banks have acquired a reputation for niggardliness in the matter of wage levels, a development which impairs rather than improves public relationships. It is not the intention here to argue the question as to whether or not this reputation is deserved. There seems to be good reason for believing, however, that after ten years or so of experience the remuneration received by the typical bank clerk compares

quite favorably with that received by white-collar workers of equal ability in other lines of business.

Even if it be admitted that, in general, wage levels in banks compare not unfavorably with those in competing lines of enterprise, banks still have the problem of deciding upon the general scheme by which periodic or other salary adjustments shall be made. The chief object in any salary adjustment is to increase the contentment, loyalty, and efficiency of the rank and file of employees. It is impossible to defend any plan which fails to achieve this end. There is, however, good reason for believing that this desirable result is not likely to be obtained by means of a practice which is quite common. Reference is to the policy of making a wholesale adjustment of all salaries on a given date once each year. Within reasonable limits it is entirely sound and proper to reward continued faithful and efficient service with an increase in salary. But primarily increases in salary should be accorded as a reward for increased value to the bank. A policy which provides for wholesale adjustment of salaries once a year makes it difficult to accomplish these objectives.

In the first place, when the custom prevails of adjusting all salaries at some stated date each year everybody expects an increase. Because he takes some advance for granted his devotion to the institution through salary adjustment can be improved only by means of an increase either larger than he expected or at least larger than the increases received by certain other individuals among his fellow workers. Furthermore, if he gets just about the same increase awarded others it seems less like a reward for volume and character of his work than it does for an additional year of service. Wholesale increases necessarily lack the personal flavor which will benefit the bank most.

When all salaries are reviewed simultaneously it is difficult, in the second place, to preserve proper maximum scales for different classes of work. The individual who has already reached the maximum salary which his particular job warrants tends to become dissatisfied if the salaries of most of his fellow workers are being increased at one time. His feeling of dis-

content is accentuated by his knowledge that a whole year must elapse before any further consideration can be expected. Because the management is likely to sense this attitude the temptation is always great to give some increase to each individual despite any maximum figures for individual jobs which may have been set.

In the third place, the policy of adjusting all salaries simultaneously makes it difficult, at least where the number of employees is formidable, to give adequate attention to the merits of each individual case. It is of vital importance for the preservation of good *esprit de corps* that the performance of each individual shall be reviewed thoughtfully with full consideration given to all aspects of his case. The larger the number of cases considered at one time the less likely it is that thoroughly defensible decisions will be reached for all members of the staff.

In view of these objections there is much to be said for the abolition of wholesale annual salary adjustments. Many banks which have abandoned the practice have substituted therefor a system under which the case of each individual comes up for review every six months at a special time determined by the date of his original employment by the bank. It is evident that this spreads over the entire year the problems connected with salary adjustments, and some bankers object to it on this ground. In banks large enough to maintain specialized personnel departments this disadvantage tends to disappear, and for smaller institutions with relatively limited staffs the increased burden does not appear to be excessive. The benefits to be derived in the way of increased loyalty and contentment when salary adjustments are made on a personalized basis seem to be worth enough to justify such additional efforts as is required to carry this policy out.

The Personnel Function

In very small institutions with only a few employees problems of selection, placement, training, promotion, and salary adjustments are quite naturally handled by the chief executive officer. This procedure is most desirable, but as we pass from

these small institutions to larger and larger banks it becomes progressively more difficult for the personnel function to be handled in this way. In large metropolitan banks, therefore, it is necessary for the president or other principal executive officer to delegate completely this function to some other person. In recent years a growing recognition of the importance of personnel relations has been clearly evident, and it has accordingly become more common to make this job either the sole or the principal responsibility of a senior officer. This tendency is highly desirable and it is to be hoped that the practice will come to be adopted generally by large institutions.

It is of the utmost importance that the person in active charge of personnel shall report directly to the president and not to some intermediate official. All business enterprises are so organized that the wishes of the management reach the rank and file with a minimum of friction. A clearly marked avenue through which the reverse process can be facilitated becomes more important with every passing year. In other words, the best results in personnel relations can be achieved only if topmost management can be kept constantly in touch with the reactions of the rank and file of workers to policies which directly affect them. Some large banks have attempted to achieve this by placing a vice-president in active charge of all personnel relations. In too many cases, unfortunately, it has been delegated to a senior officer whose training, experience, and main interests lie elsewhere. Thus he has neither the time nor the inclination to keep fully informed concerning new ideas and methods in personnel relations. It is customary for this officer to subdelegate the real personnel function to a subordinate personnel director, a post frequently carrying no official rank. Under these conditions the major attention of the senior officer is not directed to personnel work at all while the person in actual charge has no real standing in the organization. The best results cannot be achieved by this set-up.

In the first place, the man who is actively in charge of the personnel function, and is devoting his entire time to it, should be in position to make final decisions, in consultation with supervisors, section heads and department heads, concerning

individual transfers, promotions, and salary adjustments. He should have complete and final authority to hire and fire. It seems scarcely appropriate to delegate such authority to a man either with no official status or, at best, with only junior officer standing.

In the second place, and what is perhaps of even more fundamental importance, men of real ability cannot be attracted to these subordinate positions, not just because they are subordinate, but also because there is no clearly marked avenue for real promotion for the man who does a first-class job as personnel director. Because of the lack of any real prospects of getting to the top personnel work has not been in good repute among ambitious young men of high quality. It has looked too much like a blind alley. One might achieve modest advancement, perhaps even become personnel director, but in general the big prizes of senior official rank have appeared to lie beyond the reach of those coming up through personnel work.

In view of the greatly increased importance of sound personnel relations it would seem to be of the utmost importance that high-grade talent be attracted to that work. This can be done if the personnel function is considered as really coordinate with the other principal banking functions—loans, investments, operations, business development. Then the vice-presidential rank would become the legitimate objective of the man who has demonstrated outstanding ability in minor personnel posts.

PART V

INTERRELATIONSHIPS OF TOPMOST MANAGEMENT

Problems discussed in the preceding chapters have all had one common characteristic: they have involved policy decisions by topmost management. This final section is devoted to an examination of means by which the fundamental ability and sound judgment of the board of directors can be brought to bear to the best advantage on these problems and thus to insure that the decisions themselves shall be sound.

CHAPTER 13

THE BOARD OF DIRECTORS AND THE MANAGEMENT

Personnel of the Board

One of the important problems facing the promoters of a new bank is the wise selection of members for the board of directors. If the new institution is to be successful it is clearly essential for it to acquire some banking business currently being handled elsewhere. One obvious method of doing this is to invite to membership on the board individuals who are heads of business enterprises and who are, therefore, in position to bring to the new bank an important volume of business. Others may be chosen because their standing in the community is so high that their names on the board will add the necessary prestige to attract to the bank a large number of accounts from the rank and file of citizens of the community. The president of the bank, of course, will be a member, and in some cases one or two other officers.

The fundamental philosophy underlying these practices is sound for newly organized banks. Success in some other line of business activity is likely to connote sound judgment, and surely in no place is sound judgment more necessary than it is in the banking business. In addition to sound judgment, successful businessmen possess an intimate knowledge of the problems and risks involved in their own lines of business, and this expert knowledge can be of tremendous value to the bank in certain of its loan and investment policies.

Old, well-established banks also find it necessary to choose new board members from time to time. The prevailing practice appears to be to base such selections on the precise grounds which appear so suitable for a new bank. It must be admitted that going institutions with high standing in their respective

communities also need men of sound judgment and intimate knowledge of some nonbanking business. Presumably such banks wish to continue to grow and to become still more successful and influential. Obvious recourse is to heads of business enterprises who are able to bring with them a substantial volume of new business. It has been a generally accepted canon that invitations to banking boards should be extended only to those whose names on the board will enhance the standing of the bank; that such invitations should never go to those whose own prestige would be augmented thereby. In banks where this policy obtains exclusively the board is likely to be composed of men past their prime. Few men attain real eminence in their chosen field until they have reached at least middle age. Experience gained through a period of years on the board is necessary before a member can render most effective service. But by that time men chosen originally for their eminence and business ability are getting well along in years. Shortly they will be old men and their constructive influence will tend to wane.

Notwithstanding these considerations it may still seem necessary or at least highly desirable to select a few such men for membership on the board no matter how old or how successful a particular bank may have become. There is much to be said, however, for also adding to the board from time to time younger men of outstanding ability and promise, who are still on the way up. Not only will they bring to the board the fire and enthusiasm of the man who is still going places, but they are likely to have greater familiarity with newer methods and practices. The presence of a few such men can thus serve to leaven the whole board and their influence will eventually help not only to keep the bank abreast of the times but to make it a more forward-looking institution and a greater constructive force in the community.

Educating the Board

However competent a banking board may be it cannot be expected to function efficiently without the active leadership of the management as represented on the board by the president

and possibly other principal executive officers. Nonbanking members of the board may all be hardheaded and successful business and professional men but they are not likely to have even a cursory understanding of the various problems with which an active management must cope. Success in the various lines of industry represented on the board may be achieved without, for instance, any knowledge of the purposes, sizes, or proper constituent elements of primary, secondary, and investment reserves. They may or may not be familiar with the factors which make for soundness in bonds, but almost certainly their background is not likely to qualify them to pass judgment on the proper maximum size of the permanent bond portfolio, nor on problems connected with desirable quality, maturity, marketability, and diversification. Yet on these and other matters of general policy it is entirely inexcusable for the active management to fail to avail itself of the benefit of the sound business judgment which the members of the board can bring to the solutions of these and other matters once the implications of various alternative policies have been made clear to them.

In order to get something from the members of the board other than attendance at meetings and perfunctory approval of current policies or new policies suggested by the management, it is necessary for the latter to conduct tactfully a subtle and gradual campaign of education along banking lines. This program should be carried out over an extended period of time. For instance, the president might plan to bring up for discussion at each meeting of the board some one of the general policies being currently pursued. Various alternative policies might be suggested, making clear all the implications of each with respect to questions of risk, income, and liquidity. The president would naturally defend the policy now in effect but it is important that arguments in favor of alternatives be fairly presented. The board then should be asked either to approve formally the current practice or to express its opinion that a change appears to be desirable.

Suppose, for instance, the current policy in a particular bank is to include in its permanent bond portfolio issues having ma-

turities as long as twenty-five years, and to maintain an average maturity of, say, fifteen years. The risks involved in this policy should be analyzed in detail for the members of the board. It should be pointed out that if interest rates advance materially money bonds will certainly depreciate in market value, while if business conditions and prospects become unfavorable the depreciation in the credit bonds can be much more severe than for those with shorter maturities. The average yield being currently earned on the entire bond account should be computed and compared with the yield obtainable with maximum and average maturities materially shortened. There is a question of general policy involved here which the board, of course, should decide. But the point of this discussion is that it is highly important to the active management that the decision of the board should be made only in the light of a clear understanding by the various members of the risks and income possibilities appertaining to the two alternatives. Likewise, policy questions relating to mortgage loans, term loans, V loans, installment credits, personal loans, service charges, and personnel should be decided by the board only after it is clear to the active management that the board has been fully informed regarding the favorable and unfavorable aspects of alternative solutions.

This policy of educating the members of the board with respect to all fundamental policy problems should yield large dividends in the way of sounder bank management. The very fact that the regular order of procedure is to present a full and unbiased explanation of all the implications of each policy being currently pursued, and also of possible alternative policies with their advantages and disadvantages, makes it necessary for the principal executive officer to think these matters through for himself more systematically. In doing so he may be surprised by discovering some weakness in his reasoning. If he fails to uncover any weakness but one, nevertheless, actually exists, there is a good possibility that some astute member of the board will point it out. When all matters of general policy are subjected to a technique of this sort, the chances are much better that the policies actually agreed upon will be fully defensible.

Whether a bank be large or small the chief executive officer must shoulder tremendous responsibilities of a character which cannot be passed on to any board of directors. After all the board as a whole cannot be expected to select individual bond issues which fit into the general program it has approved. Neither can it be expected to pass on individual applications for loans except where the amount involved is large for the size of the bank or there is some question as to the extent of the risk in a particular case for a relatively large loan. Responsibility for the selection, training, and promotion of personnel must be left in the hands of the active management. The burden of actively managing a bank, in other words, is clearly heavy enough for the chief executive officer without any usurpation of the burden which properly belongs to the board of directors. Yet he adds unnecessarily to his responsibilities if he merely defends current and suggested policies and asks for board approval which is likely to be perfunctory unless the individual members of the board are fully informed of possible alternatives and the implications thereof.

Information for Board Meetings

Sound banking practice requires that the active management of the institution shall be conducted in accordance with general policies laid down by a fully informed board. Conclusive evidence that it is being so operated should be presented at each meeting of the board. It is highly desirable that a maximum of this evidence be in typewritten form with a copy in the hands of each director. Verbal reports should be confined to matters not easily reduced to tabular form.

No satisfactory evidence could be complete without an up-to-date statement of condition. A mere transcript of the general ledger is an entirely inadequate substitute for this, as is the ordinary noninformatory statement of condition which most banks use for advertising purposes. Instead of either of these, the statement should be in a form which gives really vital information along the lines suggested in Chapter 10.

Each individual bond issue held should be listed, the data including par value, maturity, rating, book value, and market

value. This information should be recapitulated by types of issuers, by quality ratings, and by maturities. A tabulation should be presented which shows each bond purchased since the last meeting, with its maturity, rating, market price, and yield to maturity. Each bond sold should be listed in a separate tabulation showing the same data with the profit or loss indicated. Typewritten data of the kinds indicated make it possible for the board to be fully informed concerning the overall condition of the permanent bond portfolio and to assure itself that its approved policies are being carried out in practice.

It seems scarcely necessary to tabulate each individual loan currently on the books, although some banks do this for all individual loans above a certain stated minimum. It is clearly important, however, for the members of the board to have before them a recapitulation of loans. The first breakdown in this recapitulation naturally might show figures for each class of loan, such as real estate, commercial, installment, term, and personal. The real estate loans should be further broken down to show the total being fully serviced and the total delinquent with respect to amortization, taxes, or interest. There should be a list of each individual mortgage loan paid off and each new mortgage loan granted, either since the last meeting or during the most recent calendar month.

Commercial loans should be divided first into two classes, unsecured and secured. The unsecured loans should be further classified to show the volume outstanding to borrowers who clean up at least once a year and the volume to borrowers who are constantly on the books and to whom, therefore, the bank is supplying permanent capital. The latter should be listed item by item.

Secured loans should be classified according to the character of the collateral. Those adequately margined by stock market collateral would constitute one class. Those secured by nonmarketable stocks of small local concerns would be placed in a separate class, with an additional tabulation showing total loans secured by each individual local nonmarketable stock. Loans secured by commodities, warehouse receipts, receivables, etc., belong in separate groups.

Details about "Other Real Estate" should appear with a listing of each individual item belonging in this category. A separate tabulation of nonbook assets should be included showing each individual item, the actual investment of the bank therein, and an estimate of potential liquidating value of each.

In the folder for each director there should be a properly classified expense account, cumulative figures for the period to date, with comparative figures for the preceding month and year. Along with this information concerning expenses it is important to present similar data covering earnings. A statement classifying earnings according to sources for the month and period to date, in comparative form, is clearly essential if the directors are to be fully informed about the direction in which the bank is moving.

The directors should be provided with a detailed list of all new accounts opened, at least all new accounts above a certain stipulated minimum. It is just as important for them to have a similar list of all accounts closed, for it is plainly essential for them to be fully informed about individual accounts which the bank is losing to competitors, and the reasons therefor. With this information conveniently available the board is in a better position to appraise the effectiveness of the management in getting new business and retaining the business already on the books.

Although not sufficient information is available to warrant any positive conclusions, it is probably true that the managements of large metropolitan banks are more energetic about supplying the board with adequate information in convenient form than are those in charge of the great majority of smaller banks. Yet many country bankers are far from negligent in this respect. As an example of good cooperation between the active management and the board there will be found in the Appendix the tabulated information presented to the directors at each meeting by the head of a certain small country bank. This exhibit does not go as far as suggested above, but the material presented is extremely informative so far as the bond portfolio and reserves are concerned.

Duties of the Board

The basic duties of the board are to select the active management, formulate general policies, and see to it that these general policies are carried out in a manner that will insure a sound banking institution and protect the assets belonging to the depositors and the stockholders. It is obviously both impossible and inadvisable for the board to make any attempt to follow the routine of daily operations. To the active management it delegates the responsibility for carrying on the details of operation in an efficient and safe manner within the general rules laid down by the board. The board is negligent, however, which does not insist on information which is adequate and essential for the formulation of sound general policies, and also conclusive evidence not only that these general policies are being carried out but that the internal checks and balances are such as to insure the accuracy of the figures and to reduce as much as possible the danger of defalcations.

Information essential for the intelligent formulation of general policies has been suggested above. But no board is justified in assuming without verification that figures presented by the active management represent the real facts. Nor is it justified in assuming that all possible irregularities or loopholes will be discovered by the bank examiners. It can, however, obtain adequate assurance in either or both of two ways. If the bank is of sufficient size to justify the procedure the board may employ a thoroughly competent full-time auditor to report to no authority but the board itself. For the best results it is highly important that this auditor be selected by the board. Full reliance cannot be placed on reports of an auditor who is subordinate to the active management and whose tenure of office depends upon pleasing the chief executive officers.

The small size of the bank or some other factor may make it undesirable to employ a competent, full-time auditor. An alternative is for the board to have made a periodic audit sufficiently thorough to be convincing that everything is in order. It is frequently the custom in smaller banks for the board, through a committee of its own members, to go through

some of the motions of an audit. It is obvious that this procedure can be of little value, for there is probably not a single board in the whole country which is competent to make any but the most perfunctory examination. For any really effective audit by the board it is necessary for it to employ an outside firm of certified public accountants, and preferably a firm which employs specialists in bank audits. These examinations should be made without advance notice to the active management. For the convenience of accounting firms it is desirable to have the audits made some time between March 15 and September 15, and also, where feasible, at least one month subsequent to the most recent examination by regulating authority.

It remains to be observed that this procedure serves to protect not only the board but the active management as well. The chief executive officer should welcome independent audits because the general public will hold him responsible for failure to prevent any large embezzlement. If he is wise he will leave nothing undone to reduce the risk of such an occurrence.

Board Initiative

In view of the fundamental position of the board in the management of a bank the initiative in all of these matters should come from the board itself. Except for the active executive officers who are also on the board, however, it is too much to expect any real initiative from that source. There is reason to believe that even the ablest business and professional men frequently assume risks by membership on banking boards which they would not consider assuming in any other direction. In order to assure adequate protection, therefore, usually it will be necessary for the chief executive officer to point out to the members of the board the liabilities that they have assumed, and to recommend strongly independent verification of the condition of the bank with reports thereof coming directly and solely to the board itself. And it should be observed, finally, that this procedure is just as important for the many small banks as it is for the largest metropolitan institutions.

APPENDIX A

First State Bank*

Statement of Condition as of November 30, 1939

Resources:		
U. S. Government Bonds and Notes	$330,258.31	
Cash on Hand and in Banks	555,285.09	
Impounded Balance, First National Bank, Detroit	13,612.42	
Total Cash Reserve Position		$ 899,155.82
Municipal Bonds	$ 25,332.72	
Other Bonds	70,512.50	
Total		95,845.22
Notes—Secured and Unsecured	$ 54,289.22	
Mortgages and Land Contracts	183,250.69	
Total		237,539.91
Bank Building—Fixtures Charged Off		10,500.00
Nonbook Assets		1.00
Customers' Bonds Deposited for Safekeeping		51,550.00
Overdrafts		10.40
Total Resources		$1,294,602.35
Liabilities		
Capital Stock	$ 75,000.00	
Surplus	75,000.00	
Undivided Profit—Net	17,032.24	
Total		$ 167,032.24
Reserve Accounts:		
(a) Bond Amortization Reserve	$ 3,325.37	
(b) Contingent Reserve	13,612.42	
(c) Valuation Reserve	4,875.00	
Total		21,812.79
Commercial Deposits	$339,203.74	
Savings Deposits	715,003.58	
Total		1,054,207.32
Customers' Bonds Deposited for Safekeeping		51,550.00
Total Liabilities		$1,294,602.35

* Referred to on page 199. At every meeting of the Board of Directors material on this and the following three pages is placed in the hands of each member.

NOVEMBER 30, 1939

	GOVERNMENTS					
50,000	U. S. Treasury Notes 1⅝ due 3/15/40....	AAA	$ 50,000.00	101.12½	101.8	$ 50,625.00
40,000	U. S. Treasury Notes 1½s due 12/15/40..	AAA	40,000.00	100	101.31	40,787.50
40,000	U. S. Treasury Notes 1½s due 3/15/41...	AAA	40,000.00	100	102.3	40,837.50
40,000	H. O. L. C. 2½s due 7/1/42-44...	AAA	40,487.50	101	104.12	41,750.00
25,000	Federal Farm Mortgage 3s due 1/15/42-47..	AAA	25,795.81	103	105.14	26,359.35
7,500	U. S. Savings Bonds due 12/1/48.....	AAA	7,500.00	100	100	7,500.00
7,500	U. S. Savings Bonds due 1/1/49.....	AAA	7,500.00	100	100	7,500.00
50,000	U. S. Treasury Bonds 2½s due 1952-50...	AAA	51,250.00	102½	104.18	52,181.25
50,000	U. S. Treasury Bonds 2¾s due 1951-54. .	AAA	51,750.00	103.16	106.3	53,046.87
15,000	U. S. Treasury Bonds 3s due 1951-55.....	AAA	18,975.00	106.16	108.29	16,335.94
325,000			$330,258.31			$336,923.41
	UTILITIES					
5,000	Consolidated Edison Company 3¼s of 1946.....	AA	$ 5,050.00	101	106¼	$ 5,337.50
5,000	Mississippi Riv. Power 5s of 1951.....	AA	5,250.00	107½	111	5,550.00
4,000	Denver Gas & Electric 5s of 1951.....	AA	4,200.00	107½	107	4,280.00
5,000	Houston Lgnt. & Power 3½s of 1966.....	AA	5,150.00	103	110	5,500.00
5,000	Nebraska Power Co. 4½s of 1981.....	AA	5,325.00	108¾	111	5,550.00
24,000			$ 24,975.00			$ 26,217.50

NOVEMBER 30, 1939

	RAILROADS					
5,000	N. Y. Chicago & St. Louis 4s of 1946.....	BB	$ 5,037.50	100	80	$ 4,000.00
5,000	Southern Pacific Company 3¾s of 1946.....	CCC	5,000.00	97	55½	2,775.00
5,000	Carolina, Clinchfield & Ohio 6s of 1952.....	A	5,376.00	110¾	108	5,400.00
5,000	Atchison, Topeka & Santa Fe 4½s of 1962.... ...	A	5,500.00	111½	109	5,450.00
5,000	Pennsylvania, Ohio & Detroit 4½s of 1977.....	A	5,125.00	105	94½	4,862.50
5,000	Pittsburgh, Cincinnati, Ohio, & St. Louis 4¼s of 1977.....	A	5,250.00	107¾	97½	4,875.00
30,000			$31,287.00			$27,362.50

	MUNICIPALS					
4,000	City of Minneapolis 4½s of 1940	AA	$ 4,396.79	109.91	103	$ 4,120.00
5,000	State of W. Va. Road Bonds 4½s of 1940	AA	5,560.93	111.21	102	5,100.00
10,000	Indianfields Twn. School Dist. No. 3, 5s of 3/15/53	A	11,500.00	115	115	11,500.00
5,000	City of Detroit—Hosp. Ref. 4½s of 1963—Callable	BBB	3,875.00	77½	99	4,950.00
24,000			$25,332.72			$25,670.00
	INDUSTRIALS					
8,000	General Motors Accept. Corp. Deb. 3¼s of 1951	AAA	$ 8,000.00	106½	106½	$ 6,520.00
	REAL ESTATE					
8,000	Alfred T. Lerchen 1st Mtge. 5s of 1943		$ 6,250.00	78	65	$ 5,200.00

RECAPITULATION

	Book Value	Market Value
Government Bonds	$330,258.31	$336,923.41
General Market Bonds:		
Utilities	24,975.00	26,217.50
Railroads	31,267.50	27,362.50
Municipals	25,532.72	25,670.00
Industrials	8,000.00	8,520.00
Real Estate	6,250.00	3,200.00
	$426,103.53	$429,893.41
Plus Valuation Reserve		4,875.00
Plus Amortization Reserve		3,326.37
	$426,103.53	$438,093.78
Potential Liquidating Profit	11,990.25	
	$438,093.78	$458,093.78

RECAPITULATION OF ALL SECURITIES BY QUALITY RATING

AAA	$333,000.00	79.6%	AAA	Highest Quality
AA	53,000.00	7.9	AA	High Quality
A	30,000.00	7.2	A	Sound Quality
BBB	8,000.00	1.2	BBB	Good Quality
BB	5,000.00	1.2	BB	Fair Quality
CCC	5,000.00	1.2	CCC	Speculative Quality
Not Rated	8,000.00	1.7		Real Estate
	$419,000.00	100.0%		

Recapitulation of Bonds by Maturities

Bonds Maturing..... 1 to 5 years	$187,000.00	44.6%
Bonds Maturing..... 5 to 10 years	55,000.00	13.1
Bonds Maturing.....10 to 20 years.....	147,000.00	35.1
Bonds Maturing.....20 years and longer	30,000.00	7.2
	$419,000.00	100.0%

Capitulation of Bank

Capital Stock—750 Shares Common.....	$ 75,000.00
Surplus Fund.....	75,000.00
Undivided Profits—Net.....	17,032.24
Unrealized Profit in Bond Account.....	11,990.25
	$179,022.49

*Book Value—$238.69 per Share

* This computation makes no provision for possible recovery in remaining balance of $13,612.42 impounded in a closed bank, nor does it take into account the liquidating value of nonbook assets with a potential market value of approximately $11,000.00.

APPENDIX B

THE FINANCIAL REPORTS OF COMMERCIAL BANKS*

By Dr. J. Brooke Willis

Although it is commonly agreed that banking is affected with a public interest which far exceeds that of most other lines of business, the public, generally speaking, is not conversant with commercial banking operations. A "veil of mystery" still surrounds the practice of banking. This situation is attributable in no small degree to inadequacies in the published financial reports of banks.

This paper endeavors to reexamine the pros and cons of fuller disclosure and dissemination of information concerning the affairs of banks, to describe briefly the kind and amount of information now published by banks, and to point out its insufficiencies and limitations with a view to promoting the adoption of a more progressive policy by the banking community.

Pros and Cons of Disclosure

Nondisclosure of pertinent information regarding the internal financial condition of banks is commonly attributable to: (1) the fear of disturbing public confidence; (2) the fear of the misuse of information by (a) competitors, (b) speculators, or (c) others, in ways harmful to clients; (3) the fear of unfavorable legislation; and (4) to the fact that the affairs of banks are already under the surveillance of the public authorities.

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* Excerpts from an unpublished monograph included here with the kind permission of Dr. Willis. His cooperation is greatly appreciated. (R. G. R.)

The Question of Public Confidence.—It has always been customary to emphasize the inability of depositors and stockholders properly to interpret statistics regarding banks or, for that matter, any corporation. It is implied that the dissemination of data would serve only to confuse and perplex, and perhaps lead to misinterpretations by the public with harmful repercussions in the shape of runs on banks or adverse speculation in bank stocks. Whereas there may be some truth in the assertion that the man in the street is incapable of interpreting complex accounting data regarding the condition of banks, secrecy in the past did not save the banks from either runs or depreciation in their stocks, and there are grounds for believing that a policy of frank disclosure of facts might in some cases have allayed public apprehension.

The Possibility of Misuse of Information.—The second argument against disclosure rests upon the possible misuse of information by competitors or by speculators. In certain respects this fear is well founded. Obviously, disclosure would serve no good purpose if the result were to permit competitors to gain unfair advantage as, for example, would be the case if a bank were to reveal the full information about each and every customer, or the means and methods by which its business was acquired and maintained. Nor would it serve any good purpose to reveal the names and extent of the indebtedness of borrowers since this might easily result in embarrassment to them.†

The same objection does not hold with regard to the publication of security holdings. Such lists are already widely disclosed by other types of institutional holders and the practice does not appear to have caused any damaging results. Rather, the knowledge that their investment decisions would face the searching light of public inspection would lead bank officers to more careful consideration and responsible action.

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† Publicity advocated in Chapter 10 refers only to the overall condition of the bank, not to details about relationships with individual customers. Such details should not be available even to individual directors, but only to the board as a whole. See page 162. (R. G. R.)

Fear of Unfavorable Legislation.—The third objection, the fear of unfavorable legislation, appears to lack foundation. It is true that the disclosure of inordinately large profits, if such existed, from, say, service charges, exchange charges, or interest charges on certain types of loans might result in their limitation by law. On the other hand, the disclosure of heavy taxes and assessments might serve to persuade intelligent and sincere legislators of the desirability of granting relief from onerous burdens. Certainly banks will be more vulnerable to unfavorable legislation when maintaining an attitude of cold secrecy than when advertising their affairs dispassionately and impartially.

The Importance of Governmental Supervision.—The contention that the affairs of banks are already under the surveillance of the supervisory authorities is undoubtedly the principal reason explaining the fact that banks for many years have been spared the compulsion of more complete disclosure to the public of their affairs. With the exercise by government of visitorial powers over banks, the need for amplification of published information evidently was deemed to have been allayed by the implied assumption of responsibility by the State as to the condition of the institutions under its care.[1]

The Securities Act of 1933 required the registration of new issues of securities with the Commission and the attendant disclosure to the public of detailed information regarding the condition and earning power of corporations. This law was intended to protect investors. However, the issues of banks were specifically exempted from its provisions on the ground that their affairs were under the surveillance of the supervisory authorities.[2] The question of exempting bank stocks was never really argued in the hearings on the bill, since it was taken for

[1] The submission of call reports to the supervisory authorities and, later, their mandatory publication antedated the practice of examination by governmental authorities. Originally, the National Currency Act in 1863 empowered and directed the Comptroller of the Currency, with the approval of the Secretary of the Treasury, to appoint suitable persons to make examinations, but it was not until 1913 that the law made provision for regular semi-annual examinations. See *Annual Report of the Comptroller of the Currency*, 1939, p. 6.

[2] See *Report of the Committee on Banking and Currency to Accompany S 875*, Senate Report No. 47 (73rd Cong., 1st Sess.) April 17, 1933, p. 14.

granted that the publication of reports of condition was already required and, moreover, that the examination system rendered unnecessary a fuller disclosure to the public. The fact was overlooked that regulation of banks had been concerned for the most part with the protection of their depositors and not with the protection of their owners. Investors in bank stocks were expected to be able to take care of themselves.

The Securities and Exchange Act of 1934 did not exempt banks. However, in practice, the disclosure requirements affecting registered companies have not embraced the banks since, with a few exceptions, bank shares are not listed on national securities exchanges, but are traded in over-the-counter markets where registration has not been required. In the hearings on *Stock Exchange Practices* which preceded and followed the enactment of this law, the question of inadequate bank reports arose only a few times incidental to discussions of malpractices of banks. The testimony of witnesses was divided as to the desirability of fuller disclosure. The opinion was expressed by a number of persons that banks should be required to publish their securities portfolios in reports to stockholders, and that loans to officers and directors, as well as pledged assets, should be shown fully in call reports.[8] Publication of earnings reports apparently did not receive consideration.

Ever since the supervisory authorities first undertook to examine banks, the reports of examiners were treated confidentially and access to them was denied to persons other than the banking authorities, except in tax investigations and criminal prosecutions. The theory of confidential treatment received further support in the Trust Indenture Act of 1939, which, in giving the Securities and Exchange Commission access for certain purposes to the reports and other records in possession of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit In-

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8 See Hearings Senate Banking and Currency Committee, *Stock Exchange Practices*, Part 4, p. 1631 ff., Part 8, p. 4129, Part 12, pp. 5478, 5752, 5786.

surance Corporation, prohibited their publication and confined their use by the Commission to the performance of its duties in the determination of the qualifications of indenture trustees.[4]

In hearings on this law, Justice William O. Douglas, then Chairman of the Securities and Exchange Commission, took the position that the reports received from federal supervisory agencies "clearly should be used circumspectly" and that the Securities and Exchange Commission should not be permitted to make such information public.[5]

Prior to the enactment of the Trust Indenture Act, the confidential nature of the examination reports submitted to the regular banking supervisory agencies had already been the subject of consideration by the United States Court of Appeals for the District of Columbia which on May 8, 1939, held that the delivery to the Securities and Exchange Commission by the Secretary of the Treasury and the Comptroller of the Currency of examiners' reports was authorized and legal, but that they should be treated confidentially when used in proceedings to obtain the necessary facts and information whereby to carry out the investigatory function of the Commission.[6]

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4 Trust Indenture Act of 1939, Public No. 253, (76th Cong., 1st Sess., S 2065) approved August 3, 1939. See Sections 310 (a) (2) and 321 (b). The Act specifies, as one condition of eligibility for institutions serving as indenture trustees, that the trustee possess a combined capital and surplus commensurate with its responsibilities. Authorization is given to the Treasury Department, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation to make available, under such conditions as they may prescribe, such reports, records or other information as they may have available with respect to trustees under indentures qualified, or to be qualified, in order to facilitate the performance of the duties of the Securities and Exchange Commission. Every trustee, as a condition precedent to qualification of an indenture, shall consent that the reports of examinations by Federal, State, Territorial or District authorities may be furnished by such authorities to the Commission upon request therefor. However, it is provided that no report or other information for the use of the Commission shall be divulged or made known to any persons other than members or agents of the Commission except the Attorney General.

5 Hearings before a Sub-committee on Banking and Currency of the U. S. Senate on S. 2344 (75th Cong., 1st Sess.), *Regulation of Sale of Securities,* pp. 71-75.

6 Decision of the United States Circuit Court of Appeals for the District of Columbia, No. 7354, decided May 8, 1939, *Bank of America National Trust and Savings Association vs. William O. Douglas et al.* A brief description of court's findings appeared in *The American Banker,* May 9, 1939, and in *Fifth Annual Report of the Securities and Exchange Commission fiscal year ended June 30, 1939,* pp. 102-103.

The Voluntary Practices of Bankers in the Matter of Disclosure

Until the last decade, all except a few banks were unwilling to reveal to the public more information regarding their affairs than was required by law. Statement making was designed almost entirely for the purpose of meeting the call requirements of the supervisory authorities. As already noted, publication of balance sheets has been a compulsory requirement for many years. This has not been true of earnings reports whose disclosure to the public or to the stockholders has depended upon the attitude of managements at annual meetings or has been conveyed in written communications to stockholders. Although there were occasional instances of detailed statements published by banks for public consumption, it was the general practice of bankers to clothe their affairs in secrecy.

After 1900, owing to public dissatisfaction, more liberal practices were adopted but little was accomplished until, in the early 1930's, more and more banks, especially the larger city institutions, began to issue fairly comprehensive statements of condition and became somewhat less grudging in clarifying the basis upon which earnings were derived. This movement gained considerable momentum during the 1930's, influenced undoubtedly by the compulsory disclosures required of other corporations under the securities laws, as well as by the pressure of public opinion. In 1933 the United States Trust Company and the Corn Exchange Bank Trust Company of New York both disclosed their list of securities holdings. Although this practice was not generally copied, other banks have been inclined to publish more and more detail about such holdings and some have shed considerable light on their investment policies. After limited experiments in 1934, banks in New York City at the 1935 annual meetings of stockholders admitted the press to attendance, in most instances without proxies and by invitation of the banks themselves. Since then the practice has spread and may now be regarded as customary.

Thus it may fairly be said that today there is more complete disclosure of the financial affairs of banks including spe-

cific information as to balance sheets, profits and losses, and policy than ever before, but the present situation leaves much to be desired. Many bankers continue to maintain an attitude of diffidence with regard to fuller disclosure and dissemination, and an inclination to maintain practices *in status quo*.[7]

In the face of this generally negative attitude of bankers, at least one supervisory official has asserted that the need for the adoption of some plan under which all banks would furnish shareholders with full information about earnings is worthy of the consideration of the legislature.[8] The financial press has echoed this recommendation and the subject will undoubtedly be reiterated in the future until some action is taken.[9]

The Principal Deficiencies and Inadequacies of Published Reports

Government regulation of banking throughout our history has been directed mainly towards the protection of the note and deposit holder, and to this end was concerned, until quite recently, almost exclusively with the determination of the technical solvency of the institutions. Emphasis was laid, therefore, upon static reports of condition rather than upon

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7 This is apparent in the answers of various bankers' associations to questions posed by the Senate Committee on Banking and Currency relative to S. Res. 125 (76th Cong., 1st Sess.). The consensus of replies to the questions, "What benefit or harm follows from requiring publication of bank balance sheets?" is that probably little harm results from the publication of these figures, that they may even be helpful, but that present laws are adequate. See *Answers of the American Bankers Association*, pp. 50-61, *Answers of the Association of Reserve City Bankers*, p. 31, *Proceedings of the Association of Supervisors of State Banks* (39th Annual Convention), September 17-20, 1940, pp. 68-69. Replies to the question, "Would you favor a requirement for publication of all earnings statements submitted to the supervisory authorities?" indicate definite opposition to such a requirement, ranging from the flat statement that such reports are too detailed and complicated to the admission that publication of the end results in standardized form is to be desired and that such figures have a direct bearing upon the availability of bank capital. See *Answers of the American Bankers Association*, pp. 88-89, *Answers of the Association of Reserve City Bankers*, p. 51, and *Proceedings of the National Association of Supervisors of State Banks*, 1940, pp. 68-69.

8 See *Annual Report of the Superintendent of Banks, State of New York*, Part One, Year ended December 31, 1941, Legislative Document No. 21 (1942), p. 20.

9 See, e.g., *The American Banker* editorials, February 16, 1940, December 2, 1941, December 8, 1941, August 4, 1942, August 11, 1942; *The New York Times* editorial, January 24, 1942; *The New York Herald Tribune*, financial page, January 25, 1942; *The Bankers Magazine*, art. by Ward Schultz (Financial Editor, *Detroit Times*)—"Clarified Bank Earnings Statements," March, 1942, pp. 225-226.

earnings. It was not until the turn of the century that earnings reports were called for generally by the supervisory authorities, but, even so, their publication has never been made compulsory. Perhaps another reason for the lack of published earnings statements is the fact that many banks formerly were owned by a small number of stockholders, including officers and directors, who very likely were in close touch with the bank's affairs and in a position to obtain any information they desired. However, owing to the admitted difficulty in the last decade of raising private capital from existing shareholders in banks, and in view of the more widespread ownership of bank stocks by institutions and trust funds, there is greater need today for disclosure and dissemination of facts relating, not only to condition, but to earning power. Indeed, there is real question why the publication of profit and loss statements should not be required. It is only in recent years that the relation of earning power to the conservation or enlargement of bank capital, and hence the solvency of banks, has been perceived. Disclosure of profit and loss statements, as well as balance sheets, is now necessary to explain to stockholders the reasons for retention of earnings in order to conserve capital, and is prerequisite to the public sale of additional shares.

Present-day practices of banks in reporting their affairs to the public can be criticized on the following grounds:

1. The use of condensed balance sheets in published reports of condition.
2. The failure of many banks to publish an earnings statement.
3. The lack of uniformity in statement presentation and in accounting practices.

Balance Sheets.—The legal form on which banks submit their balance sheets to the supervisory authorities, whatever its technical defects, today enjoys the advantage of standardization. This is the result of the combined efforts of the federal supervisory authorities, the National Association of Supervisors of State Banks, the Association of Reserve City Bankers, and the National Association of Bank Auditors and

Comptrollers. The adoption of the standard report form of condition is rendered still more valuable by the previous agreement reached upon uniform practices in regard to the valuation of assets in examinations, also agreed to by the federal as well as by a considerable number of the state authorities.[10]

Although the legal call reports are reasonably satisfactory in regard to detail, the published versions do not include all the detail which is required to be shown in schedules on the official returns. For example, the schedules which classify securities by maturities are not ordinarily published, so that there is no way of obtaining such information concerning an individual bank unless that bank voluntarily discloses it, as is now the practice of leading banks at annual meetings. However, the banks which voluntarily disclose this information do not do so on a uniform basis.

Assets are not classified in either the official returns or in their published versions according to clean-cut criteria. At present, loans are divided into a mixture of categories. Thus, there are loans classified by type of borrower (e.g., brokers' loans), loans classified by purpose (e.g., real estate loans), and loans classified by collateral (e.g., loans secured by securities). Some of these categories overlap because the classification basis is not consistent. It would be desirable if the loan total were classified according to several carefully chosen criteria, such as type of borrower, size, maturity, and purpose to which the proceeds of loans are put, e.g., for working capital or for fixed capital purposes. Similarly, the classification of deposits of individual banks, which ordinarily reveals only the amount of demand and time deposits, might also be based upon size of deposit accounts, ownership by economic classes, etc.

Some of the detailed information described in the preceding paragraph is now compiled for sample groups of banks as of selected dates from answers to special questionnaires. How-

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10 This form was reproduced in *The American Banker*, December 7, 8, 9, 10, 1938. Its adoption by the various state banking departments was urged in a resolution of the Executive Committee of the National Association of Supervisors of State Banks. A description of the advantages of and changes embodied in the new form are to be found in the *Federal Reserve Bulletin*, January, 1939, pp. 22-23.

ever, very little of it is available for individual banks. The collection and publication of this kind of information by individual banks as a regular practice would involve heavy expense. For this reason bankers can hardly be blamed for failing to publish their statements in ways which will satisfy the wide variety of purposes which the statistician or the economist may have in mind. However, there is no doubt that there is plenty of room for improvement, and that the progressive banker will advance the reputation of his institution if he shows a readiness to expand or modify stereotyped forms in reporting to the public.

Condensed Balance Sheets.—Chief criticism has been levelled at the common practice of all but a few banks of publishing their legal statements in very small type in the least conspicuous parts of the newspapers, while giving prominence in their advertising copy to what is known as the "condensed" version of the balance sheet. The condensed statement typically reduces the statement of resources and liabilities to a few major classifications, such as Cash in Vault, Deposits at Federal Reserve Bank, Government Securities, Other Securities, Loans and Discounts, Demand Deposits, Time Deposits, Capital Funds, etc. The use as catchalls of items designated as "other assets" or "other liabilities" is a common defect of published statements. The capital account is seldom broken down into its component parts so that little or no information can be gleaned as to the proportion of preferred stock outstanding, its call price and preferences, the existence of surplus, or the size of reserve accounts which may have been included.

Condensed statements almost invariably show net book values of the various asset items and give no information with regard to valuation allowances or other adjustments. No clue is to be found in most statements of the principles of valuation employed, or of the extent of the disagreement between book valuations and examiners' valuations. Thus the qualitative nature of the asset composition is almost entirely obscured by oversimplification and lack of explanation. Moreover, there is no single standardized form of condensed statement in use,

with the result that the data of one bank cannot readily or reliably be compared with those of another or with group averages.

The banking community would receive public commendation if it should adopt, through its leading associations, standards of accredited practice in statement making. Initial agreement might well concern the following:

1. The minimum number of items to be shown in condensed statements and in annual reports.
   Attached schedules should classify the maturities of the securities portfolio both by first call and final maturity dates. Similarly, outstanding loans should be classified according to maturity.
2. The selection of items which should be shown gross and which may be shown net.
   It seems desirable to show the securities holdings at book value, and valuation reserve as a separate item.
3. The minimum information to be given in memoranda regarding principles of valuation employed, pledged assets, etc.
4. The degree to which details of the capital account should be amplified.

The Inadequacies of Published Earnings Statements.— Although banks are not required to publish earnings statements, such reports must be submitted to the supervisory authorities. Few banks voluntarily publish more than a simple net earnings figure. This information is made available annually at stockholders' meetings. More frequent information must be deduced from changes in surplus and undivided profits occurring between balance sheet dates.

A recent study of the reports to stockholders of 107 banks in various parts of the country showed that 101 included earnings data. Twenty showed only the figure of net profits and dividends. No agreement prevailed regarding the proper division between operating and nonoperating sections of the income account, few banks showed nonoperating income in any detail,

and still fewer revealed the sources and disposition of income in detail. Dividends in some cases were represented as a deduction from operating earnings, in other cases as a deduction from nonoperating earnings. In few cases was any attempt made to reconcile the profit and loss statement as given with the changes occurring in the capital accounts. The reported data were seldom sufficiently complete to make this possible.

Treatment of profits and losses on securities differs not only as to their inclusion or exclusion in the operating section of the income account, but also as to the manner in which profits and losses on security sales are handled. Similarly, practices differ with regard to the treatment of write-downs and recoveries, some banks following the practice of charging losses and crediting recoveries and profits on securities sold to reserve accounts without giving any indication in the earnings statement of the extent of such transfers from or to reserve accounts. Furthermore, it is impossible to know what kinds of reserves are referred to in the narrative which sometimes accompanies these reports.

The absence of uniform practice seems to have been caused by a desire not to reveal the changes which take place, but also is attributable to differences in accounting theories employed.[11] All banks do not observe the same accounting principles. Furthermore, a bank may not employ the same basis in rendering an earnings report to different supervisory authorities, nor does it always employ the same basis in reporting to stockholders as it employs in reporting to the supervisory authorities. An example of this is to be found in the practices observed in reporting interest earned on investment securities. In reporting to the federal authorities some banks deduct amortization from interest earnings, while in reports to stockholders they may include it in expenses.

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11 Differences in accounting practice are strikingly brought out in a questionnaire submitted by the New York City Bank Auditors and Comptrollers Conference to its membership in May, 1940, regarding treatment of various accounts in reports to state and federal supervisory authorities and in reports to stockholders. See also digest of replies in Spencer Marsh, *A Bank's Annual Report to Its Stockholders* (thesis, Graduate School of Banking, American Bankers Association, New Brunswick, June, 1942).

Defects of Earnings Reports to Supervisory Agencies. —The earnings and dividends reports to supervisory authorities are now more nearly uniform than in the past, but the report forms are by no means identical, nor are they collected with the same frequency. Differences among the forms of the federal agencies are relatively unimportant.[12] However, great variation is to be found among the forms prescribed by the various states owing to different legal and supervisory requirements. The adoption of a standard legal earnings and dividends report form through cooperative action of the various supervisory authorities (as was done with the reports of condition) would go far toward rendering feasible the adoption of a uniform basis in the voluntary reports of individual banks.

In view of the growing conviction that earnings data must be published if private capital is to be attracted to the banking business, compulsory disclosure of earnings would seem to be an eventual development unless leading banks agree through clearing house or other associations upon some form of uniform condensed earnings report.

The choice of the most desirable form in which earnings statements should be made depends upon the amount of information it is desired to disclose. In order to prove of analytical value, it seems necessary that the form should: (1) be based upon the legal report form of earnings and dividends submitted to the federal authorities; (2) be divided into an operating and nonoperating section, the former designed to show both gross and net earnings and their principal sources; and (3) show separately profits on sale of securities, transfers from valuation reserves, recoveries on assets previously written down, as well as losses and charge-offs and transfers to valuation reserves; and finally, (4) include a reconciliation of the earnings statement with changes in capital accounts.

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12 For example, depreciation of national and state member banks reporting to the Board of Governors of the Federal Reserve System is shown as a single item under losses and charge-offs. Insured banks in reporting to the Federal Deposit Insurance Corporation classify regularly recurring depreciation as current operating expense. See the various forms prescribed, or *Annual Report of the Federal Deposit Insurance Corporation,* 1940, p. 90.

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