UNIVERSAL
LIBRARY
OU_172349
UNIVERSAL
LIBRARY

BANKING AND EXCHANGE.

BANKING
AND
EXCHANGE

BY

S. EVELYN THOMAS, B.Com. (Lond.)

Certificated Associate of the Institute of Bankers, London Associate of the Chartered Institute of Secretaries Fellow of the Incorporated Secretaries' Association Fellow of the Royal Economic Society "Beckett," "Charles Reeve," and "Gwyther" Prizeman, Institute of Bankers, Author of "The Principles and Arithmetic of Foreign Exchange", "Banker and Customer," "Elements of Economics" and "Principles of Banking" also Joint Author of "English Grammar, Composition and Correspondence"

THE DONNINGTON PRESS
40-42 ST PETER'S STREET
ST ALBANS

THE GREGG PUBLISHING Co LTD.
KERN HOUSE
KINGSWAY, W C 2

PREFACE

In preparing this book I have had before me the needs of those who, being neither bankers nor exchange dealers, must nevertheless find a general knowledge of the principles of Banking and Exchange of inestimable value in their daily work My task in planning the volume was much lightened because the useful scope of the subject to the particular class of reader which I have had in mind has been clearly defined in the syllabuses of such professional bodies as the Institute of Chartered Accountants, the Chartered Institute of Secretaries and the Incorporated Secretaries' Association I have accordingly had particular regard to the limits so imposed, in the hope that the work will prove useful, not only to students for the examinations of these bodies, but also to those who are engaged in the higher branches of professional and business activity

The compilation of a book which is intended to deal only with the main principles of a vast body of knowledge must of necessity, involve a considerable amount of compression, and the exclusion of certain points of detail or intricacy But this should not detract from the utility of the work as a general exposition, and there are, of course, innumerable excellent authorities to which the reader in search of further information can most usefully refer

My thanks are due and are here accorded to the Publishers of my books " Banker and Customer " and " Elements of Economics " for their permission to make use of certain material in those publications, and also to Messrs MacDonald and Evans, of London, for their permission to base the Foreign Exchange section of this book on the Fifth Edition of my " Principles and Arithmetic of Foreign Exchange ", which is published by them

S E T

April, 1950

CONTENTS

Part I.

BANKING AND CURRENCY

CHAP		PAGE
1	From Barter to Money	1
2	The Theory of Money and Prices	16
3	Monetary Standards and Currency Systems	35
4	Credit and its Functions	50
5	The Development of British Banking	57
6	The Functions of British Banking	76
7	The Banker's Funds, their Source and Employment	86
8	The London Money Market	99
9	The English Capital Market	112
10	The Bankers' Clearing System	124
11	The Bank of England and the Money Market Central Banking	132
12	Trade Cycles and Financial Crises	148

Part II

BANKS AND THEIR CUSTOMERS

13	The Customer's Account	163
14	Personal Customers and Partnerships	176
15	Impersonal Customers	189
16	Securities for Advances	203
17	Personal Security	212
18	Collateral Security	225
19	Safe Custody and other Services for Customers	248

Part III

BANK INSTRUMENTS

20	Bills of Exchange	257
21	Cheques	280
22	Indorsements	293
23	The Payment of Cheques and Bills	308
24	The Collection of Cheques and Bills	327
25	Other Banking Instruments	342

Part IV.

BANKING AND THE EXCHANGES.

PAGE.		PAGE
26.	THE THEORY OF THE EXCHANGES	359
27.	EXCHANGE QUOTATIONS AND TERMINOLOGY	370
28.	FOREIGN EXCHANGE MARKETS	381
29.	FLUCTUATIONS IN THE EXCHANGES	387
30.	THE BALANCING OF NATIONAL DEBITS AND CREDITS: CENTRAL BANKING POLICY	401
31.	THE SILVER EXCHANGES AND THE GOLD EXCHANGE STANDARD	416
32.	POST-WAR CURRENCY PROBLEMS	425

Part V.

BANKING AND THE FINANCE OF TRADE AND INDUSTRY.

33.	THE FINANCE OF TRADE: MINIMISING EXCHANGE RISKS	434
34.	THE FINANCE OF TRADE: MINIMISING CREDIT RISKS	448
35.	BANKS AND THE FINANCE OF INDUSTRY	472
	INDEX	495

PART I.

BANKING AND CURRENCY.

CHAPTER 1.

FROM BARTER TO MONEY.

When wants are primitive and the number of exchangeable articles is small—as was the case in the early history of the world, and is still the case in many uncivilised communities—man's bodily needs are satisfied without difficulty by the direct exchange of one commodity for another Such a system—if it is a system at all—is known as *barter* So much wheat is given for a sheep, so much fish for a certain number of apples, a cow for a certain number of days' work, and so on

The difficulties and inconvenience of such a system become apparent with the increase in the number of exchangeable articles and with the increase in the number of times those articles are exchanged Barter not only involves the satisfaction of both parties to the bargain , it also requires that one man must need what the other has to give, and that he shall give what the other happens to want The hunter may offer furs for goat's milk, but the herdsman with goat's milk to spare may want fruit and not furs

Barter is obviously impracticable when a man's possessions are such that they cannot be subdivided without loss, for if his wealth consists only of cows, or sheep, or goats, it is well-nigh impossible for him to obtain articles of small value by direct exchange Again, barter implies that, when two articles are exchanged, one must be *immediately* transferred, and the other *immediately* accepted It provides no means whereby something may be given *now* for an equivalent good *in the future* Barter affords no method of comparing the relative values of two commodities, and no standard for measuring *deferred* payments

The exchange of services under these conditions is a matter of still greater difficulty, and so we find that, in any organised community, the time and trouble involved in seeking for a *double coincidence of wants and of possessions* make barter quite impracticable.

The Demand for a Medium of Exchange.

The inconveniences of barter led men from the earliest times to fix upon some intermediate commodity which would function as *money*, and, as such, would always be accepted within the community in exchange for goods and services The nature of the article thus chosen did not matter, as long as it was familiar, easily recognisable, and generally accepted So, in the many different parts of the world where the need for such an intermediary has been recognised, articles in great variety have been utilised in this important rôle—oxen in ancient Greece, whales' teeth in Fiji, cowrie shells on the African Coast, bricks of tea in Tibet, and rice in Japan

All such articles had the advantage that they could at any time be transferred from one person to another in exchange for goods or services They fulfilled the first and original functions of money in affording a *means for the exchange* of other commodities, and in forming a *basis for the measurement and comparison of the value* of such commodities

The Need for a Store of Value.

But all these early forms of money were subject to disadvantages Some were bulky, indivisible and inconvenient, others were perishable and unsuitable as a means of holding wealth for any period of time Oxen die, grain, rice and tea perish Ultimately, such commodities become valueless and cease to be acceptable They obviously fail to fulfil the requirement that money should act as a *store of value* and as a *standard* for the evaluation of *deferred* payments

The absence of these attributes in the early forms of money led to the search for some more durable and more compact commodity, possessing value and acceptability in itself, which could be relied upon, not only as a means of immediate exchange, but also as a store of value for future use Articles of adornment or the materials from which such articles were made afforded the obvious solution, and so it was that men came to adopt for exchange purposes the precious metals—gold and silver—which, because of their lustre and scarcity, have always been attractive as a means of ornament, and are now used as money by all civilised communities

Definition of Money.

Money is therefore *a commodity chosen by common consent to be a means of exchange and a measure of value between all other commodities.* The commodity used as money must be universally accepted within the community in exchange for goods and services, and must be received without demur in final settlement of obligations

Although money may exist in countless forms, the idea underlying all of them is that they can be used, either now *or in the future*, to command in exchange the labour or the product of the labour of others Money represents a claim upon all other members of the community, it is an order or promise to deliver which can be enforced *whenever the owner pleases* It is a means to an end, held temporarily, not for its own sake, but as a means of obtaining other articles or of commanding the services of others Money enables the consumer to generalise his purchasing power, and to make his claims on society at the time and in the form which suit him best It eliminates the waste and inconvenience which would attend payments in kind, and ensures that anyone with the *means* of enjoyment may obtain *actual* enjoyment with the minimum of trouble and delay

Clearly, the use of money is a most important aspect of the division of labour Without it, production on the modern scale would be impossible, for present day producers could spare neither the time nor the energy required to barter their goods for the products of others Were it not for the existence and development of the money economy, man as producer could not minister to the increasingly varied and extending wants of man as consumer The use of money facilitates the transfer of capital by loans and payments of all kinds, and it has made possible that extension and efficiency of the credit system which has contributed so materially to the progress of mankind

The Functions of Standard Money.

The definition of money which we have given is the definition of *standard money*, *i e*, the commodity, now usually gold, which is used as the standard of value within the community, and it is clear from what has been said that such a commodity must be capable of fulfilling a number of important functions.

MEDIUM OF EXCHANGE —The first and original function of the commodity chosen is that it shall be freely accepted within the community in exchange for all other commodities and services Its owner must be enabled to obtain satisfaction of his wants without difficulty

MEASURE OF VALUE —The next essential is that the commodity must be such that the values of all articles to be exchanged shall be capable of measurement by reference to the standard commodity The measurement of the value of articles in this way facilitates comparison of their utility, and thus simplifies their exchange

STORE OF VALUE —Whilst practically any commodity, perishable or otherwise, may serve as a mere medium of exchange, a satisfactory standard money must not deteriorate with time Its owner should be enabled to retain it indefinitely so that he can *at any time* exchange it without prejudice or loss for the satisfaction of his wants

STANDARD OF DEFERRED PAYMENTS.—Persons who arrange now to receive payment at a future date must be assured that the value they will receive in the future will correspond to what they could demand now. Some medium must be chosen whose commodity value is reasonably steady over a period, and of which neither the supply nor the demand is subject to violent change. The relationship between individuals and between communities must be equitably and reasonably maintained. Debtors must not gain at the expense of creditors, or creditors at the expense of debtors. This can be achieved only if the basis of all credit transactions is of reasonably stable purchasing power.

The Qualities of a Good Standard Money.

By no means all of the forms of money to which reference has been made can be regarded as satisfactory if adjudged by the foregoing analysis. Many of them entirely fail to fulfil the functions mentioned, and their use would certainly be a hindrance rather than an asset under modern conditions. Moreover, most of them fall far short of possessing what are usually regarded as the essential qualities or characteristics of good money, *viz.*—

GENERAL ACCEPTABILITY.—The material must be such that anyone within the community will take it without hesitation in exchange for goods or services.

The precious metals are always acceptable for, apart from their monetary use, they possess utility in themselves *e.g.*, for ornament, and their possession is desired in all countries.

PORTABILITY OR EASE OF TRANSPORT.—A satisfactory money must be of relatively high value for small bulk and must be capable of being carried from place to place without inconvenience, expense or difficulty.

The precious metals are eminently satisfactory in this respect, gold more so than silver. But this attribute, so far as metallic currency is concerned, becomes of less importance with the extension of the credit system.

DURABILITY.—The material must not deteriorate in itself, or as a result of wear and tear, otherwise it will not last for a reasonable period of time, and will be incapable of transport over long distances without losing some value. Durability is essential also if stability of value (see below) is to be maintained.

Gold coins last for many years without great deterioration. Silver is far less durable, but, if mixed with a suitable alloy, will retain its lustre and remain free from rust or tarnish.

HOMOGENEITY, DIVISIBILITY and MALLEABILITY.—All coins of the same metal must be as nearly as possible of the same quality throughout. One coin must not be superior to another. Further, the metal must be

capable of division without difficulty, so that all pieces, of whatever size, are of uniform quality and of value as material in proportion to their weight Coins of the same metal must also be capable of being easily re-united without loss

Precious stones have many of the qualities of good money material, but they are incapable of division without loss, are by no means homogeneous, and cannot, of course, be stamped or moulded On the other hand, the mechanical properties of the precious metals are excellent they are capable of easy division , their standard of purity can be fixed and maintained with remarkable accuracy, while their great malleability permits of their being easily stamped and impressed with intricate designs

Cognizability —It is essential, if counterfeiting is to be made difficult, that the material of which money is composed be instantly recognisable and distinguishable from all other materials whether by the eye, the ear or the touch

Gold and silver are at once recognised by their distinctive colour, metallic ring and heavy weight for small bulk

Stability of Value —Commodities which are subject to violent changes in supply or demand are useless as money It is no less disadvantageous to have a fluctuating standard of value than it would be to have a changing unit of weight or of measurement The value of a material which is used to measure the value of other materials must be as consistent and stable as is possible

The value of gold is fairly constant because the yearly production is small compared with the total quantity in existence Changes in value do occur, but they are normally so gradual as not to occasion any widespread loss, inconvenience or distrust in the metal as a monetary material

Silver is not so satisfactory in this respect since its value in recent years has fluctuated very considerably in consequence of marked changes in both demand and supply

Paper Money.

In modern times the precious metals, and particularly gold, have tended to be used for internal exchange purposes in a constantly decreasing degree The inhabitants of the United States have always preferred notes and cheques for everyday purposes, and since the Great War European nations have, by force of circumstances, also adopted paper media of exchange, with the result that gold has almost universally disappeared from circulation.

The term " paper money " is used in contradistinction to " hard " money, *i e* , metallic or coined money, and includes bank notes and

government notes which pass from hand to hand without difficulty or question, and not generally cheques and bills, which have a limited circulation only Paper money is often issued by the State, although in many countries, such as England, Scotland and Ireland, it is issued by private banking institutions which are subject to legal control

Paper money may be either *convertible* or *inconvertible* In the former case the holder has the right of conversion on demand into gold or silver, held as a reserve against the issue. In the case of inconvertible paper, however, the holder has no such right of conversion sometimes the fact of inconvertibility is frankly confessed , at other times, although in theory the notes are convertible, in practice they are not

Convertible Paper Money.

This type of money may perform the functions of a good money in the highest degree, provided that the promise to repay is unmistakable and is always fulfilled immediately on demand Its cognisability can be made almost perfect , it is light and portable, it can easily be issued for various amounts and can be made unmistakably homogeneous The use of paper is obviously a great economy, and although it is not very durable in itself, the difficulty is overcome by the frequent withdrawal of soiled notes and the issue of new ones

Moreover, the stability of value of paper money can be satisfactorily maintained if sufficient care is exercised by the issuers to ensure good reserves and free convertibility into the standard of value In this way the currency may be almost entirely self-regulating any issue in excess of the wants of the community is converted into metallic money, and inflation of the currency is consequently obviated Immediately the value of notes falls below the value of bullion, the position is adjusted by the conversion of notes into bullion , and *vice versa*

Distinction is sometimes made between notes which are backed unit for unit by gold, and notes which are issued against a reserve partly of securities and partly of gold Both may be absolutely convertible, but the former are regarded as being issued, for convenience, *in place of* the metal which is reserved against them , they are really *bullion certificates*, the possession of which entails no risk On the other hand, notes backed partly by securities may conceivably become inconvertible if so many are tendered for encashment at one time as to exhaust the actual bullion reserve and make realisation of the securities impossible within the time at the disposal of the issuers

Inconvertible Paper Money.

Unfortunately, the history of paper currencies is marred by the frequency with which such issues have been subject to periods of

inconvertibility, short or prolonged. It requires the utmost good faith and most careful management to ensure the convertibility of paper notes, particularly in times of financial stringency, when the temptation to over-issue is very great At such times, there is always a tendency for more notes to be issued than is warranted by the bullion reserve, and, when demand slackens and the notes return for encashment, it may become difficult and eventually impossible to redeem them They may then become inconvertible and subject to all the evils of a depreciated paper currency Such excess issues are in the nature of forced loans, and the notes can be kept in circulation only by virtue of the power of the State which lies behind them And, obviously, the value of a paper currency with no metallic backing is liable to fluctuate considerably People estimate the value of the paper according to the stability of the issuing government, and according to the fortunes of the ship of State , the elements of personal opinion and speculation are thus introduced into a sphere which should have a far more certain foundation

Although, as a general rule, a paper standard is unsatisfactory because of the possibility of abuse by the issuing authority, much theoretical argument may be advanced in favour of a currency consisting entirely of inconvertible notes, the issue of which is rigidly limited to the current public need Paper money is economical and convenient , it is easily issued and, since the volume of currency is not regulated by the size of a metallic reserve, it can be expanded or contracted so as to achieve a fine degree of price stability and to avoid changes due to fluctuations in the value of the precious metals Furthermore, there is no loss due to the maintenance of a sterile metallic reserve, there is no wastage of expensive coinage by wear and tear, and no loss on reminting The difficulty is to ensure that only sufficient money is issued to satisfy current demands and to ensure that, while inflation is avoided, the community is not deprived of sufficient money to cover its normal economic activity and progress This matter is further discussed in Chapter 3

Various Forms of Money.

If we pause for a moment to consider the various forms of money which circulate in a modern community—gold coins, silver coins, coins of base metals and paper money of all kinds—it soon becomes obvious to us that some of these do not entirely fulfil the functions of standard money nor possess all its essential qualities Paper money is clearly useless in itself as a store of value, while coins of copper, bronze or nickel, because of the relative destructibility of the metals and the frequent changes in their value, are equally unsatisfactory as a store of value or as a standard for deferred payments

For these reasons it is now usual to apply the term "money" (as distinct from the term "standard money") in a general sense to mean *anything which is widely used and accepted as a means of exchange*

According this definition, a thing is regarded as money even though it cannot function as a standard of value, provided that it is expressed in terms of the standard. Thus, notes, cheques and bills of exchange are regarded as money so long as they pass in payment for goods or in discharge of debts "Money is as money does," and all such media are effective money so long as they facilitate exchange and are actually doing the money work The only essentials to their acceptance in this way (excluding for the moment any question of credit) is that their form should inspire confidence and that their amount should be a multiple or sub-multiple of the unit of account or the *unit of calculation*, which will usually exist as a coin of the standard metal

Credit Money.

Occasionally, these instruments of exchange are described as *credit money*, a useful term which serves to remind us that cheques and bills are taken in payment because the receiver is reasonably certain that he can convert them at his option into legal tender currency If there is any doubt upon this point, such instruments are not usually accepted, and a demand is made for payment in coin or notes For this reason, cheques and bills tend to circulate as money only to a limited extent and between persons who have confidence in the fact that they are good for their face value

Moreover, we must remember that such circulating media, being merely pieces of paper, cannot function as a standard or store of value except in so far as they represent the standard of value If there is any doubt as to the value for which they stand, they cease to be acceptable and cease to function as money Hence, if we adhere to the conception of money as something which operates both as a medium of exchange *and* a standard of value, then we may reasonably regard bills, cheques, notes and any other instruments of exchange as *representative money*, *i e*, as convenient substitutes for the standard of value.

Practical Tests for Money.

Having thus arrived at an understanding of the meaning of the term "money," we may safely apply our definition in one or two special cases with a view to clarifying still further our ideas We may add to the utility of our test cases by bearing in mind that anything which serves the community as money has an effect on the general level of prices because, as is more fully explained in the next chapter, it adds to the supply of money which is available to do the money work.

Let us consider first of all the Bank of England note, the paper promise to pay of a privately owned institution Such a note is certainly money because it is generally accepted for exchange purposes, it is expressed in terms of the standard of value and is ordinarily convertible into that standard It makes no difference whether that note is backed pound for pound by gold, or that it forms part of the Bank's fiduciary issue, or, indeed, that it forms part of an emergency issue in excess of the fiduciary maximum, provided that—and this is an important provision—the notes continue to be acceptable as a convenient representative of the standard of value

What, then, can we say of the gold *bullion* in the form of bars held by the Bank against its notes? Clearly, such gold is no more money than unmined gold, or gold which lies in the hold of a sunken ship It certainly can be bought and sold on the Bullion Market, and it may be exchanged for metallic or paper currency, but the bullion itself is not expressed in terms of the standard of value and would not be generally acceptable as a medium of exchange In short, it is not money because it is not doing the "money work"

Bank Money and Credit Money.

Again, are we justified in following the lead of certain economists and going so far as to include in the term *bank money*, not only cheques which have actually been drawn and put into circulation as media of exchange, but also the whole of the funds left with banks on current account? Such writers contend that "the deposit which is not being drawn against is idling bank money, just as the shilling in my pocket is idling common money, and the passage of a cheque is a kind of transitory manifestation of bank money as the passage of a Bradbury note is a transitory manifestation of common money We may thus think of the deposit as a kind of generating station or mother-ship for cheques" [1]

It is not altogether easy to regard the funds on deposit at a bank in the same light as we regard gold sovereigns or Bank of England notes Yet the fact remains that in our own country, at any rate, a vast proportion of commercial settlements are effected by cheque or bill of exchange drawn against bank deposits, and so far as such deposits are turned into means of payment, they clearly perform part of the money work of the community At the same time, we know that only a small part of the total deposits in the hands of the banks circulates in this way at any particular time Hence, only that proportion of the deposits actually in use can be strictly regarded as performing the money work Bank deposits, like unmined gold or gold bullion, can have no effect on prices unless and until they become available in the form which the community

[1] D H Robertson, *Money*, page 49

will accept Then and then only do they become factors in the effective quantity of money

Currency.

The term *currency* is frequently used to indicate any form of money which passes current within a community, and, in this sense, it includes metallic money and most kinds of credit instruments It is better, however, to confine the term to money which is issued by the State, and which is regarded as the current medium of exchange by virtue of the government authority behind it

COINS AND COINAGE.

The first metallic media of exchange consisted simply of rough ingots of the chosen metal, which had to be weighed and assayed each time an exchange was effected In time, the disadvantages of this arrangement led to the adoption of shaped pieces of the metal, upon which the weight and fineness had already been certified by a mark or stamp Thus, in China to-day, the *sycee* or "shoe" of a variable weight of silver used for exchange purposes is marked with the "chop" or stamp of the native bullion dealer, in token of its purity and weight Money in this form possesses the advantage that its value is at once ascertainable, and that it can be counted

The next step marks the advent of the *coin*, a piece of metal stamped with a die in such a way that its metallic contents cannot be chipped or abraded without detection Under modern conditions the edges of the coin are *milled*, and an intricate design is impressed on its surface as a protection against counterfeiting and as a guarantee by the issuing authority of its genuineness

The coining or minting of metallic money is usually a rigidly protected monopoly of the State, the operation being carried out by the State mints The actual weight of each type of coin and the degree of purity required are prescribed by law, and must be maintained by the mint subject to certain specified "*remedy allowances*," within narrow limits of which the coins may vary in weight or in the "fineness"

Fineness is the proportion of pure metal to alloy in the coins the sovereign is eleven-twelfths fine, that is, it consists of eleven parts of pure gold and one part of alloy, the latter being inserted in order to harden the money material and to improve its wearing qualities

Under modern conditions, with the existence of extremely accurate machinery and delicate measuring instruments, the remedy allowances in weight and fineness are scarcely necessary Hence, the English "*Trial of the Pyx*" *i e*, the trial of newly-minted coins by a jury of

London merchants to ensure that they are in accordance with the coinage laws, is now merely a matter of form and ceremony which has long outlived its utility

Gratuitous and Free Coinage.

The arrangements under which metal is coined vary in different states Modern arrangements differ also from those ruling in past times To-day, coinage of the standard metal in most countries is *gratuitous*, *i e*, free of any charge for minting, and is sometimes *free*, *i e*, anyone may have any amount of the metal accepted by the mint for conversion into coin, without any restrictions

Mintage and Seigniorage.

In some countries a charge known as *mintage* or *brassage* is made to cover the actual cost of converting bullion into coin, but it is not now usual, as it was at one time, for the State to abstract *more* precious metal than is needed to cover the actual expenses of coinage, the excess being retained as a profit

A charge of the latter kind is called *seigniorage* or *seigneurage*, and it may be taken in two ways (*a*) a certain proportion of alloy may be inserted in the coins instead of the precious metal, (*b*) the coins may contain the full weight of precious metal, but a direct charge exceeding the cost of minting may be exacted from the person leaving the bullion for coinage

The coining of metal is obviously a great convenience to the public, and one which may rightly be subject to a small charge Coinage has a special utility in that it satisfies the need for a medium of exchange, and therefore the metal is worth more as coin than as bullion Labour and capital are expended in the manufacture and issue of coins, and the cost thereof is one that should properly be borne by the users

Another justification for the imposition of seigniorage is that such a charge acts as a deterrent against the melting down of coin for export as bullion or for use in the arts, since the coined metal is worth more as money than as bullion The principle underlying this is precisely the same as that at work in the case of an inconvertible currency In both cases, the currency may be maintained at a value far in excess of its value as a commodity provided that its quantity is strictly limited to legitimate demands, and that the confidence of the money-using population in the good faith and solvency of the issuing authority is not shaken—in other words, the currency *must be acceptable* If, however, the metal retained is itself coined, then the quantity of standard money may be so much increased as to reduce its purchasing power

On the other hand, gratuitous coinage is justified on a number of grounds, of which we may notice two of the most important First, it is one of the functions of the State to provide an efficient currency, and no specific charge should be levied for such a service The cost of minting is relatively small and should be defrayed from tax-revenue, just as the cost of other State services is defrayed Secondly, the parity between the value of gold as bullion and as coins provides an automatic check on inflation, as coins are melted or exported immediately an excessive issue causes any divergence from this parity

The Mint Price and the Market Price of Gold.

The mint price of gold in any country is the price at which the metal is coined into the standard currency In England, for example, the Mint accepts gold for coinage at the rate of £3 17s 10½d per ounce standard, eleven-twelfths fine, *i e*, at the equivalent of about 85s per *fine* ounce, so that 3 894 sovereigns are coined from one ounce of standard gold Since the coinage is gratuitous, the whole of the metal is returned in the form of sovereigns, which accordingly contain 123 27447 grains of standard gold

The mint price may be below but can rarely be above the *market price*, *i e*, the price at which gold bullion can be purchased in the Bullion Market, due allowance being made for its fineness and for varying convenience of handling

During and after the War, the market price of gold in this country rose considerably above the mint price and consequently very heavy penalties were necessary to prevent the melting down of sovereigns for use as bullion The rise in the market price of gold would have been impossible had the currency notes then circulating been fully convertible into specie, but, although legally they were at all times convertible on demand, the restrictions on the export of the metal and on the melting down of gold coins made the right of convertibility a purely nominal one

Debasement and Depreciation.

Various methods of debasement and depreciation of the coinage have been adopted from time to time Debasement may be due to the action of the State itself, as where coins are issued much below the legally fixed weight or quality, or it may result from felonious interference with the coinage after issue, with the object of extracting some of the valuable material Among the methods adopted for this purpose are (*a*) *Clipping*, *i e*, cutting away small portions from the edge of the coins—now made impracticable by milling or otherwise distinctively

marking the edges, (*b*) *Sweating, i e*, reducing the quantity of metal in the coins by the action of corrosive chemicals, and (*c*) *Abrasion, e g*, shaking up the coins in a bag and thereby removing minute particles of the metal

Under modern conditions the strict enforcement of penalties against those debasing the coinage and issuing counterfeit coins has done much to perfect and to protect the issues in circulation Even the issuing State itself is restrained from tampering with its standard currency by the fear of incurring discredit and national dishonour

Gresham's Law.

During the reign of Elizabeth it was found that the coins in circulation in this country had been so debased, clipped and sweated in previous reigns as to be a reproach to a nation well on the high-road to prosperity, but all attempts to improve matters by the issue of new coins proved useless The new issues disappeared as soon as they were placed in circulation, leaving the currency in a state but little better than before

The position was explained by Sir Thomas Gresham, a merchant of great experience and famous to posterity as the founder of the Royal Exchange, in the law which now bears his name, to the effect that "*bad money tends to drive good money out of circulation*" Gresham pointed out that when a currency consisted of good and bad coins circulating together, people tended to hoard the better coins, to melt them down, or to export them in settlement of debt or for profit, thus leaving only bad coins in circulation Goldsmiths and bankers who traded in gold kept back the full-weight coins coming into their hands, and passed on those which were worn or debased As the metal was sold by weight, heavier coins were obviously more profitable to export, since light-weight coins could be used for internal purposes just as well as those fresh from the Mint, so long as no law prohibited their tender or acceptance

In modern times the operation of Gresham's law in this way is obviated by a very careful control of the circulating coins Light-weight coins are constantly withdrawn and reminted, and in this and other countries cease to be legal tender if they fall below certain legally fixed minima

Some economists argue that Gresham's law cannot be applied at all to modern conditions, as it was applicable only to such unscientific monetary systems as existed during the time of Gresham and throughout the Middle Ages In Gresham's day its influence was accentuated by the endeavour of various nations to establish and maintain independent systems of *bimetallism, i e*, the adoption of a double standard of silver and

of gold, the two metals circulating side by side and being legal tender for the discharge of debts at a ratio fixed by the nation concerned

Bimetallism will be dealt with hereafter, but we may note at this point that its great difficulty lies in the fact that the ratio between the market prices of the two metals frequently differs from the mint ratio fixed by law The market price has no fixity it varies with changes in the production of the metals, and with the variations in the demand for them for coinage and for other purposes The State may decree that 15 units of silver are to be taken as equal to 1 unit of gold, but the relative market prices may make 20 units of silver equal to 1 of gold This means that gold is *undervalued* at the legal ratio or overvalued at the market ratio, while silver is overrated at the legal ratio, consequently the gold currency follows the tendency of "good money" under Gresham's law and disappears from circulation

This is precisely what happened in bimetallic countries during the nineteenth century The great discoveries of silver lowered its gold value below the ratio legally fixed in those countries Consequently gold disappeared from circulation in the countries concerned, and silver remained In the absence of an international agreement to maintain the market price of gold and silver, the ratio between their values could never be constant, and while only *some* of the principal countries adopted bimetallic systems based on fixed ratios between the metals, there was a constant movement of one or other of the metals from the currencies in accordance with Gresham's law

Gresham's law also operates to drive from circulation a gold or silver currency circulating along with a depreciated legal tender *paper* currency the good metallic money disappears, leaving the bad paper currency in circulation, as happened in most European countries during and after the Great War

Yet another application of the law is to be found where a currency is composed partly of depreciated inconvertible paper money and partly of convertible paper money In such a case the convertible paper tends to be hoarded or presented for conversion, and only the inconvertible paper is returned into circulation.

For the operation of Gresham's law in any of the foregoing circumstances two conditions are essential First, there must be in circulation at least sufficient money for effecting the necessary exchanges within a community Good money cannot be hoarded or exported if the circulating medium is scarce and is urgently needed for business requirements Secondly, bad money cannot displace good if the community as a whole refuses to accept and to circulate it for exchange purposes Under such conditions the good money will be retained against any pressure tending to its removal Moreover, the depreciation of the currency may be so gradual as not to be noticed by the public until it has reached an advanced stage.

Legal Tender Money.

Among the many forms of money which exist in a community, there are some which a creditor need not necessarily accept in full settlement from his debtor For example, there is no obligation on a creditor in this country to accept a cheque or bill of exchange A cheque rarely circulates except between people who are known to one another and can be relied upon not to pass a worthless instrument A bill has a wider and more general circulation than a cheque, but neither of these circulates to the same extent as notes issued by a government or central bank

In order to facilitate exchange and to obviate all difficulty, the State declares one or more forms of money to be a standard of value and unlimited *legal tender, i e , that which must be accepted by a creditor up to any amount when offered in final discharge of debt or in full payment for commodities* The refusal of a creditor to accept payment in legal tender places him in a difficult position As a rule, the standard adopted is gold, but in some countries silver is the standard, while others have adopted a bimetallic or dual system, under which both metals are equally acceptable

Token Money.

The high value of gold makes it impracticable for use for small coins, and so coins of a low denomination in a cheaper metal are issued These are known as *tokens* or *token coins,* because their face value is greater than the actual commodity value of the material of which they are made They are representatives or substitutes for the more valuable *standard* metal, and are maintained in circulation because (*a*) only sufficient are issued to satisfy the requirements of the community for making small payments , (*b*) they are more valuable as coins than as bullion, and (*c*) they are made *limited legal tender, i e* , legal tender for payment of small amounts only

As a rule, the State makes a profit on the issue of token coins because the value of material used is not as great as the face value of the coins manufactured therefrom A rise in the market price of the metal material may, of course, remove such profit altogether, and a reduction in the proportion of precious metal used may become necessary if the profit of the State is to be maintained

In so far as a profit is made by the State on the issue of token money, such money may clearly be regarded as being subject to a seigniorage charge Moreover, paper money may be regarded as token money on which the seigniorage charge is one hundred per cent Clearly, it is essential that the manufacture of token money should be a State monopoly and that its amount should be carefully regulated according to the community's need, for, if it were otherwise, Gresham's law would operate and the standard coinage would be driven out of circulation by the overvalued token currency.

CHAPTER 2.

THE THEORY OF MONEY AND PRICES.

No branch of the science of Economics—or, for that matter, of any other science—has been the subject of such violent controversy and speculation as that which is centred around the theory of money The definition of money given in the preceding chapter is one which is widely accepted and one which serves a useful purpose in enabling us to clarify our minds on the subject But modern economists are far from being unanimous in their conception of the nature of money Much controversy turns on the question whether money can properly be regarded as a commodity, and, if so, whether its value is determined by the ordinary laws of supply and demand

What is the Value of Money?

Before considering the various theories of money which have from time to time been advanced, we must arrive at a satisfactory answer to the question What do we understand by the value of money? In attempting to do this we are faced with an initial difficulty by reason of the fact that, whereas the value of all other commodities is nowadays expressed in terms of one commodity—money (*i e*, gold or its representative), there is no one commodity in terms of which the value of gold itself may be measured

But just as we can measure the value of a table in terms of so many bushels of wheat, for example, so we can measure the value of a sovereign also in terms of so many bushels of wheat Hence we say that *the value of money is measured by the quantities of other articles for which it will exchange*, it rises if a given unit of money purchases more commodities, and falls if a smaller quantity of the same things can be bought

Now, the values of commodities expressed in terms of money are called *prices*, so the value of money in terms of commodities is measured by the general level of prices, *i e*, by its general purchasing power If a unit of money purchases more of certain commodities to-day than it did yesterday, its value is said to have risen Conversely, its value falls if it purchases less of the same commodities than before In other words, *the value of money varies inversely as the general level of prices*

This use of the term *value of money* in the sense of "purchasing power" is to be distinguished from its use to mean the value of *floating*

capital or of short term loans as indicated by the prevailing rates of discount on the Money Market, and also from its use to mean the "*long term* rate of interest," as in the statement that "the value of money over the next decade is likely to fall" Another misleading application of the term "value of money" is its use to refer to the material worth of the metal of which standard money is composed

Price Index Numbers.

It is obviously impossible to obtain any precise information as to the general level of the prices of all commodities at any particular time The commodities bought and sold are almost innumerable, while the prices at which similar transactions are effected in the same commodity are subject to great variation On the other hand, it would be useless to rely upon changes in the value of one or two selected articles as an indication of general changes in prices Consequently, it becomes necessary to fix upon *an arbitrary selection* of commodities, and to obtain an indication of the changes in the general level of prices by considering an *average* of the fluctuations in the prices of a large number of representative articles Such an average is called a *Price Index Number*

Clearly, in making any kind of financial comparison as between one period and another we must correct for the *price factor*, as for example, when we compare the pre-war and the present national income, or figures of imports and exports for different years, or the purchasing power of money and rates of wages at different times Index numbers provide us with the means of making the necessary corrections and allowances, without which even reasonably accurate comparison would be impossible

The Formation of Price Index Numbers.

In this and all other leading countries index numbers of both wholesale and retail prices are compiled periodically, and it is found that, in spite of a considerable variation in method, the results approximate very closely Essentially, the method adopted is to choose a number of representative commodities in constant demand, and to note the average price of a given quantity of each commodity in any year or series of years which it is intended to use as a basis Obviously, the year chosen must be *normal* so far as possible, it must not fall in the middle of a war period, or so far back in the past as to make it unacceptable as a basis for modern calculations Consequently, the base years of most index numbers have been changed from time to time, although some have been continued without alteration

The compilation of index numbers, involving as it does the comparison of prices over a series of years, is necessarily a task requiring the greatest possible care. As in other departments of statistics, an

entirely unbiassed and unprejudiced mind is essential, together with a wide general knowledge and adequate sources of information. Moreover, the greatest care and discrimination are necessary in (*a*) the choice of the commodities it is proposed to use as a basis, and (*b*) the determination of the prices of those commodities in the periods concerned.

The Choice of Commodities.

This is naturally the first and most important essential. The articles selected must be in constant and regular demand by all classes within the community. Uncertain demand causes considerable fluctuations which would not give a true perspective, hence *articles of ordinary consumption* are those chiefly used.

Yet even when this is done, it has to be remembered that a larger proportion of small incomes is spent on some commodities than on others; bread is a far more important article of diet to the poor than to the rich, who have a greater variety of food at their disposal. Then, again, bread is a more important article of general use than is silk or fruit; far more people buy bread every day than buy silk every week. On the other hand, a fair proportion must be maintained between manufactured goods and raw materials, for the average income is about equally divided between the two classes.

To overcome these difficulties and to give important articles their due proportion of influence on the final result, the system of "*weighting*" is adopted, *i e*, the average price of each commodity is multiplied by a number indicative of its estimated comparative importance (judged by the *quantity consumed*) in the general list of commodities, *e g*, the average price of bread may be multiplied by 11, that of meat by 7, that of tobacco by 1, and so on. Small differences in the weights do not greatly affect the final result, and a weighted index is likely to inspire greater confidence than one which is not weighted.

The Determination of Prices.

The task of determining the prices of the chosen commodities is clearly one of considerable difficulty requiring unremitting care. As a rule, wholesale prices are taken, chiefly because wholesale articles, and particularly raw materials, are subject to less variation in quality and description than manufactured articles, and because it is easier to obtain accurate figures from records supplied by such agencies as the Board of Trade, Chambers of Commerce, wholesale dealers and others, than from retail shopkeepers and the ordinary consumers of goods. Moreover, wholesale prices tend to approximately the same level throughout the country, and are cut much finer than retail prices, which may

differ widely as between one district and another, or indeed, as between one shop and another in the same locality

Retail prices also are more subject than wholesale prices to the many influences such as changing tastes, fashions, and standards of comfort, which affect the consumption of the same commodities as between one period and another Changes in relative prices may result in the complete or partial substitution of one commodity, the price of which has risen, by another, the price of which has not changed or has fallen Further, some articles of consumption may in a later period replace other articles formerly used "A generation which knows not butter may have supplanted a generation which knew not margarine"[1]

Nevertheless, retail prices are obviously necessary as a basis for cost of living index numbers, which now regulate the wages paid to certain workers It is only right that the figures determining remuneration should be based on the prices of articles on which that remuneration is actually spent Changes in wholesale prices may not necessarily result in proportional changes in retail prices, and the latter may vary even though the former remain unchanged Normally, there is a *lag* in the adjustment of retail to wholesale price movements

The Economist Wholesale Price Index.

The index number of the weekly *Economist* (commenced in 1869) was originally based on prices during the period 1845-50, but the base has been changed several times since and is now calculated on the average wholesale prices of forty-four chosen commodities during the year 1927 These commodities are divided into five groups, respectively, Cereals and Meat, Other Food Products, Textiles, Minerals, and Miscellaneous

The system of weighting is not used in the *Economist* index number but is replaced by the method of using several prices of *different varieties* of important commodities in determining the average, *e g*, two wheat prices and four cotton prices are taken Moreover, the basic figure for each group (*e g*, 500 for cereals and meat) bears to the total figure of 2,200 a proportion estimated to correspond to the relative importance of each group in the national economy The basic total of 2,200 is equated to 100, and totals for subsequent periods are expressed as a percentage of this figure, thus affording a reasonably accurate indication of the percentage rise or fall in prices as compared with those of the base year.

The Board of Trade Wholesale Price Index.

Another important price index number, that of the Board of Trade, is now based on the average wholesale prices in 1913 of one hundred

[1] *Money*, by D H Robertson, page 25

and fifty important commodities. The total of the average prices so determined forms a basis which is equated to 100, and the sum of the averages in subsequent years is indicated as a percentage rise or fall on the figures of the base period Thus, if the index number in one year is stated to be 123, it indicates a rise of 23 per cent as compared with the period adopted as the standard of comparison

Cost of Living Index Numbers.

In spite of the care bestowed on the selection of commodities, it is frequently objected that the results obtained are arbitrary and that the commodities chosen are too limited both in number and scope In wholesale index numbers the costs of many items such as the rent of houses and land, the cost of clothes, furniture and amusements, etc , are omitted, although, of course, part of all incomes is spent thereon

Attempts are made to obviate these difficulties in certain *cost of living indexes*, like that of the Ministry of Labour This is based on the average cost, in July, 1914, of such items as food, rent, clothing, fuel and light, and the index in subsequent years is shown as a percentage rise or fall on the original figure

The Advantages of Index Numbers.

In spite of the difficulties and the objections mentioned, it is found that the results obtained by various price index numbers are in broad agreement Index numbers are at best only approximate , they are not intended to be meticulously accurate, but merely to afford some reliable indication of the trend of prices over a period They have certainly proved of the greatest utility to the economist and politician, to the statesman and business organiser alike, while recognition of their general accuracy is indicated by the use of the cost of living figure as a basis of the wages and salaries paid to large numbers of workers

What Determines the Value of Money ?

Although the method of index numbers gives us a reasonably accurate basis for comparing changes in the value of money over a period of years, it gives us no indication of the *cause* of those fluctuations Rising prices mean a fall in the value of money, falling prices mean that the value of money is rising But what are the factors which influence or determine these movements ? *How* is the value of money determined ?

Obviously the matter can be approached in two ways We may endeavour to discover the causes of fluctuations in the prices of com-

modities, or we may try to find the reasons for changes in the value of money, for a change on the one side results in a change on the other The prices of commodities, however, are subject to innumerable factors which are incapable of accurate estimation, as, for example, fluctuations in harvests, floods and insect pests, political and social conditions and the prospect of peace or of war Hence it is usual to approach the problem from the other side, and to endeavour to formulate some general conclusion with regard to the exact nature of money itself It is in this connection that we find great disagreement among those best qualified to guide us.

Unit of Account Theories. The State Theory of Money.

By some economists it is maintained that money, as it is to be understood in the modern sense, is not necessarily a commodity, but that it is merely a *symbol* or *device*, without value in itself, which is created by law to function as a medium of calculation and as a means of settling debts

The leading exponent of this theory, the German economist, Professor G F Knapp,[1] holds that money derives its value, not from any intrinsic worth which it may possess—as is the case with gold—but solely from the action of the State in declaring it to be legal tender The fundamental function of money, he says, is to express units of value, and the form of money may change from time to time so long as the *unit of account* remains the same Hence, it is contended, pieces of tin, stamped with the Government *fiat*, would serve as money just as well as gold, provided (and this is a very important proviso) that the issue of such money was strictly controlled, and provided also that effective measures were taken to guard against forgery

This theory has much to commend it It is clear that the State, by choosing as money a commodity which the public are willing to use, can influence the value of that commodity, since the demand for the commodity for use as currency will affect conditions in the outside market Obviously the market value of gold, for instance, is increased by its use as currency Moreover, the State can vary the laws relating to legal tender or modify the monetary standard

Against this theory there are the objections that the Government is not perfectly free in its choice of a commodity to serve as money, and that, although the State may decide upon such a commodity, there are obvious difficulties in giving the commodity a determinate or constant value in terms of goods because any increase or decrease in trade activity (*i e*, in the demand for money) will affect the value of money in terms of goods, and so vitiate any arbitrary ratio established by law

[1] See *The State Theory of Money*, publ MacMillan

R. G. Hawtrey's Theory.

The English economist, Mr R G Hawtrey, has propounded a theory which has much in common with that of Knapp Hawtrey[1] defines money as "the means established by law (or custom) for the payment of debts", of which money forms the objective representation He defines a debt as "an economic relationship which requires to be expressed as a number or quantity, and, in order that it may be so expressed, it must be expressed in terms of some unit The unit for the measurement of debts must be a unit for the measurement of value" "*Debts* are the foundation of the economic system, and the existence of the monetary standard is so to regulate the unit in which *debts* are measured as to maintain the stability of that system"

Hawtrey does not accept the theory of the classical economists that money has value because the material of which it is composed has value "Gold", he writes, "is undeniably a commodity But gold itself, so long as it is being used for money, is subject to all the laws which govern the value of money A gold coin is *itself a ticket*, its character of legal tender is derived not merely from the material of which it is made, but from the fact that it has been through the Government Mint, and has been issued for the express purpose of being the means of discharging debts It is stamped on gold in preference to being printed on water-marked paper, because this arrangement facilitates the maintenance of a standard of value So long as the coin is not melted it remains a ticket Its quality of discharging a debt is attached to it conventionally, whether by law or custom, just as the quality of admitting to a performance of a theatre ticket"

Medium of Exchange Theories of Money.

The majority of economists, while expressing widely divergent views of their interpretation of the "meaning of money," are agreed on the general conclusion that money is a *commodity* used in the exchange of goods for goods, and that as such it has value

But even though it be agreed that money is a commodity and has value, the very difficult questions immediately arise What is the nature of this value, and how is it determined from time to time? Two distinct groups of theories have been advanced in an attempt to solve these problems, viz, (*a*) the *Quantity* theories of money, and (*b*) the so-called *Marginalist* theories.

All the theories in the latter group, of which the principal supporters are Wieser, Von Mises and Cannan, are on common ground in regarding money as precisely similar to any other commodity in that it has some value in itself, and that this value is determined by the relationship

[1] *Currency and Credit*

between marginal utility and cost of production The exponents of these theories, (which, it should be observed, were not framed in the light of modern experience of paper money), contend that credit instruments are not money, and that they merely function as *convenient substitutes* for the money commodity which they represent

The Quantity Theory of Money.

The orthodox, and most widely accepted of all theories of money, depends on the acceptance of the fact that money is a commodity whose value is determined by the ordinary laws of supply and demand

We have seen that the value of money is measured by the quantity of other articles for which it can be exchanged, and so exponents of the Quantity Theory say that the general level of prices at which goods are sold depends on the quantity of money available to effect purchases A sudden increase in the quantity of money available, without any corresponding increase in the volume of goods, will result in a rise in prices, for more units of money will be available to purchase each unit of commodities Conversely, a decrease in the quantity of money, with no change in the available quantity of commodities, will result in a fall in the prices of the commodities bought, because less money can be offered in exchange ' This, in short, is the *Quantity Theory of Money*, and in its barest form it may be thus stated —

" *Every change in the quantity of money in circulation produces, other things being equal, a directly proportional change in prices* "

This statement of the tendency was that adopted by the older economists, and, though the orthodox theory has been much contested in recent years, it is without doubt generally true that an increase of money in circulation does result in a rise in prices Since the War, we have had numerous examples of soaring prices (*i e*, a fall in the value of money) resulting from too great an issue of paper currency in various states* It is also common knowledge that in gold and silver mining communities, where the precious metals are comparatively abundant and commodities are comparatively scarce, prices are very high Further, in the past marked rises in prices have often followed great discoveries of the precious metals in various parts of the world

The Unqualified Statement too Hypothetical.

But the bald statement of the theory could apply only in a hypothetical community where the only forms of money are gold coins, where every piece of money exchanges but once, where no hoarding takes place and money is used for monetary purposes only Then the value of money would be the value of gold , every increase in the quantity of

money, unaccompanied by a change in the number of commodities, would raise prices and so lower the value of the medium of exchange, whilst the converse would also be true If the quantity of goods remained constant while the quantity of money doubled, prices would also double, if the quantity of money decreased by 50 per cent, prices also would fall by half Similar results would accrue if the quantity of money remained constant while the number of commodities varied if the quantity of commodities doubled while money remained constant, then prices would fall by half and the value of money would be doubled In such circumstances, the elasticity of demand for money is equal to unity

In modern communities no such hypothetical conditions exist, and the bare statement of the Quantity Theory has to be modified because account must be taken of three important factors (*a*) the use of credit instruments as money, (*b*) the rapidity of circulation, and (*c*) the activity of exchange or the volume of trade

The Use of Credit Instruments as Money.

Nowadays by far the greater proportion of the world's currency consists of cheques, bills and bank notes, the use of which economises that of metallic currency, and must obviously be taken into consideration in computing the quantity of money in circulation Further, the system of modern banking and of book-credits permits a great reduction in the use of money for the settlement of debt, and has undoubtedly prevented that enormous rise in the value of money which must otherwise have resulted from the difficulty of keeping the supply of metallic currency proportionate to the demand

The Rapidity of Circulation.

To-day, one piece of money may function in a thousand transactions, and, each time it circulates, that piece may perform as much work as if an entirely new piece were used Hence, in endeavouring to estimate the quantity of effective money in circulation, we must consider each unit of money in relation to *the number of times it passes or circulates*' If two countries have exactly the same number of units of money, but in one country those units circulate twice as quickly as in the other, *i e*, if the "momentum" of money in one country is twice as great as in the other, then the quantity of *effective money* in the former country is necessarily twice as great as in the latter

Thus the use of credit instruments and the increased rapidity of circulation of all forms of money *increase the supply of effective money*, *i e*, the total quantity of money available to settle transactions, and *accordingly cause a lowering of its value.*

The Activity of Exchange or The Volume of Trade.

The greater the activity of exchange or the greater the volume of trade, the more sales and purchases, advances and loans, wage and salary payments, etc , which have to be effected by the use of money The more transactions there are to be made, the greater the demand for the money commodity, and, consequently, *the higher its value*, and the lower the general level of prices Conversely, stagnant industry means a surplus of money and a fall in its value This is indicated at once by the high rate of interest for money when trade is brisk, and by the low rate which prevails when trade is stagnant

The Value of Money.

Thus the Quantity Theory, in its modern guise, states that, at any moment, *the value of money, like that of other commodities, is determined by the relation between the demand for money and its supply* By *supply of money* must be understood the quantity of all forms of exchange media multiplied by the rapidity of their circulation, *i e*, the supply of *effective* money, and by *demand for money*, the total number of exchanges which have to be effected by the use of money

If, therefore, the supply of money remains constant during any period of time, while the demand for money increases because of greater trade activity, then a given quantity of money will purchase more goods than before, that is, its value will rise and general prices will fall Conversely, if the total quantity of goods to be exchanged remains the same, while the supply of money increases, either through an increase in the quantity of exchange media or through an increase in the rapidity of their circulation, the value of money will fall and general prices will rise To proceed a step further, if the demand for money at any time increases more quickly than the supply, the result will be a rise in the value of money and a corresponding fall in general prices , while, if the supply of money increases more quickly than the demand, there will be a fall in the value of money and a corresponding rise in general prices.

Irving Fisher's Equation of Exchange.

Certain modern economists have sought to present the Quantity Theory more precisely in mathematical form The American professor, Irving Fisher, for example, states the Quantity Theory in the following terms —

> *The general level of prices tends to vary directly with the quantity of money and its rapidity of circulation* (*i e , its supply*), *and inversely with the activity of exchange* (*i e , the demand for money indicated by the number of goods exchanged multiplied by their prices*)

Professor Fisher[1] calls this "the equation of exchange" and expresses it mathematically thus —

$$P \propto \frac{M \times V}{T},$$

where P is the price level, M is the quantity of money in circulation, V is the velocity of circulation of that money, M, and T is the volume of trade effected, or the total amount of debts and of all forms of transactions to be liquidated by the use of the money

Alternatively, it may be expressed thus —

$$PT = MV$$

In this case PT is described as the "goods side" of the equation and MV as the "money side" In order to cover the use of credit instruments, the equation is extended as follows —

$$PT = MV + M'V',$$

where M′ is the total amount of all forms of cheques, notes and instruments of credit in circulation, and V^1 is the average velocity of the circulation of these credit instruments Then M′V′ is the total value of purchases effected by means of credit instruments

J. M. Keynes' Theory.

Professor J M Keynes has presented a somewhat more complicated formulation of the equation of exchange which he has designed more expressly in order to take into account such factors as the changing habits of the community in regard to the use of money Briefly, his theory is as follows —

The community normally requires a certain volume of purchasing power in its hands with which to effect current purchases. The rest of its resources will be held, not in purchasing power, but in goods or investments The amount held in purchasing power will depend (*a*) on the wealth of the community, and (*b*) on its habits in the use of currency Yet if these two things remain unchanged, the total amount of purchasing power held in the form of money is definitely fixed This amount may be measured in terms of its command over goods and services

Suppose that the community normally requires to hold purchasing power, in the form of money, having a command over K "consumption units" (*i e*, a unit aggregate of consumable goods and services) Then, if the price of each unit is represented by p, and the total amount of money in circulation by n, we have the following simple formulation of the Quantity Theory —

$$n = pK.$$

[1] *The Purchasing Power of Money*, Chap XI, Sec. 2. N B $\propto$ = "varies as"

If K remains the same, therefore, the price level will vary directly with the quantity of money

Suppose, however, as is the case to-day, some purchasing power is held in the form of bank deposits equal to K′ consumption units, against which reserves are held by the banks in the proportion r The equation then becomes —

$$n = p\,(K + rK')$$

Thus, if the habits of the community in the use of money (K and K′), and the custom of banks in the keeping of reserves (r) remain unchanged, there is still a direct relationship between the quantity of money and the price-level (*i e*, between n and p) But if the banks keep greater reserves, if the public keep more of their resources in legal tender currency, *ceteris paribus*, the price level will fall This theory, therefore, is precisely similar to Fisher's theory, save that the former stresses the more practical features and is therefore less artificial As Keynes himself remarks, it is easy to pass from one formula to the other

Cannan's Theory of Money.

Of importance from the point of view of readers of this book is the theory of money associated with the name of Prof Edwin Cannan

Cannan[1] accepts the orthodox theory that money is a commodity subject to the fundamental laws of supply and demand, but he stresses the fact that, unlike most commodities, money is not governed by the *strict* laws of supply and demand because there is always such a huge stock already in existence that an additional supply is barely felt unless it is of extraordinary amount Accordingly, the *supply* of money at any moment is the total stock then in existence, while the *demand* for currency is furnished " not by the number and amount of *transactions*, but by the ability and willingness of persons to *hold* currency, in the same way as we think of the demand for houses as coming not from the persons who buy and re-sell or lease and sub-lease houses, but from the persons who occupy houses "

Cannan argues from this that the " velocity of circulation " of money cannot affect its value, for although " more purchases and sales of commodities and services may in a sense be said to involve increase of demand for money, in the corresponding sense it may be said to involve an equal increase of supply of money , the two things cancel "

Cannan proceeds to give other reasons for regarding the factors of supply and demand in relation to money on a basis different from that applicable in the case of other commodities It is not possible in the space at our disposal further to pursue his arguments, but it may

[1] See *The Application of the Theoretic Apparatus of Supply and Demand to Units of Currency*, *Economic Journal*, Dec , 1921 Also *Money*, page 72

be observed that, subject to his special analysis of the factors mentioned, Cannan agrees that the value of money is determined at any moment by the interaction of supply and demand

Limitations of the Quantity Theory.

It is very necessary in estimating the position of the Quantity Theory in economic science to avoid, on the one hand, the danger of accepting the statement of the Theory as an *exact* explanation of the way in which the value of money is determined, and on the other hand, the mistake made by those who dismiss the Theory as a worthless truism

It must be understood that the Theory, like most economic laws, is merely indicative of a *tendency*, and, while it depends essentially on the acceptance of the proposition that money is a commodity, and, as such, that its value is determined by the laws of supply and demand, it does not imply that every change in the *volume* of money has a corresponding effect on prices (and, inversely, on the value of money itself) It sometimes happens that a slight increase in the quantity of money stimulates the demand for money (*i e*, the supply of goods) to such an extent that the ultimate effect of the increased volume of money is actually to lower prices, and thus to *raise* the value of money Again, while brisk trade may result in an increase in the volume of transactions, it may nevertheless coincide with a period of high prices (as in 1919-20), conversely, a period of slack trade may coincide with the prevalence of low prices (as in 1920-25) This may be explained by the fact that during a boom period the volume of trade increases, but the volume of money (at the beginning of the boom at any rate) increases more than proportionately Similarly, in a slack period, although the volume of trade contracts, the volume of money also contracts to an even greater extent

The charge that the Theory is merely a truism, *i e*, that it merely shows that the general level of prices is determined by the formula,

$$\text{General Price Level} \propto \frac{\text{Quantity of money exchanged for goods}}{\text{Quantity of goods exchanged for money}}$$

seems plausible at first But it is evident that the Theory tells us more about the determination of prices than this The value of the Quantity Theory, as modified to allow for modern conditions, lies in its explanation of the effect which is *likely to result* from changes in, say, the rapidity of circulation of money, new discoveries of gold, a contraction of credit, huge issues of paper money, or from improvements in industry leading to a vastly increased output of goods In considering the effect of any one of those influences we must be very careful to watch for other factors which may balance or even outweigh the particular influence under consideration

Arguments in Favour of the Theory.

On behalf of the Theory it has been claimed that a law similar to that enunciated regulates prices in proportion to the amount of money of all kinds in circulation, and that this law has applied in some degree to conditions of trade and labour in all countries and at all times, all persons having some appreciation of its existence Secondly, it is held that the law is applicable to conditions prevailing to-day, but the complexity of the term "money" considered in all its forms prevents the law from being enunciated in such a manner as permits of close definition, or one which admits of positive proof by substitution of numerical values for the terms involved

Thirdly, it is maintained that the Theory must be considered as regulating the rise in prices throughout the world, and that when it is applied to explain movements in prices in a particular country, the indirect working of the Theory in regulating prices in other countries must likewise be taken into consideration

Finally, it is pointed out that a clear case can be established for the acceptance of the Theory in its relation to the general level of prices, because it is possible to lower, to stabilise, or to raise the general level of prices by any of the following methods of regulating the amount of money in circulation or by a combination of some of these methods, as, for example, by (*a*) controlling the working of the gold mines and curtailing or subsidising the production of gold, which plan was considered and rejected by the Monetary Conference of 1892, (*b*) regulating the amount of gold in circulation by controlling the mintage, as was done in the Scandinavian countries during the War, when the central banks were no longer obliged to buy gold at the legal rates of mintage, (*c*) varying the standard of value while retaining the name of the unit of account, as suggested by Professor Irving Fisher in his plan for an "unshrinkable" dollar (See Chapter 3), (*d*) controlling the circulation of bank and Government notes, (*e*) regulating the circulation of cheques and instruments of credit by fixing the proportions of banking reserves, (*f*) encouraging an increase in the volume of trade, for the liquidation of which money in all its forms is required.

FLUCTUATIONS IN PRICES.

If the foregoing explanation of the Equation of Exchange is accepted, it is clear that fluctuations in the general price level may be attributable to fluctuations in the demand for money (*i e*, variations in the number of transactions) or to fluctuations in the supply of money, or to a combination of both of these causes.

Fluctuations in the Demand for Money (*i e*, on the "goods side"), may be attributable to one or both of two factors (*a*) *Changes in the volume of turnover*, *i e*, changes in the total quantity of goods exchanged, which tends to increase under modern conditions, with

the great extension of output which follows industrial development. On the other hand, a contraction of credit induces traders to sell stocks at low prices in order to obtain ready capital (*b*) *Changes in the rapidity of turnover*, *i e*, changes in the number of times certain goods are exchanged Just as one piece of money may circulate several times, so may a given article be purchased and sold again and again

Fluctuations in the Supply of Money (*i e*, on the "money side") may also result from one or both of two causes (*a*) *Changes in the amount of money* available for effecting exchanges The amount tends to increase with the extension of the use of bills, notes, and cheques, and with the vast expansion of credit arrangements in recent years On the other hand, the increase in the use of the precious metals for hoarding and for the arts tends to restrict their supply and to enhance their value (*b*) *Changes in the velocity or rapidity of circulation of money* Circulation depends on the volume of trade, influenced chiefly by the density of population and the stage of industrial development, and on the development of the credit system, which facilitates and extends the use of cheques and bank notes

The Effects of Fluctuations in Prices.

The value of any person's income depends on its power to purchase the goods and services produced by others If the power of one person's income to purchase the products of other people varied in exactly the same proportion as the power of their income to purchase his products, general fluctuations in prices might not have any very serious results But unfortunately, this is not what happens in actual fact Changes in the value of money, *i e*, fluctuations in prices, are generally harmful because they disturb the even basis of trade and industry, and because they tend to benefit some classes at the expense of others

From this point of view people may be divided into two broad classes first, those who are able to adjust their incomes comparatively quickly to changes in prices, and secondly, those whose incomes are fixed for a long time ahead in terms of money In the first group are producers of commodities in fairly regular demand, who can adjust their prices—and consequently their profits—according to the changes in the value of money The second group includes professional men whose charges are fixed by custom, wage earners—who, unless they have a strong trade union, have to fight hard for increases—, persons receiving pensions, annuities, retired pay, or allowances, and the *rentier* class, *i e*, persons whose income consists primarily of interest from investments Clearly, the former are affected less than the latter by price fluctuations

In considering the general effects of fluctuations in prices it is convenient to distinguish between their reactions on the *Production* of wealth

(or, as it is sometimes stated, on the volume of the National Dividend), and their reactions on the *Distribution* of that wealth or Dividend.

Effects of Changing Prices on Production.

Violent fluctuations in prices react adversely on the production of wealth because they create uncertainty, one of the greatest enemies of healthy business enterprise In modern industry, production is almost always initiated long ahead of demand on an estimate of what that demand is likely to be Countless operations are nowadays conducted on a credit basis underlying which are faith, hope and expectation Appreciable changes in the general price-level—in other words, in the purchasing power of money—destroy this basis of sound trading because they cause purely arbitrary, and usually unforeseeable, changes in the relationships between those who have to pay and those who have to receive Even when such changes are spread over a long period, they may produce serious effects, when they take place during relatively short periods they do incalculable harm. These reactions are particularly evident in international trade, since violent price fluctuations are always reflected in movements of the exchanges, and such movements often reduce foreign trade to a chaotic speculation

Effects on Distribution of Rising Prices.

Of the broad classes in the community which we have distinguished—those who are readily able to adjust their incomes to changes in the price level, and those who are less fortunately placed—those in the first class, roughly synonymous with the business or producing community, are beneficially affected by rising prices The prices of the goods and services produced by these classes quickly respond to a fall in the value of money, but the costs of labour (wages) and of capital (interest) rise more slowly There is always a *lag* between the upward movement of prices and the rise in wages and other items in costs Even when profits are rapidly expanding, the workers have usually to fight hard for additional earnings to meet the higher cost of living Moreover, producers generally obtain higher prices for their goods than those on which their estimates were based Consequently, profit margins are widened, business is stimulated, and the business classes reap rich rewards.

This gain of the producing class is, of course, illusory, in so far as the increased profits have to be expended on consumers' goods, the prices of which have risen or are rising For this reason rapidly rising prices may result in a considerable inflation of book profits, and make these appear very much greater than they really are This reacts psychologically on business confidence—already increased by the *real*

gains—and leads to a rapid increase in productive activity Rising prices, therefore, are said to be "good for trade"

On the other hand, since wages and salaries lag behind prices, the working classes tend to lose, and there is a growth of discontent and hardship The duration of this time-lag, and therefore the extent of the loss to the workers, depends chiefly on the efficacy of the trade union organisation, and of the machinery, if any, for the automatic regulation of wages in the industry concerned

Probably the most serious effects of rising prices result from the fact that debtors gain at the expense of creditors, since money borrowed when it was dear is paid back when it is cheap, while interest payments are lightened from the debtor's standpoint and become of less real value to the creditor Rising prices are thus politically beneficial in so far as a country's national debt becomes a smaller real burden to the taxpayer Indeed, one of the greatest inducements to inflation as the events of the last few years have proved—is that national debts may be virtually repudiated by constant currency inflation, as happened, for example, in the case of Germany Very adverse effects, however, fall upon the *rentier* class, for the real value of their incomes, as well as of their capital, falls as prices rise

Effects on Distribution of Falling Prices.

Falling prices have exactly opposite effects People of the *rentier* class are benefited by the increase in the purchasing power of their incomes, and by the increased real value of their capital Creditors (*e g*, war loan stockholders) gain at the expense of debtors (*e g*, the taxpayers), so that the internal debt and its annual charge becomes a greater real burden to the community

The producing classes suffer because prices fall more rapidly than wages and other production costs can be reduced Profit margins are narrowed, they may even disappear and be converted into losses Hence business is depressed Producers aim at curtailing, or, at any rate, at not expanding production, while the fall in the prices of consumers' goods tends to the under-statement of profits or to the over-statement of losses The psychological effect is to increase the existing depression, and it is universally agreed that falling prices are "bad for trade"

To some extent, wage-earners gain because wage-reductions are strenuously resisted and lag behind the fall in prices, but labour, as a whole, bears its main share of a depression in the form of unemployment Thus, falling prices, or a rise in the value of money, mean that non-producers benefit at the expense of producers, labourers are put on short time and unemployment increases, and there is a continual drag on credit, current industry, and enterprise, due to the enhancement of past burdens in the form of debt and fixed charges

Clearly, fluctuations in prices are of the profoundest social significance, and may exert immeasurable influences on the production and distribution of wealth Indeed, it has been said with a great deal of truth that the instability of the value of money is one of the greatest economic drawbacks of modern times

Inflation and Deflation.

It should be clear from the foregoing explanation that the effects of rising and falling prices are the effects of a *changing* and not of a *changed* currency It is *the process of change* in the value of money which brings about important reactions on production and distribution, and such reactions will continue until the community has adjusted itself to the new currency conditions It is, therefore, not difficult to appreciate the great responsibility which rests upon the authority—either the Government or central bank—which in the modern community controls the volume of currency, nor is it difficult to understand the controversy which in recent years has surrounded the monetary policy of forcing prices up or down by "inflation" or "deflation"

INFLATION may be defined as an *abnormal* and *deliberate* expansion of currency and credit beyond the amount necessary to supply the needs of trade at the existing level of prices It is quite distinct from an ordinary expansion of currency and credit, such as may be rendered necessary by an increase in trade or population

DEFLATION denotes a contraction of currency (and usually of credit) relatively to trade requirements at the existing level of prices Deflation, like inflation, implies deliberate action by the monetary authority, but this time in the contractionary direction

Professor Cassel[1] describes deflation as "a process by which the internal value of the monetary unit is increased This means a deliberate raising of the purchasing power of the unit in regard to commodities and services—*i e*, a general and uniform reduction of prices, wages and salaries as measured in terms of the monetary unit," which is effected by a restriction in the supply of the means of payment and a consequent reduction of the nominal purchasing power in the hands of the public This, of course, involves a rise in the central bank rate, a reduction of credit facilities and a greater discrimination in granting loans At the same time, increased taxation and reduced Government expenditure are usually necessary in order to raise a fund for the redemption of excessive note issues.

When currency is inflated, as it was, in varying degrees, by most countries during the War, five main stages may be detected In the first place, prices, profits, and money wages rise, but despite the apparent prosperity there is no rise in the general standard of living

[1] *The World's Monetary Problems*, p 112.

Secondly, inflation breeds further inflation As the rise in prices continues, the cost of Government supplies becomes heavier, and the increased expenditure has to be met by further inflation Thirdly, the currency becomes an unsuitable store of value, and people give up saving in domestic money Some purchase foreign currencies which are still effectively tied to gold, others purchase goods the value of which is likely to endure, while business firms invest their profits immediately in new machinery and plant The spendthrifts indulge in an orgy of extravagance The fourth stage consists of violent fluctuations in prices In most cases people have become accustomed to inflation, and knowing the probability of its continuance, endeavour to anticipate it by charging "to-morrow's price" *Thus, although currency is abundant, it is always scarce relative to the level of prices* When inflation is stopped and supplies of currency are reduced, it is found that practically all the issued currency is actually circulating, and there is a shortage of liquid capital Finally, the currency breaks down as a measure of value People refuse to enter into long term contracts in terms of a rapidly depreciating currency, the currency loses its acceptability for all purposes, and may finally become valueless During this process, the widespread changes already referred to will have taken place in the distribution of wealth

Both inflation and deflation have thus most important psychological effects on the economic organisation While inflation tends to overconfidence, dangerous speculation, and an extension of business which is not justified by the real economic position, deflation tends to lack of confidence, stagnation, and a greater general depression than is justified by the underlying strength of the economic fabric There are times, however, when deflation is an economic necessity After a period of inflation, for example, a deflationary policy is essential in order to bring prices down to a healthy economic level

Gold Inflation and Deflation.

Before leaving this subject we must briefly notice the views of a group of economists who maintain that *any* upward or downward swings of prices, *whatever* their cause, constitute inflation or deflation Taking stability of the price-level as their ideal, these economists maintain that fluctuations in prices, whether they are the result of *conscious* policy or of a superabundance or shortage of gold supplies, are vicious, and, moreover, are capable of being prevented by effective action by the central banks

It seems wiser, however, to reserve the terms "inflation" and "deflation" for changes in the value of money following *deliberate action by the monetary authority*, and to distinguish a rise in the price-level due to abundance of gold as *gold inflation* and falling prices due to a shortage of gold as *gold deflation*.

CHAPTER 3.

MONETARY STANDARDS AND CURRENCY SYSTEMS.

THE term "Currency System" or "Monetary System" is used to mean the complex of all the various different types of money in use within a country, these various types being related, not by the material of which they are made, but by way of value In other words, a currency system is composed of a variety of moneys of different denomination, maintained at internal parity by being linked or related to a definite *standard*, which may take one of five forms It may be (1) the national unit of account, (2) the national unit of coinage, (3) full legal tender money, (4) the kind of money chiefly used, or (5) the kind of money freely coined, with which all other types of money are kept at par

In considering the standard and its relation to the system as a whole, two major questions arise for discussion (*a*) Whether the standard is entirely independent or is itself linked to some external object, and (*b*) If the standard is linked to an external object, the method by which this linking is effected and maintained The table overleaf indicates the various types of standards at present recognised

Monometallism.

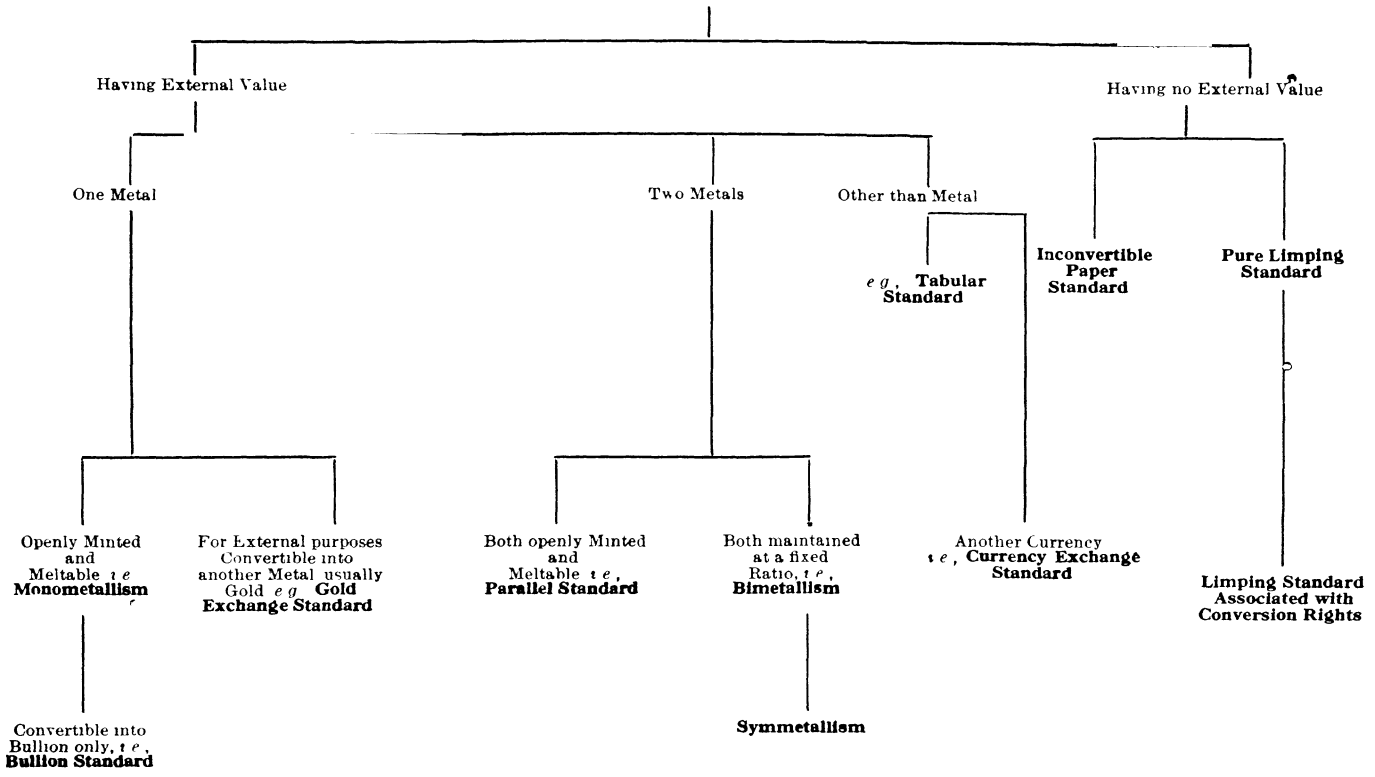
Monometallism is that system of currency wherein one metal only is adopted as the standard and is made legal tender for all payments Token coins of cheaper metal, or notes of small denomination, may also circulate, but in the strictly monometallic system, *i e*, the *Single Legal Tender System*, only the standard metal is made legal tender Gold is now the basis of most monometallic systems

Bimetallism.

Bimetallism involves the adoption of two metals—usually gold and silver—as legal tender for the payment of any amount at a legally fixed ratio, and the coinage of both metals with equal facilities Bimetallism is otherwise known as a *Multiple Legal Tender System*, and was adopted in 1803 by France, and in 1865 by the Latin Union,

TYPES OF MONETARY STANDARD.

(To which Subsidiary Units are linked)



comprising France, Belgium, Switzerland and Italy. Other continental countries afterwards adopted the same principle, and, during the nineteenth century, strenuous efforts were made to secure the adhesion of Britain and other nations with a view to ensuring stability in the world value of silver

The Bimetallists advanced as their main argument the contention that the universal use of both metals as money would stabilise the value of both and so lead to price steadiness throughout the world They also maintained that the world supplies of gold would ultimately prove inadequate to satisfy the requirements of all countries if universal monometallism were adopted.

Such arguments have not, however, outweighed two proved disadvantages of the bimetallic system (*a*) the great difficulty of maintaining the mint ratio between the metals in face of constant fluctuations in the market ratio, and (*b*) the impossibility of preventing the operation of Gresham's law in driving from circulation the underrated metal as soon as the market prices diverge from the mint ratio, resulting in an alternating coinage of gold and silver

Even before the outbreak of the Great War, France, the staunchest supporter of the Latin Union, had experienced great difficulty in adhering to the arrangement In fact, the system as it operated in that country had so broken down that it was sometimes referred to derisively as the *étalon boiteux* or "*limping*" *standard*[1] Legally, the French national unit of account was the franc, defined as one gramme of silver, nine-tenths fine, and the silver 5-franc piece was legal tender for any amount on a par with gold Yet there was no free mintage of silver and the silver currency actually in circulation was only 835 fine, while France's external exchanges were maintained on a purely gold basis, except that, whenever there was an exceptional demand for gold, the Bank of France prevented a drain on its reserves by paying out silver 5-franc pieces

Conditions resulting from the Great War brought about wide differences in the financial and economic positions of the various countries participant in the Latin Union, and more especially as between those countries which remained neutral and those which were actually engaged in the conflict It was found impossible to continue the agreement that the several currencies should circulate in any of the participating countries, and in 1926 the Union was formally dissolved by general consent All the countries concerned have now renounced the bimetallic system and have re-established their currencies on the tried and more certain basis of the gold standard

In spite of the disadvantages which have resulted in practice from the adoption of bimetallism, many leading economists have advocated

[1] This term implies that silver, having lost its equal status as a standard, is regarded as "limping" or functioning with difficulty alongside the superior metal, gold

a universal bimetallic system on a scientific basis They contend that if several of the leading countries co-operated to maintain the circulation of the two metals at a ratio fixed by international agreement, then no profit would accrue by exporting one of the metals from one country to another, and consequently Gresham's law would not operate A strong combine of mints could arrange to maintain the joint standard by controlling the market price of bullion, and could prevent any serious divergence between the universal mint ratio and the market ratio Such arrangements, they suggest, would not only make possible the advantages of a bimetallic system, but would also solve the difficulties nowadays experienced in exchanging gold standard currencies for the currencies of silver standard countries

As Gide points out,[1] the great difficulty would lie in obtaining international agreement "Each country makes it a point of honour to adopt a gold standard The English Government in particular, whose aid would be indispensable in re-establishing bimetallism, has always set its face against it"

Symmetallism.

Symmetallism is the term applied to a modified form of bimetallism proposed by Professor Marshall before the Gold and Silver Commission of 1888 According to the scheme, anyone who wished to obtain legal tender currency would be permitted to receive it in exchange for gold and silver bullion in a fixed proportion between the two metals On the other hand, any one desirous of obtaining gold and silver in exchange for currency would be permitted to do so at the fixed rates, *i e*, both metals would always be issued in the fixed proportion at which they were compulsorily received Hence, if only one of the two metals was actually desired, the recipient would have to realise the unwanted metal in the market at market rates By this means, fluctuations in the prices of the two metals, and so in the rates between them, would be kept within moderate limits.

The Parallel Standard.

This proposed system involves the adoption as a standard of *two* metals which are both openly minted and meltable The metals are coined at prices which are adjusted by the Mint from time to time according to the prevailing market ratio, thus preventing the operation of Gresham's law This system thus differs from bimetallism in the fact that there is no *legally* fixed mint ratio between the two metals

[1] *Principles of Political Economy*, page 237

The obvious difficulty of the Parallel Standard is that constant changes must be made in the Mint prices of the metals to compensate the frequent fluctuations in the market ratio.

The Gold Standard.

Although the dissolution of the Latin Union and the renunciation of bimetallism were regarded as inevitable even in the more placid days before the Great War, the ultimate consummation of these events was in the nature of a triumph for those who, in this country especially, had championed the gold standard for upwards of one hundred years But it is not always understood that many countries which are now regarded as being on the gold standard have currency systems which differ materially from the *full* gold standard (or the *gold specie standard*) which existed in Britain prior to the Great War, and which still exists in the United States of America and certain other countries

Three conditions are essential to the maintenance of a *full* gold standard First, all forms of paper currency circulating within the country must be redeemable without restriction in gold coin of equivalent face value Secondly, both notes and coins must stand at absolute parity with gold bullion This means that there must be no restrictions on the movement of gold or on the exchange of the gold currency of the country with the gold currency of other countries having a gold standard, at mint par rates or approximately so In measuring mint par rates, due allowance must be made for any tax on gold imports or exports, or for any subsidy given for the encouragement of gold mining or for the exportation of gold Thirdly, any person must be entitled to receive gold coin or legal tender in exchange for gold bullion from the Mint or central bank, free of all charge for minting and without any restrictions as to amount These essentials are such as to provide an automatic machinery by which expansion of credit and fluctuations in exchange rates are strictly limited because of their effects on the reserve of the central bank

The Gold Bullion Standard.

The systems now existing in most of the so-called gold standard countries are really modifications of the full gold standard In Great Britain, France, Norway, the Argentine, and certain other countries, the existing system is described as a *gold bullion standard* This implies that gold bullion, but not necessarily gold coin, must be freely issued or accepted by the central bank in exchange for legal tender currency Circulating legal tender notes are convertible into an uncoined weight of metal but not into gold coin, and a holder of gold bullion is not entitled to demand that it shall be minted into gold coin

The Gold Exchange Standard.

A second modification of the full gold standard which is now being widely adopted is the *gold exchange standard* The essential of this system, which is operative in Germany, Austria, Japan, and a number of other countries, is that at the country concerned shall use an internal currency of silver or paper which is maintained at a fixed parity with *a given quantity of gold* by artificial control of the currency and of the exchanges between the country concerned and a gold standard country This involves, first, regulations entitling the holder of currency to exchange it *for gold* or gold exchange, and entitling the holder of gold or gold exchange to exchange it for currency, at fixed rates , secondly, the maintenance of reserves of foreign exchange on gold standard countries in the form of bills, notes or securities of those countries, so that exchange can be sold against those reserves as and when required to maintain the currency at the fixed parity *with gold*

Both the gold bullion standard and the gold exchange standard have the great advantage over the full gold standard that they economise the use of gold, and render unnecessary the expense and waste involved in the issue and maintenance of gold coins Further, under the gold exchange standard, the necessity of maintaining an expensive gold reserve is obviated, while the reserves of interest-bearing securities and bills constitute an appreciable source of profit and revenue

On the other hand, the wide adoption of the gold exchange standard since the War has been attended with certain disadvantages The holding of large amounts of dollar and sterling bills by the central banks of countries such as Germany Austria and Poland, in order to maintain their gold exchange standards, has greatly increased the sensitiveness of the position of both New York and London The gold reserves of London, in particular, have from time to time been subjected to great strain in consequence of the reliance of other countries upon them for the support of their credit structures

Currency

Finally, there is what has been called the *currency exchange standard*[1], in which a silver or paper token currency is used for internal purposes, and the external value of that currency, as indicated by the rates of exchange, is artificially kept at a par *with another currency*, usually one which is on a gold standard Such a system exists in Ireland, which maintains a *sterling exchange system*, *i e* , the currency of that country is kept at a par with sterling, the currency of the United Kingdom A similar system functioned with great success in India

[1] See the author's *Principles and Arithmetic of Foreign Exchange*, 5th Edition, page 338.

between 1893 and 1917, when the value of the rupee was artificially maintained at a fixed parity of 16d in terms of sterling, as indicated by the London exchange on India. Neither of these are examples of a *pure* gold exchange standard, for, in the case of a currency exchange standard, the value of the exchange standard currency follows that of the currency to which it is allied, whether the latter functions on a *full* gold standard or not.

Some economists contend that all currencies which now purport to function on a gold standard or gold exchange standard are, in reality, on a currency exchange standard with the dollar as the basis, *i e*, on a *dollar exchange standard* The gist of their argument is that the vast wealth and accumulated gold stocks of the United States now place that country in the position of being able to regulate the value of gold throughout the world according to the value of the dollar Hence, countries which purport to base their currencies on gold really base them on the dollar, and, actually, their currency systems are under the control of the American Federal Reserve Board at Washington, which, by regulating American prices and so the value of the dollar, controls the value of gold and of gold currencies throughout the world.

The Advantages of the Gold Standard.

Apart from the eminent suitability of gold as a metal for coinage purposes, the greatest merit of the gold standard is that the metal has universal acceptability It is taken without hesitation by the nationals of all countries, and is therefore rightly regarded as an *international measure of value* Under an effective gold standard a country may be said to maintain an automatic mechanism by which credit expansion and exchange fluctuation are regulated Another advantage of such an arrangement is *the confidence which it inspires* As Mr McKenna has stated, the psychological and moral aspects are as vital in this matter as the purely economic considerations, for, "so long as nine people out of ten in every country think the gold standard the best, it is the best"

Disadvantages of the Gold Standard.

Against these very powerful advantages there are a number of serious disadvantages. In spite of its relative stability of value, gold has been proved by experience to be by no means as stable in value as may be wished, partly because the demand for currency purposes tends constantly to exceed the supply, and partly because of the effect of the supply of new gold on world prices—an effect which, though slight, makes itself felt in the long run.

Over long periods, the level of gold prices has fluctuated considerably, rising as new discoveries of the metal have increased the credit basis, and falling when the enlargement of the volume of production of commodities, assisted at times by the wider adoption of the gold standard, has outrun the available gold supply. It is clear that when currency and credit are operated on a gold basis, fluctuations in the relation between gold supplies and the demand therefor must exert an important influence. How much influence they are allowed to exert depends upon the degree of *management* introduced into the working of the gold standard. Before the War the gold standard operated more or less automatically, but in recent years it has been much more deliberately controlled, partly as a result of the application of new methods to meet abnormal conditions, and partly as a result of genuine and permanent improvements in central banking technique.

Recognition of the disadvantages of the gold standard has in recent years occasioned widespread controversy both in this and other countries, particularly in relation to the post-war reorganisation of the collapsed currencies of Europe. Many eminent thinkers have put forward proposals for currency systems which, they contend, would be much more in keeping with modern requirements, and save the various countries from certain troubles which appear inevitable if the gold standard is to be slavishly maintained.

Inconvertible Paper Standard : Fiat Money.

A paper standard is said to exist when the unit of account is represented by paper money which is issued with no reference to metallic reserves and without being linked to any external object such as gold or gold exchange. Such a system must be clearly distinguished from one in which the circulating media consist of notes whose issue is based on actual reserves of gold or silver. Under a paper standard, there is no right to exchange paper currency for metal and, for this reason, the notes in circulation are called *fiat money*, a term which implies that the use of paper as money and its value depend merely on the command of the issuing authority.

Generally speaking, the adoption of a paper standard results from the misuse of a paper currency, as, for example, where financial difficulty or some disturbing international event such as the outbreak of war compels a monetary authority to suspend the right of conversion of its notes and to issue further notes without increasing the reserves of metal held. In such circumstances, the value of the currency will vary, not with the value of the standard metal, but according to the extent of the issue and the confidence placed in the issuing authority.
(See page 6).

A Managed Currency : The Tabular Standard.

Many theoretical proposals have been advanced to provide for the issue of an inconvertible currency whose value, while not being dependent on the value of gold, would be otherwise carefully controlled

Of these proposals, probably the best known is that described as a *managed currency standard*, a system of currency regulation which has received much influential support in this country from those who consider that Britain's post-war financial difficulties have been increased rather than ameliorated by the sacrifices necessary to resume the gold standard

Before the War, the American economist Professor Irving Fisher had advocated a *tabular standard of value*, sometimes known as an *isometric standard*, *i e* , a currency system based on a monetary unit whose value would be controlled and regulated by reference to a group of commodities represented by price index numbers in the country concerned Such a standard would have special advantages for the settlement of deferred payments in that it would obviate those injustices between debtor and creditor which arise from fluctuations in the general level of prices (See " The Compensated Dollar " below)

Following Professor Fisher, many currency theorists (foremost among whom is the famous Cambridge economist, Mr J M Keynes) have asserted that our currency should be managed by credit manipulation with the prime object of maintaining internal price stability, and this end, they contend, could be best achieved by the institution of an inconvertible paper currency, the issue of which would be regulated according to the needs of trade with the acknowledged aim of stabilising internal prices at an agreed level It is argued that a paper pound so controlled would, within narrow limits, always purchase the same quantity of goods internally, manufacturing costs and selling prices would be accurately determinable, wage disputes would be reduced to a minimum and industrial fluctuations would tend to be smoothed out

Objections to Currency Management.

Such unorthodox suggestions in a country which had for upwards of a century been the world's principal exponent of the gold standard were naturally not permitted to go unchallenged, and the City ranged itself almost solidly against the managed currency theorists Unquestionably, a managed currency might in some ways be beneficial, but there are a number of pertinent objections to be met.

In the first place, there is the objection that the maintenance of *internal* price steadiness does not guarantee freedom from *external* exchange fluctuations, and to achieve such exchange stability some form of international agreement in the matter of monetary policy would be

essential Secondly, it would be difficult to ensure that a managed inconvertible note issue would be entirely free from political interference, since the Government of the day, with manifold financial problems before it, could scarcely refrain from exercising some degree of influence on current monetary policy Then there is the important point, in the case of countries with a big export trade, that external price stability is in many ways more important than internal price stability, and, in the case of our own country particularly,—with its vast international communications and ramifications,—this is an aspect of the problem which is of vital significance

Further, it is contended that price stability would not be achieved by a managed currency owing to the fact that changes in the volume of currency must of necessity *follow* price movements To secure absolute stability, changes in the volume of money must *coincide* with changes in the demand for money

Finally, it has to be recognised that monetary policy is only one of many factors in the intricate problem of the trade cycle Business stability cannot be achieved by currency management alone It demands the closest co-operation between industrial interests and those responsible for financial policy, while past experience has shown only too clearly that there is no golden rule either of finance or of business management which will obviate the baneful effects of trade fluctuations

The Gold Standard and Britain's Export Trade.

Even after Britain's return to gold had become an accomplished fact, the managed currency theorists in this country did not cease to criticise the Government's policy, although their opposition, which had previously been mainly theoretical, was now based on the more practical ground that the national monetary policy was injuring our export trade. This line of criticism was directed, not so much against the gold standard itself, as against the *rate* at which sterling was stabilised It was argued that, at the pre-war mint parity and on the basis of the existing level of internal prices, sterling was *overvalued* in the foreign exchange market (Chapter 32), and that *devaluation* (*i e*, a reduction in the normal gold content of the sovereign) would have been preferable to deflation

In a pamphlet entitled "The Economic Consequences of Mr. Churchill", Mr J M Keynes asserted that the policy of improving the foreign exchange value of sterling up to its pre-war value—involving a rise of about 10 per cent—meant that, whenever we sold anything abroad, either the foreign buyer had to pay 10 per cent *more* in his money or we had to accept 10 per cent *less* in our money. That is to say, we had to reduce our sterling prices for coal, or iron or shipping freights, or whatever it might be, by 10 per cent in order to keep on a competitive level with other countries unless prices in those countries

rose in proportion Since there was little likelihood of the latter, the policy of improving the exchange by 10 per cent meant, in practice, a reduction of 10 per cent in the sterling receipts of our export industries But, Mr Keynes continued, prices in these industries could only be cut by 10 per cent if the costs for wages, transport, and other items were also lowered by 10 per cent, and thus Mr Churchill's policy of improving the exchange by 10 per cent was sooner or later a policy of reducing everyone's wages by 2s in the £ In a word, Mr Keynes maintained that the return to gold at a rate which clearly overvalued the pound sterling was bound to involve a large measure of deflation and, consequently, unemployment Similar views were put forward by Sir Josiah Stamp, who, in his addendum to the Coal Inquiry Report, concluded that currency policy had aggravated, although it had not caused, the depression in the coal trade

On the other side was a large and influential body of our leading bankers and financiers who not only believed that the gold standard was the best but that the Government had acted wisely in returning to it at the earliest possible moment They did not dispute the fact that an overvalued currency acts as a temporary stimulus to imports, or that, by forcing up the external value of the £ by 10 per cent in less than a year, we had placed a temporary impediment in the way of our export trade But they pointed out that in both cases the effects on our overseas trade must be temporary only, and furthermore, that this phase was an inevitable preliminary to the benefits which the return to gold would confer The solution was to be found in raising the internal value of the £, or, in other words, bringing down our home prices to the level which would correspond with that placed on sterling by the external exchange They contended that the mechanism for the reduction of prices was inherent in the return to the gold standard, and that the rise in the external value of the £ would promote, and must ultimately cheapen, imports in the same way, and in the same measure, as it must impede exports Cheaper imports meant a lower cost of living, a reduction in money wages, and so, through a diminished cost of production, an ultimate compensating benefit to the export trade

In brief, exponents of the gold standard sought to show that the difficulties which arose consequent on our return to gold were the inevitable and *temporary* product of economic friction, *i e*, those influences which prevent adjustments from being made *immediately*

The Compensated Dollar.

Currency theorists in this country have not, by any means, been alone in their strenuous opposition to the use of the gold standard on the pre-war basis Strong pleas for a more modern system of

currency regulation have been advanced by leading economists throughout the world, and a number of alternatives to the gold standard have been propounded, all of them with the object of ensuring some greater degree of conscious control of the internal value of money—the factor on which so largely depends the progress and prosperity of each community

In the United States, Professor Irving Fisher proposed that internal price stability should be achieved by the indirect regulation of the demand for gold as currency according to a monthly price index number No direct regulation of either demand or supply of the metal was proposed, but instead Professor Fisher suggested the artificial control of the power of gold as the basis of currency and credit expansion In practice, the scheme would be operated by the institution of a gold bullion standard, and all the gold reserves would be held by the Government, certificates being issued to the banks against the deposit of bullion These bullion certificates would represent not a fixed amount of gold but a varying number of dollars, the legally fixed gold content of which would fluctuate, according to a definite plan, with changes in the price level as indicated by index numbers If prices rose beyond a stated minimum percentage, the gold content of the monetary unit would be increased to counteract the fall in its value, similarly, if prices fell, the gold content would be decreased In order to maintain a fixed percentage ratio between gold and certificates, the latter would be withdrawn (and cancelled) or issued, simultaneously with the rise or fall in the gold content of the unit

Unfortunately for the success of the scheme, it provides only for the control of legal tender currency and does not suggest any clear cut regulation of the many other forms of money within the community The difficult question of the regulation of bank credit is not covered, yet failure in this direction would vitiate the whole proposal To attain this end considerable monetary skill and the closest co-operation of the central bank are necessary, and herein lies the chief weakness of the plan Obviously, such a scheme would, in effect, result simply in the currency being "managed" on special lines, and it has been contended that, if a community were able to administer successfully such a scheme, they should be ready to go a step further and dispense completely with the gold basis

Professor Lehfeldt's Scheme.

Another far-reaching scheme which has merited world-wide attention is that put forward by Professor Lehfeldt, of the University of the Witwatersrand, Johannesburg, whose suggestions have much in common with Fisher's scheme, but are based on the regulation, not of the *demand* for gold, but of the *supply* of it, by the control of the annual new output of the metal according to the level of world prices Possibly this is the

most ambitious plan yet suggested, since it involves acquisition of all (or at least the bulk) of the world's sources of gold supply by an international commission, which would arrange to increase or decrease the production of the metal according to the fall or rise in the world price level

Although insuperable obstacles would need to be overcome before such a plan could be inaugurated, its advantages would seem to be less substantial than those of Fisher's scheme, owing principally to the greater time-lag between price changes and the compensating action of changed supplies of gold The same remarks apply as in the case of the " compensated dollar " it is hardly worth while to go to such lengths to " manage " a gold standard when management of a currency quite independently of gold would appear to be no more difficult

The Pure Limping Standard.

This system arises where a standard, once freely coined or issued, remains in circulation although no longer freely coined One example, that of France prior to 1928, has already been mentioned Another example occurred in the case of India when the mints were closed to silver in 1893 The supply of rupees then became definitely fixed, and thus there was no limit to the possible rise in the value of the silver rupee, since it was not, as it is to-day, linked to an external object Its " downward value," however, was limited by its value as silver bullion

The Limping Standard Associated with Conversion Rights.

This is simply a limping standard of which the " limping " metal is convertible into the full standard metal, although the converse does not hold good

BRITAIN'S MONETARY SYSTEM

During the eighteenth century and until 1816, Britain had a bimetallic currency system, under which silver and gold were freely coined on an equal basis, and were legal tender for all payments at a certain fixed ratio The relative production of the two metals varied continually during this period and great difficulty was experienced by the government in maintaining the legal ratio, which had to be constantly altered to meet the changing conditions By 1800 the production of silver had increased considerably , the silver currency was overrated and tended to drive gold from circulation Consequently, in 1816, the free coinage of silver was discontinued, and gold was definitely adopted as the sole standard of value, being made legal tender for all payments At the present time our coinage is regulated by the Coinage Acts of 1891 and 1920.

Metallic Currency.

GOLD COINS, consisting of sovereigns and half-sovereigns, are legal tender for payment of any amount. A sovereign consists of 123·27447 grains of standard gold, eleven-twelfths or 22 (out of 24) carats fine, and is legal tender so long as it does not weigh less than 122·5 grains. A half-sovereign is exactly half the weight of a sovereign, but its minimum legal weight is 61·1250 grains.

In pre-war days, the Mint accepted gold for coinage at the rate of £3 17s. 10½d. per ounce standard, provided that it was of the required fineness and of sufficiently large quantity, but at the present time, by virtue of the provisions of the Gold Standard Act, 1925, all gold has to pass to the Mint through the Bank of England, by which gold is purchasable at the rate of £3 17s. 9d. per ounce standard.

The difference of 1½d. per ounce between the Mint and Bank prices is not profit; it is a margin intended merely to cover the expenses and loss of interest involved in passing gold through the Mint for coinage. The Bank pays over legal tender in exchange for bullion immediately, or gives immediate credit for the gold in account, and it must accordingly be recompensed for the expense and loss of interest involved in having the bullion converted into sovereigns if it so desires.

The gold coins issued by the mints at Pretoria, Sydney and Melbourne are legal tender in this country, while English gold coins are legal tender in Australia.

SILVER COINS are legal tender for payments up to 40s. only. Those at present in circulation are of two kinds: (*a*) *The old silver coins* issued under the Coinage Act, 1891, which decreed that five shillings and one sixpence were to be coined from one ounce of silver, $\frac{37}{40}$ths or 925 (out of 1000) fine. As the price of an ounce of silver was generally about 2s. 6d., the Mint usually made a handsome profit, or "seigniorage," on the coinage of silver. (*b*) *The new silver-nickel currency*, issued under the Coinage Act, 1920. These coins are only 500 (out of 1,000) fine, being composed of an alloy of silver and nickel. The decreased proportion of silver was made necessary by the great rise in the price of the metal during and after the war period, consequent on the widespread shortage which resulted from a greatly increased demand for the metal for currency purposes and the withdrawal of coins for melting and export.

COPPER COINS are made of bronze, an alloy of copper, nickel and tin. They are legal tender for payments up to 1s. only.

English Paper Currency.

BANK OF ENGLAND NOTES, *of £5 and multiples thereof*, are issued by the Bank of England in London, and by its various branches in

Manchester, Birmingham, Bristol, etc. By the Bank of England Act, 1833, these notes were made legal tender in England and Wales for payment of all amounts *above* £5, except by the Bank itself or its branches, but by the Currency and Bank Notes Act, 1928, it was provided that they should be legal tender for *any amount*, *i.e.*, including amounts of £5 *and over*.

BANK OF ENGLAND NOTES, *of* £1 *and* 10*s.*, are now issued by the Bank under the Currency and Bank Notes Act, 1928, having replaced the Currency Notes issued by the Treasury from 1914 to 1928 under the Currency and Bank Notes Act, 1914. These notes are legal tender in England and Wales, Scotland and Northern Ireland, for the payment of any amount, even by the Bank itself and its branches.

Any outstanding Treasury notes are gradually being withdrawn from circulation, and, for the time being, all such notes are deemed to be Bank notes, for the repayment of which the Bank is responsible.

Following the recommendations of the Cunliffe Committee on Currency and Foreign Exchanges after the War, 1919, and the Committee on the Currency and Bank of England Note Issues, 1925, the Gold Standard Act, 1925, abolished the existing restrictions on the export of gold from this country, and instituted a *gold bullion* standard.

Under this Act, the Bank of England notes and the then circulating Treasury notes were made inconvertible into gold *coin* for internal purposes, the object of this provision being "to prevent the *internal* circulation of gold coin until such time as the gold standard has been firmly re-established for the purpose of international transactions." On the other hand, holders of any "legal tender" are entitled to demand in exchange, at the head office of the Bank and during office hours, gold bars containing approximately 400 ounces of fine gold, at the rate of £3 17s. 10½d. per standard ounce. Moreover, while it was decreed that gold bullion shall no longer be taken to the Mint for conversion into gold coin by anyone except the Bank of England, gold bullion can still be offered in unlimited quantities to the Bank, which is compelled to buy the metal at the rate of £3 17s. 9d. per standard ounce.

The Bank of England has now a monopoly of the issue of paper currency in England and Wales, and is required to make and publish a weekly return of the position of its Issue Department in the form reproduced and explained in Chapter 11.

CHAPTER 4.

CREDIT AND ITS FUNCTIONS.

THE word *credit* in its original meaning connotes simply belief or trust, but the term is now applied to that belief in a man's probity and solvency which will permit of his being entrusted with something of value belonging to another, whether that "something" consist of money, goods, services or even credit itself, as when one man entrusts to another the use of his good name and reputation.

The simplest form of credit transaction arises when one person *transfers goods to another in return for a promise to pay an equivalent value at some future time.* This is an arrangement for deferred payment; its fundamental elements are *confidence*, *amount*, and *time*. A more advanced stage is reached when money and not goods is transferred in the present in return for a promise to pay its equivalent in the future; *i.e.*, a system of *loan* develops, in which the borrower must use the borrowed money productively and profitably, while the lender must run a certain amount of risk that his loan will never be repaid.

The arrangements are still further complicated by their extension to embrace the whole world and by the system of contra accounts, wherein each party may be at the same time borrower *and* lender, and debts may be settled by a mere process of compensation, cancellation or set-off. Underlying the whole is the foundation of mutual trust, the idea that prompt payment may be demanded and will be given at any time. These factors enable men in various countries to accept the written word of others whom they have never seen as equivalent to payment in gold itself, and permit of the transfer of goods from one end of the earth to another merely against the signature of some one whose word is regarded as being as good as a bond.

A man's credit is, therefore, said to be good or bad according to his known ability and willingness to meet his obligations promptly, and in the business world the highest value is placed on the retention of such a reputation for solvency and prompt payment as will ensure an immediate acceptance of the name of a person or firm as good for any obligations undertaken. Apart from this moral basis, credit transactions are protected also by law, inasmuch as a creditor can always obtain the assistance of the law in enforcing his *right* against the debtor, and in compelling the latter to discharge his *legal liability*. It is, therefore, natural to find the highest development of the credit system in

those countries where there exists a high standard of business morality, a well-maintained security of private property, and a strict enforcement of the law

Credit Instruments.

Usually the promise to repay at a future time which forms one element of all credit transactions is given on paper in one of several forms, known collectively as *credit instruments*, such as bank notes, government notes, cheques, bills of exchange, promissory notes, postal orders and money orders

Underlying all such instruments is the idea of confidence—the knowledge that the holder can, at any time to suit his convenience, exchange the instrument or instruments in his possession for legal tender currency, and, if he so desires, for gold—the basis of all credit in highly developed communities These credit instruments are, in fact, simply substitutes for gold and legal tender, their intervention economises the use of gold and also facilitates exchange on a large scale

In the case of the cheque, bill of exchange and promissory note, the confidence is a strictly personal one the promise to pay is clearly evidenced by the signature of the giver of the instrument, and by that signature he is both morally and legally bound By that signature, also, the worth of the instrument is judged if the credit of the signer is good, the cheque, bill or note may pass as a medium of exchange in several transactions, if it is bad, the circulation of the instrument is restricted accordingly Thus we find that, as a general rule, cheques and bills pass current only in a limited circle within which the financial soundness of the parties is known, and again that bills pass current far more frequently than cheques, which are used principally for single transactions only as between drawer and payee

Bank and government notes are on a different footing Under normal conditions in the principal countries the credit of the issuers is usually undoubted, and the security of the notes is generally maintained by the provision of ample metallic reserves Consequently, when such notes are passed from hand to hand they are accepted, not so much on account of the credit of the transferor, but because of the credit of the issuers In fact, they act merely as representatives of gold itself, and the question of credit or solvency becomes of almost negligible importance.

The distinction between bank notes and cheques and bills is important also from the point of view of their effect on prices Obviously a man's reputation for solvency, *i e*, the question as to whether his credit is good or bad, can have little effect on the price level, but when credit instruments are used for settlements in place of metallic currency, they affect prices to the same extent as would metallic

currency of the same amount Bank notes pass far more frequently and far more readily than cheques and bills, they are rarely hoarded, and are not kept out of circulation in the same way as bills of exchange which are discounted and locked away in a banker's or broker's portfolio Consequently, the effect on prices of the circulation of bank notes is far greater than in the case of cheques and bills of exchange

Book Debts and Loans.

Evidences of the giving of credit may exist in forms other than such instruments already mentioned A sale on credit by a tradesman or an advance of money by a banker is evidenced simply by an entry in the books of the tradesman or of the banker, and no promise signed by the borrower may exist But the right of action on the one hand and the liability on the other are just as clear as if an instrument existed, and the transfer of credit by book entries is recognised universally as involving a legal and a moral obligation

A feature of modern commercial organisation is the enormous increase in the transfer of credit by means of book entries, and the development of that vast system of contra accounts and set-off which is practised between countless business firms, and reaches its highest pitch of intricacy and yet wonderful perfection in the clearing houses and stock markets The greater the civilisation of a community and the higher its development, the more efficient usually is its system of credit and method of cancelling indebtedness

Frequently loans by one person to another are evidenced by instruments of various kinds, such as bonds and debentures Joint stock companies, especially, obtain considerable amounts of capital by the issue of debenture bonds or debenture stock Debentures to bearer are negotiable instruments in the same way as bills or cheques, but they are not used to the same extent for the settlement of transactions in the ordinary course of business

The Functions and Utility of Credit.

The great advantage of credit, in its broadest meaning, is that the reputation of one man or firm may be made use of for trading purposes by another A great bank, with almost unlimited credit in the sense of reputation for solvency, may transfer the benefit of that reputation in a multitude of directions, to enable an enterprising but perhaps little known London merchant, not possessed of much capital, to buy goods to the value of thousands of pounds in the Argentine, to enable a reliable farmer, of little means, to become possessed of a farm which he can cultivate successfully and profitably, to enable a great railway or a newly-developing state to borrow considerable sums of money,

collected by the bank from balances small and large, in the names of numerous depositors living in widely scattered localities.

The great function of credit is to finance the producer who is engaged in turning out goods in anticipation of demand This system of producing for a future market is a characteristic of modern industry,—a characteristic which would have been incapable of development in the absence of credit facilities sufficiently elastic and progressive to keep pace with a constantly increasing demand for them Because the moderate expansion and contraction of credit in modern society are accomplished easily and conveniently, producers can apply themselves without undue limitation to that specialisation and organisation which is so marked a feature of modern business

Credit, therefore, economises metallic currency, and substitutes a cheap medium of exchange for a more expensive and less convenient one, which would not in any case be available in quantity sufficient for modern requirements It enables payments to be deferred until it is convenient for the borrower or promisor to make them, and consequently diminishes difficulty and hardship It permits the collection of a multitude of small amounts into centralised reservoirs (*i e*, the banks) whence they can be drawn, in small or large quantities, for productive purposes The proportion of idle capital is thus minimised, large undertakings involving huge capital are made possible, and production as a whole is stimulated Then the careful regulation of credit tends to minimise fluctuations in prices and to stabilise trade conditions, this is achieved by a restriction of credit facilities when a "boom" is imminent and speculation is rife, and by an expansion of credit when trade is reviving slowly after a period of depression Finally, there is little doubt that the modern credit mechanism does much to promote progress, to aid development, and to encourage invention and industry.

The Dangers of Credit.

The creation of credit is necessarily a matter subject to human control Notes can be issued to almost any extent if reserves are disregarded, while advances by a banker can be increased beyond the limit of safety for a considerable period before a crash ensues There is no absolute limit to the expansion of a credit system as there is to an expansion of a metallic circulation, and the intervention of the human element, with its usual accompaniments of uncertainty and variableness, is the chief source of danger in a credit organisation

Hence the greatest danger of credit lies in its liability to excess There is always a possibility that more notes will be issued than are necessary and healthy, or that more bank advances will be granted than are safe to the community The confidence induced by general prosperity in trade and industry very frequently leads to excessive zeal,

over-production and speculation. An enormous superstructure of credit may be built up on a small metallic reserve, and any outstanding event which shakes public confidence may serve to bring about a violent contraction of credit facilities, with consequent commercial and financial stringency

There is also little doubt that the modern credit system tends to the *disguising of financial weakness*, for it enables a low grade entrepreneur to continue a losing business with the help of borrowed capital In the absence of credit facilities such a producer would be forced to cease his operations, but by borrowing he can continue until his eventual failure brings widespread loss and hardship to the many whose capital was committed to his keeping Such men are enabled to persist in their businesses because an extensive credit system means low interest rates and the consequent keen competition among capitalists to invest their funds results in money being sunk in enterprises which cannot hope to succeed

It is frequently pointed out that the modern credit organisation makes possible the *control of vast capital by monopolistic combinations* of producers, and, although the results are not necessarily harmful, they may not be so beneficial as when the capital is in the hands of a number of individual producers Only too frequently, the control of large capital by certain individuals and organisations leads to the exploitation of labourers, to an exaggeration of prices, to large combinations and to unfair competition

Lastly, it must be recognised that credit is so easily obtained in periods of expanding trade that *waste may be encouraged*, particularly on the part of government departments and irresponsible entrepreneurs

Influences Determining the Volume of Credit.

The expansion or contraction of credit is influenced by a number of important factors In the first place may be mentioned the influence of *trade and industrial conditions* at home and abroad When trade is good, credit is usually abundant but bad trade creates distrust and fear of the future, which are accompanied by depressed conditions of credit The second factor is *the state of public confidence and general security* When confidence is high, credit is good, but the superstructure of credit is quickly contracted by any event which shakes public confidence, such as the outbreak of war, a great earthquake, or widespread anticipation of governmental interference with the currency Marked instances occurred in 1923-24, when the Japanese earthquake caused a considerable disturbance of credit conditions in that country, while the rumoured proposals to inflate the currency had a similar effect in the United Kingdom

Foreign affairs and the political outlook are important chiefly because of their influence on public confidence and the feeling of security. The

outbreak of a war is always followed by a contraction of credit, for the uncertainty causes bankers and others to strengthen their reserves and to reduce their commitments A change of government has a similar effect, particularly if its policy is distrusted The advent of Britain's first Labour Government in 1924 was preceded by considerable apprehension in the London Money Market, largely because of the threat of a levy on capital, and a large contraction of credit resulted

Speculation is an important influence by reason of the fact that most speculative enterprises are instituted and conducted on borrowed money, *i e*, on credit Consequently in a period of active trade culminating in a boom, speculation is rife Speculation and credit expansion go hand in hand, and as speculative enterprises are the first to suffer when credit contracts, so is a threat of reduced or dearer credit facilities followed at once by a decrease in speculation

Lastly may be mentioned the effect of the *state of the currency* A sound currency system based on an adequate gold reserve promotes an expansion of the credit superstructure As we shall see later, a fundamental principle of modern banking is that credit can be created to several times the extent of the actual metallic reserve held Consequently, a sound currency system permits bankers to increase their reserves and so to extend their credit facilities On the other hand, the existence of a bad currency in itself creates distrust and uncertainty, resulting in a restriction of credit

As was shown in discussing the Quantity Theory of Money, the amount of credit is a determinant of the general level of prices Consequently it is of paramount importance that credit facilities should be subject to careful control Under an effective gold standard system the principal factors influencing the volume of credit are movements of gold to and from the country When gold flows into a country, it strengthens the reserve of the central bank and so increases the basis of credit Money rates become easier and the volume of credit is expanded When gold flows out of a country, the central bank's reserve is weakened, money rates tend to rise, and credit is curtailed But the actual *extent* to which the movement of gold is allowed to influence the volume of credit depends partly on current banking policy and partly on the policy of the authority which controls the legal tender currency This important and controversial matter is discussed in Chapter 11

Credit and Capital.

Credit must be distinguished from capital The former cannot create wealth and is not itself an instrument of production It is,

however, an *instrument* or *mechanism* which, by its intervention, enables production to be carried on. Credit permits the transference of wealth from those who cannot utilise it effectively to those who can turn it to profitable use. "Credit being only the permission to use the capital of another person, the means of production cannot be increased by it, but only transferred" (J S Mill) "Credit does not create capital, it only determines by whom that capital shall be employed" (Ricardo)

Only in an indirect sense can the granting of credit, as, for example, in the form of bank advances, result in the creation of capital As we have seen, an expansion of credit forces up the general level of prices The effect is that some degree of economy in the purchase of goods for immediate consumption is forced upon the community, in other words, a greater proportion of the community's total purchasing power is devoted to capital uses as distinct from immediate consumption uses

Credit and Prices.

It has been shown that changes in the volume of credit instruments used for exchange purposes have the same effect on prices as the increased or decreased use of metallic currency, whilst the effect of the use of bank notes is greater than that which follows the use of cheques and bills One other aspect needs to be mentioned, and that is the considerable temporary effect on prices which may follow an expansion of all forms of credit (principally book credit) consequent on speculative activity

Most speculators work on borrowed money, and an extension of credit is bound to follow action by several speculators who borrow in order to purchase goods or otherwise embark on speculative transactions in anticipation of rising prices One speculator may anticipate a rise in the price of wheat, and, with the object of making a profit, may buy now so as to sell later at an enhanced figure Other speculators do the same, practically all of them buying on credit or with funds borrowed from a bank The increased purchases—other things being equal—will force up the price of wheat, and the rising price of the commodity will stimulate further speculation If such operations are overdone, the rise may be far greater than was ever anticipated by the original dealers, and any fall which ensues will be all the greater by reason of the over-speculation If trade is expanding and a boom period is anticipated, speculation on a credit basis may extend in all directions, and prices of a great number of commodities may be forced up Thus the development of credit makes speculation possible, and such speculation may result in considerable fluctuation in the prices of commodities.

CHAPTER 5.

THE DEVELOPMENT OF BRITISH BANKING.

BANKING in this country may be said to have originated many centuries ago in the business of lending or usury which was conducted by certain wealthy Jewish merchants in London. These early financiers were, however, subject to much interference, and ultimately they were expelled from the country. Later, in the fourteenth century, merchants from the Lombard States in Italy conducted a similar business, and to them is attributed the name of that most famous of all streets, Lombard Street, E.C. The term "bank", also, is attributed by some to the custom of these traders of acting as money changers on benches ("banco") in various mediæval trading centres.

There is little real connection between present-day banking and the simple form of money-changing and money-lending conducted in mediæval times. The money-lenders were simply usurers; they made profits by loaning their own private capital and performed only one side of that characteristic function of modern banking, *i.e.*, that of borrowing from some in order to lend to others.

It was not until about 1645 that any organisation similar to that of a modern bank began to take shape. The London merchants had been accustomed to leave their surplus wealth at the Royal Mint for safe custody, but when, in 1640, Charles I appropriated £130,000 of this money, the merchants determined to seek some other place of security. The strong rooms of the goldsmiths offered undeniable attractions, and consequently large sums were left with them for safe-keeping against signed receipts called "goldsmiths' notes," embodying an undertaking to return the money to the bearer on demand.

The goldsmiths soon discovered that they could safely lend out a part of the funds left with them in this way, for experience showed that only a comparatively small proportion of gold was required to meet current withdrawals and probable demands. This loaning of other people's money at interest soon proved to be a very profitable operation. Hence the more enterprising merchants began to pay interest as an inducement for the deposit of money with them, at a lower rate, of course, than they charged for loans, while some of the goldsmiths abandoned their original functions and applied their whole energies to this new business. At the same time, competitors sprang up who were bankers first and last, and who performed no function other than that of dealing in money.

The Foundation of the Bank of England.

It is in the foundation of the Bank of England in 1694, however, that we find the first step in the direction of joint-stock banking as it exists to-day in this country.

The Bank of England owes its foundation to a Scotsman, William Paterson, who was responsible for the scheme under which an amount of £1,200,000 was subscribed as a loan at 8 per cent to the Government of William III, then in financial difficulties In return for the loan the subscribers were granted a charter incorporating them as the Bank of England, with the privilege of issuing notes to the extent of the sum lent This loaning of capital at interest, rather than the issue of notes, was the primary object of the Bank, although its notes now constitute the greater part of the legal tender currency of the country

The new bank proved an immediate success, and in order to prevent the formation of rival institutions, an Act was passed in 1708 forbidding the issue of notes by joint-stock banks other than the Bank of England.

The Birth of the Cheque System.

The Act of 1708 was of first importance in the subsequent history of English banking Its effect was to give the Bank a virtual monopoly of joint-stock banking which contributed essentially to its predominance in succeeding years

By forbidding joint stock banks to issue notes,—the essential function of all banks in those days,—it had the practical effect of restricting the growth of joint stock banking and of confining the function of note issue in England and Wales to a multitude of small private banks, which were subject to no legal regulation, and were in many cases totally unfitted to bear their responsibilities

Another important result of the Act was its effect on the functions of bankers in London Here, and in the surrounding district, the Bank of England note was supreme, and its predominance eventually caused the London private bankers to abandon the issue of notes, and to develop *deposit banking*, *i e*, the acceptance of deposits, withdrawable at first by letter and later by cheque

The early form of the goldsmiths' note had been a *written* request of the customer that the goldsmith should pay a certain sum out of the customer's money to a named payee In July, 1729, printed forms for their notes were first issued by Messrs Child & Co, these forms being similar to the modern *cheque* in that spaces were left for the customer to fill in the name of the payee and the sum payable The London bankers encouraged this practice as it enabled them to compete with the Bank of England, and, about 1780, they gave up the issue of notes in favour of the issue of these printed forms of *cheques*,

by which depositors could withdraw upon demand such amounts as they required, or instruct their bankers to make payments to third parties

While these early cheques were largely similar to those which exist to-day, they differed in the important respect that they were invariably made payable to *bearer* on demand, a clear indication of the fact that the cheque had its origin in the desire of the London banks to circumvent the growing strength of the Bank of England, so largely dependent upon its practical monopoly of the right of note issue in London

Financial Difficulties During the Napoleonic Wars.

At the beginning of the nineteenth century, therefore, we find banking in this country in the hands of three different types of institution First, we have the Bank of England, supreme by virtue of its charter and its monopoly of the issue of notes in and around London Then there were the London private banks, struggling to establish the system of deposit banking and the issue of cheques Finally, there was the heterogeneous group of small private banks throughout the country, instituted and conducted by people in almost every walk of life whose sole pretension to establish themselves as bankers was the fact that they possessed more of this world's goods than their fellows

It is not surprising that a sequence of disturbing factors should entirely disorganise such a weakly knit fabric England's participation in the Napoleonic Wars towards the close of the eighteenth century had involved her in serious financial difficulties The Bank of England's gold reserve had been seriously depleted, and, when rumours of a French landing brought about a panic and a demand for gold, an Order in Council had to be issued in 1797 permitting the Bank to suspend payments in cash Extra notes were issued to meet the deficiency in the currency, but the issue was in excess of actual requirements, with the result that the notes became depreciated in value, while gold coins disappeared from circulation The price of gold rose to such a height that in 1810 a House of Commons Committee was appointed to consider the whole question of the high price of bullion

The Bullion Report, 1810.

The famous report of this Committee set forth a number of important conclusions in regard to currency and exchange, and in spite of the fact that more than a century has since elapsed, these conclusions are still recognised as fundamentally sound

Four important propositions were enunciated . (*a*) that the variations of the exchanges with foreign countries from par can never for any considerable time exceed the expense of transporting and insuring the

precious metals from one country to another, (*b*) that the considerable variation in the chief exchange rates beyond these limits was due to the excess issue of Bank of England notes and their depreciation as compared with gold, which had to be used for foreign payments, (*c*) that the market price of gold could not exceed the mint price unless the purchasing medium—in this case paper—was depreciated, and (*d*), that this depreciation was measured by the difference between the mint price and the market price of gold

The Committee regretted the continuance of the suspension of cash payments, and expressed the opinion that the only safeguard against excess issues of paper currency was convertibility into specie, and that the increased price of gold and unfavourable exchanges were the best criteria for judging the sufficiency or otherwise of the paper currency and for regulating the issues of Bank of England notes

Banking and Currency Troubles.

The House of Commons for party reasons refused to adopt the recommendations of the Committee, but the views expressed were upheld by subsequent events Violent speculation and disaster followed the declaration of peace with Napoleon in 1814, and hundreds of private note-issuing banks failed The collapse of the note issues meant a reduction in the volume of the paper currency, so gold fell in price, and the exchanges moved above par In 1816 the system of gold monometallism was adopted and the Bank attempted to resume cash payments This attempt failed on account of large withdrawals to France, but in 1821 the bank-note currency was finally established on a convertible basis

In some quarters, the currency and banking difficulties were attributed to the monopolistic privileges of the Bank of England, and in subsequent years, a number of Acts were passed with the object of mitigating the effects of this monopoly.

An Act of 1826 permitted the establishment of joint-stock banks of issue with *unlimited* liability provided that they did not conduct business within a radius of sixty-five miles of London This was an important departure, for it not only lessened the monopoly of the Bank so far as joint-stock banking was concerned, but also strengthened the provincial banking fabric, hitherto made up of a large number of weak private bankers

It is in the Bank Act of 1833, however, that we find the beginning of the really modern period This Act permitted the establishment in London itself of joint-stock banks for the transaction of *all* banking business other than the issue of notes to bearer on demand In this respect the Act still further modified the power of the Bank of England,

by the same Act, its notes were made legal tender in England and Wales for all payments over £5 (except by the Bank itself or its branches)

The Act of 1833 marked the beginning of a new and prosperous era for banking in this country It was followed immediately by the establishment in London of several joint-stock banks,—the forerunners of the great institutions of to-day,—and it gave rise to an entirely new class of banking institutions, best described as *banks of deposit* in contradistinction to the old-established class of *banks of issue*

By many people, the constant currency troubles and the repeated banking failures at this period were attributed to the over-issue of notes by the Bank of England and the small private banks Considerable controversy arose as to the best method of controlling such issues, and ultimately two opposing schools of thought were identified, advocating the *Banking Principle* or *Theory* and the *Currency Principle* or *Theory* respectively

The Currency Theory.

The exponents of this theory held that bank notes were issued merely to provide convenient and economical substitutes for metallic money, and not to provide instruments of credit They maintained, therefore, that the issues should be limited to the amount of gold held against the notes, and that the circulation of notes should be regulated according to the flow of gold into and out of the country These reformers also contended that the banks should create credit only in return for specie, but obviously their ideas were not altogether compatible with that great development which was still to come.

The chief objections to the Currency Theory were that it provided for a *non-elastic* paper currency, which could not vary as trade conditions varied, and also that it made no provision for a temporary shortage of gold As later events proved, note issues may be an effective *addition* to the currency provided they are adequately controlled, even though they are not necessarily a *substitute* for the actual metal

The Banking Theory.

The members of the Banking School took the view that the issue of notes could safely be left to the discretion of the bankers, whose object it should be to limit the circulating currency to the *legitimate* demands of business and trade They held that any notes in excess of trade requirements would be presented for encashment, and that, so long as an *adequate* reserve was maintained, strict convertibility could be ensured and inflation prevented without the necessity of holding gold to cover every note issued.

Those who objected to the Banking Principle pointed to the experience of past years in order to strengthen their case That experience, they contended, had clearly demonstrated that bankers were not always in a position to judge the operations for which notes were required, nor were they always sufficiently prudent and careful, while to leave to them the control of note issues was to place too much power and responsibility in the hands of one class of business men

The Bank Charter Act, 1844.

The Government was eventually won over by the Currency School, and many of their recommendations were embodied in the Bank Charter Act, 1844 In some respects the Act was a compromise, for it did not altogether exclude the ideas of the Banking School although it ensured the maintenance of adequate gold reserves behind the Bank of England note, it provided also for a limited issue against securities

As a first step in the direction of reorganisation, the Act laid down that the Bank of England was to be divided into two distinct departments, called the Issue Department and the Banking Department respectively The Issue Department was authorised to issue notes against securities (the *Fiduciary Issue*) to the amount of £14,000,000, and was required to cover all issues in excess of this by gold and silver in reserve, the silver not to exceed one-fourth of the gold held Any person was to be entitled to demand notes from the Issue Department in return for gold bullion at the rate of £3 17s 9d per ounce standard, *i e*, 1½d per ounce below the legally fixed mint price of gold, while, in order to ensure full publicity regarding its position, the Bank was required to publish, in the *London Gazette*, a Weekly Return of the assets and liabilities of both Departments

Those responsible for the Act were clearly convinced that adequate publicity respecting bank note issues was the best method of preventing or, at least, lessening future losses to the public, while it is clear that they were equally determined that the English issue of bank notes should be ultimately concentrated in the hands of the Bank of England Hence it was provided that no further banks of issue were to be established, and that any existing bank losing the right of issue through bankruptcy, amalgamation, the opening of an office in London, etc, should not be entitled to resume such issues Moreover, every existing bank of issue was to forward a weekly return of its issues to the Stamp Office for publication in the *London Gazette*, and its issues were not to exceed its average circulation for the twelve weeks preceding 27th April, 1844, otherwise the right of issue would be forfeited

Finally, it was decreed that if, after the passing of the Act, any country bank ceased to issue notes, the Bank of England could obtain an Order in Council empowering it to increase its fiduciary issue by two-

thirds of the lapsed issue In accordance with this provision, the Bank from time to time obtained the necessary authority to increase its fiduciary issue, the last of such increases under the Bank Charter Act being effected in 1923, when, following the absorption by a large joint stock bank in 1921 of the last remaining private bank of issue, the Bank was empowered to raise its fiduciary issue to £19,750,000

By these provisions, the Act of 1844 aimed at ensuring the absolute convertibility of note issues in this country, together with full publicity regarding the amount of the issues and of the reserves held against them It aimed also at so regulating the paper currency that inflation would be prevented, speculation and crises obviated, and the foreign exchanges stabilised Its object of centralising the note issues in the hands of the Bank of England was attained, as we have seen, in 1923, when the Bank took over the remnant of the private bank note issue

The Growth of the Joint-Stock Banks.

The Bank Charter Act established the Bank of England as the supreme institution in English banking, and succeeding years saw a great increase in its power and influence Its note issues were the sole legal tender paper currency until the outbreak of war in 1914 , it acted as the banker to the British Government and, in course of time, to all the other joint-stock banks in the country, who came to leave their surplus balances on deposit with the central bank This arrangement proved of vital significance in its relation to the structure of the English banking system

But while the bank of banks was thus passing from infancy to virile maturity, the joint-stock banks were by no means at a standstill Faced from the outset with jealousy and even open hostility on the part of the Bank of England and the private bankers, hampered by the difficulties which necessarily attended inexperience, and, by reason of their inability to issue notes, forced to develop the comparatively new system of deposit banking, these early joint-stock banks nevertheless made great progress At a time when Britain was opening up her vast resources and was rapidly placing herself ahead in the industrial race, the facilities afforded by the joint-stock banks supplied a pressing need And while the remarkable development of these banks may be traceable in part to that general advance which marked British industry in the last century, there is no doubt that they are entitled to a considerable share of distinction for having made that development possible

The half-century following 1844 witnessed two important amendments of banking law which did much to strengthen the position of the joint-stock concerns and to facilitate their development

The first of these was *The Extension of Limited Liability to Banks by an Act of* 1858 The shareholders in the first joint-stock banks were

liable *in full* for all debts of the companies, and it was not until 1858 that the principle of *limited* liability, which had already been applied to other corporations, was extended to banking concerns

The removal of this anomaly gave a further impetus to the expansion of banking, as it widened the area of investment in bank shares by attracting a new class of investor

Then, in 1879, the principle of *Reserve Liability* was legalized, when limited companies were empowered to increase the nominal amount of their shares, provided that a certain amount over and above that paid up on each share could be called up only in the event of liquidation of the company The adoption of this principle by the more important banks gave depositors and creditors an added security by creating a reserve which could be called upon if necessary, and also had the effect of restricting the holding of bank shares to wealthier persons who were in a position to meet the added obligation if required to do so

The English System of Note Issue.

Between 1844 and 1914 the fiduciary issue of the Bank of England was rigidly fixed under the Bank Charter Act, 1844, and no provision existed for its automatic increase either in times of exceptional pressure or to meet the demand for additional currency arising from normal economic progress of the community During these years the provisions of the Act were subject to much criticism It was frequently pointed out that it had failed signally in its object of preventing financial crises by its control of note issues Serious crises occurred in 1847, 1857 and 1866, which were relieved, not by aid of the provisions of the Act, but by their *suspension*, thereby enabling the Bank to increase its fiduciary issue of notes, supply currency to those who required it, and, at the same time, make its own position secure Similarly, during the 1914 crisis, at the outbreak of the Great War, when the issue of Bank of England notes proved entirely inadequate to fill the gap in the currency caused by the withdrawal of gold, the Government, which stood prepared to suspend the Bank Act, if necessary, met the emergency by issuing Treasury notes of £1 and 10s

Critics of the Act pointed to these difficulties as justifying their contention that the fiduciary circulation was too small, and that no provision existed to enable it to be increased when necessary to meet modern requirements, for with the constantly increasing demands for currency, notes are required in *addition* to gold and not instead of gold It was argued that the note circulation could not be increased in times of pressure except by the uncertain interference of the Government, whereas a modern note issue should be elastic and be capable of automatic expansion, when necessary, to provide adequate currency for legitimate trade requirements Finally, it was urged that, although

the Act had restricted bank note issues, it had exercised no control over the issue of cheques, which could be just as much subject to over-issue as are bank notes

In favour of the Act it was contended that its first object of controlling the paper currency had been well achieved, and that the provision for a Weekly Return by the Bank ensured ample publicity regarding its financial position and the Reserve which it maintains The note issue was certainly restricted and inelastic, but any deficiency in this respect was adequately made up by the circulation of cheques, the issue of which automatically and easily expands or contracts according to the current need for credit facilities, while the cheques themselves are frequently preferred to Bank notes Finally, it was maintained that, although no provision existed for the expansion of the note issue to meet currency requirements in times of stress, the suspension of the Bank Act (or even the proposed suspension thereof), had almost invariably resulted in a restoration of confidence

In the difficult War and post-War years, 1914-1928, the position was to some extent modified by the circulation of Treasury notes, but the inelasticity of the Bank note issue, as the basis of our credit system, was subjected to much criticism Well-known authorities suggested that the stringent provisions of the Bank Charter Act had proved a failure, and contended that the inelasticity of our currency system partly explained the prolonged post-War depression in this country, particularly as compared with the prosperous conditions in the United States, where the more elastic system, which was advocated for adoption in this country, has made possible the expansion of credit to keep pace with business demands.

The existing system and the Bank Charter Act were not, however, without influential support In 1918, the Cunliffe Committee recorded their view that the stringent provisions of the Act had often prevented dangerous developments, and expressed the opinion that although the Act had had to be temporarily suspended on certain rare and exceptional occasions (and those limited to the earlier years of the Act's operations, when experience of working the system was still immature), that fact alone did not invalidate the conclusion that it had fulfilled its object

At the same time, the members of the Cunliffe Committee recognised that modern conditions demanded a greater degree of elasticity in our currency mechanism Hence they recommended the continuance of the principle of the Bank Charter Act, but with a slight modification to provide ready means of supplying emergency currency in time of acute difficulty

Prior to 1914, such currency could be issued only by breaking the law, and afterwards obtaining an indemnity from Parliament (as in 1847, 1857 and 1866), but the Currency and Bank Notes Act of 1914

gave the Bank of England, with the consent of the Treasury, the right to issue notes "in excess of any legal limit"

The Committee advised that this provision should be continued in force subject to the conditions that Parliament should at once be informed of any step taken by the Treasury in this matter, that any profits from the excess issue should be surrendered by the Bank to the Exchequer; and that the Bank Rate should be raised to as high a figure as would ensure the earliest possible retirement of the excess issue

The Amalgamation of the English Note Issues.

Apart from the points which have been mentioned, it came to be recognised in the years immediately after the War that the dual system of note issue control then existing in this country in consequence of the issue of currency notes by the Treasury was not without its disadvantages

Both the Cunliffe Committee (1918) and the Committee on the Currency and Bank of England Note Issues (1925) reported in favour of the amalgamation of the issue of currency notes with the note issue of the Bank of England, and it was generally recognised that amalgamation sooner or later was a corollary of the return to the gold standard in the Spring of 1925 In financial circles, much importance was attached to this question of unifying the control of our paper currency, and the opinion was widely held that the issue of paper currency in this country should be free from political influence and not subject to the possibility of radical changes in policy

The Cunliffe Committee advised that the contemplated combination should not be effected until the country had obtained the benefit of at least a year's experience of satisfactory working of the exchanges with a normal minimum gold reserve of £150,000,000 This condition was fulfilled towards the middle of 1928, and the necessary legislative sanction for the amalgamation of the note issues was embodied in the Currency and Bank Notes Act, 1928.

The Currency and Bank Notes Act, 1928.

This Act provided that *as from an appointed day*, fixed subsequently as 22nd November, 1928, all outstanding currency notes were to be deemed to be Bank notes, and the Bank was made responsible for their repayment The existing restriction on the Bank's power to issue notes below £5 was removed, and the Bank was given authority to issue notes for £1 and 10s, which were made legal tender for the payment of any amount in England, Wales, Scotland, and Northern Ireland, by the Bank itself or any of its branches, and even in payment of the Bank's larger notes. The £5 Bank note was made legal tender in England and

Wales for payment of *any amount*, except by the Bank itself or its branches, and not, as under the Act of 1833, legal tender for payments *above* £5 only

So far as the amount of the note issue is concerned, the Bank was authorised to issue notes against the Issue Department's total holding of gold coin and gold bullion (and not gold *or silver*, as under the Bank Charter Act, 1844), and in addition, to issue notes against securities to an amount of £260,000,000 The securities so held may include silver coin to an amount not exceeding £5,500,000, the amount previously held by the Treasury against the currency note issue

The fiduciary issue cannot be increased above the limit of £260 millions except by sanction of the Treasury, immediately communicated to Parliament Any authority so given shall apply only for a period not exceeding six months, but it may thereafter be renewed for a further period of six months, provided that no expansion of the fiduciary circulation shall exist for more than two years without express Parliamentary sanction

Any profit made by the Bank from its note issue accrues to the Treasury, as before. This profit, which for the year ending 31st March 1929, amounted to £4,442,193 2s 7d , arises from the fact that the backing for the great bulk of the notes consists of interest-bearing securities

The Act of 1928 thus retained the principle of a fixed fiduciary issue established by the Bank Charter Act, but replaced the clumsy and uncertain method of suspending the Bank Act, and met the demand for a more elastic note issue, by clearly prescribing how the fiduciary issue may be increased to meet unusually heavy demands for currency and credit

Critics who favour a higher degree of elasticity in our credit system suggest that even the new fiduciary limit is too low, and that the powers given to the Bank of England to expand the fiduciary circulation will not be used freely, but only in times of emergency.

If this were so, the position would be much the same as before—there would be no clearly defined arrangements for increasing the fiduciary circulation in times of genuine business expansion and activity From official statements on the subject, however, it would appear that the new device for increasing elasticity is intended to be used freely

Systems of Note Issue in Other Countries.

The system of note issue which exists in this country is sometimes described as the *Partial Deposit System*, *i e* , some notes are issued against securities, in contrast to the *Simple Deposit System*, under which every note is backed by its equivalent in gold

The latter method has the disadvantage of being expensive and unprofitable, while the former permits the use of a proportion of the reserves for profitable purposes, and at the same time ensures an adequate reserve of gold for maintaining convertibility in all likely circumstances The partial deposit system has now been adopted in all countries, but there are important differences between the English system of Bank note issue and the systems adopted elsewhere

France : Proportional Reserve System.

In France, the monopoly of note issue is in the hands of the Bank of France, which is a private institution like the Bank of England, but is under strict Government control Until June, 1928, the issue was subject to a statutory limit (known as the "*maximum issue principle*"), but the maximum was raised several times to meet emergency demands for currency, as, for example, during the Franco-Prussian War and the Great War

There was no legal restriction as to the form or amount of the reserve, but a large reserve of gold and silver was usually maintained and protected by exceptional measures Thus, in times of emergency, advantage was taken of the fact that the notes were convertible into either gold *or silver*, and, on occasion, a premium was charged on conversion of the notes into gold with the object of inducing holders to accept silver

During the War and post-War period, 1914 to 1928, the notes of the Bank of France were inconvertible When the gold standard was adopted in June, 1928, the maximum limit was abolished, and the note issue was based on a *proportional reserve system*, under which a gold reserve of 35 per cent must be held against all notes issued The fiduciary proportion is *fixed*, and cannot be increased except by a change in the law

Germany : Elastic Issue.

During and after the Great War, huge note issues of small and large denomination altogether replaced coined money in Germany, and resulted in such an inflation of the currency that it became practically valueless. The notes were largely issued against Government Treasury Bills, the restrictions on the note issue of the Reichsbank having been removed at the commencement of the War. In 1923, the Dawes scheme was adopted with a view to putting the currency upon a more stable basis The Reichsbank was reorganised to form a new central bank, and in November, 1924, the existing paper issues were replaced by a new currency based on the gold *reichsmark*, made equivalent for exchange purposes to one billion paper marks.

The Reichsbank has a virtual monopoly of note issue, other existing issues being of negligible amount. Against its notes a reserve of 40 per cent must be maintained, 30 per cent at least to be in gold and the rest to consist of certain foreign gold currencies, or foreign credits readily convertible into gold. In an emergency this reserve can be reduced, subject to (*a*) the imposition of a graduated tax on the difference, (*b*) the maintenance of the discount rate at a minimum of 5 per cent., and (*c*) the increase of the discount rate from this minimum as the reserve falls. The system thus possesses *elasticity* in that extraordinary demands can be met without difficulty or delay by increasing the fiduciary issue in the manner legally authorised.

United States: Elastic Issue.

The United States note issue is controlled by the *Federal Reserve Act*, 1913, which established in the principal towns twelve Federal Reserve Banks under the control of a Federal Reserve Board. Each of these banks was empowered to issue notes against securities of a liquid character and a gold reserve which was fixed at a minimum of 40 per cent., but which could be reduced in emergency on payment of a steeply graduated tax, as in the German system.

Prior to 1913, the bulk of the United States note circulation consisted of notes issued by the National Banks, secured by United States Government Bonds of nominal amount equal to the authorised issue, deposited at the United States Treasury. A fixed proportion of gold to deposits had to be kept by each National Bank, and there was no method of providing for an increased demand for notes except by restricting credit and calling in loans. The 1913 Act was designed to overcome this difficulty, and provided for the eventual transfer of the right of issue from the National to the Federal Reserve Banks. It aimed at centralising the gold reserve of the country under the control of the Federal Reserve Board, and changing the decentralised system of independent banking into a more centralised system. Thus, our own reserve system was adapted to the conditions of the United States where is no single central bank, but all the note-issuing banks are subject to central control.

FEATURES OF MODERN ENGLISH BANKING.

The development of the joint-stock banks has never faltered. Their progress has naturally been bound up with that of the country as a whole, and their organisation has been constantly improved to keep pace with modern conditions. Striking features of that development include the concentration of the banks by amalgamation and absorption into a small number of very large institutions, the establishment by the larger institutions of branches throughout the country, the extension

of the activities of English banks to other countries, the organisation of the Clearing House System (dealt with fully in Chapter 10), and the development of the Central Reserve System.

Amalgamation in English Banking.

The process of amalgamation between the banks has resulted in the development of vast organisations, notably the "Big Five,"—the Midland, Lloyds, Barclays, the Westminster, and the National Provincial—, which rival in importance the world's greatest industrial combinations These great banks, which have at their disposal almost incredible resources and facilities for the convenience of customers, have achieved their present size by a variety of methods, including (*a*) *The Absorption of Private Country Banks by Joint-Stock Banks* —Some of the largest banks of to-day are mainly amalgamations of large numbers of small private and local banks, *e g*, Lloyds Bank and Barclays Bank (*b*) *The Absorption of Smaller London Banks by Large Provincial Banks* (*c*) *The Amalgamation of Larger Joint-Stock Banks* —This process was particularly active during 1918-1920, when the five leading institutions assumed their present proportions mainly as a result of amalgamations between joint-stock banks which had already attained considerable dimensions

The Economic and Social Effects of Bank Amalgamations.

The constant growth in the size of English banks has occasioned a certain amount of uneasiness among statesmen and business leaders Some maintain that the concentration of enormous resources under the control of a small number of men constitutes a danger to the community Some fear the harmful effects of monopoly, whilst others are concerned with the more obvious danger that such large institutions may become unsound

In 1918 a Government committee was appointed to consider and report to what extent if at all amalgamations between banks may affect prejudicially the interest of the community, and whether it was desirable to introduce legislation to prohibit such amalgamations or to provide safeguards under which they might continue to be permitted

In its report the Committee divided amalgamations into two classes (*a*) *The old type of amalgamation*, *i e*, the absorption of local banks by a larger and more widely spread joint-stock bank, and (*b*) *The new type of amalgamation*, *i e.*, the union of one large joint-stock bank with another similar bank

In Favour of Amalgamation the Committee reported that amalgamations of the first type were apparently inevitable owing to the force of competition, unless the local bank is able to give its customers

a special type of service, as in Lancashire and Yorkshire, where the local banks, by reason of their intimate association with the cotton and woollen industries, have shown themselves well able to hold their own against outside competition

As regards the second type, it was pointed out that amalgamation usually results from one or more of several reasons, as, for example, the greater convenience to trade secured by an extension of bank areas or by the much improved facilities provided by the larger organisations, particularly in so far as such organisations, by reason of their more extensive resources, can afford to make larger individual advances on a more generous scale A number of special reasons were also mentioned, as, for example, the desire to gain admission to the Clearing House, or to secure a monopoly in a certain area, or to prevent another bank from obtaining a monopoly in a particular area

In addition to the advantages specifically indicated by the Committee, a number of others may be mentioned The concentration of banking business in comparatively few hands makes concerted action in time of emergency more easily obtainable, as was the case, for example, on the outbreak of the Great War Large organisation also makes for greater economy, increased efficiency, and greater uniformity, while national efficiency and productive capacity are increased because capital is cheapened, rendered far more mobile, and made more easily available where required Furthermore, there is a tendency to greater security when loans are diffused over many industries, when reserves are well managed, dividends well regulated, and accounts made public and subject to searching criticism

THE ARGUMENTS AGAINST AMALGAMATION were summarised by the Committee under three headings (*a*) *Reduction of capital* As a rule, amalgamations result in the reduction of bank capital because the shares of the absorbing bank are usually worth more than those of the smaller bank it swallows up, and the exchange of shares in the amalgamated concern for the shares of the absorbed bank results in a reduction of the nominal capital of the two considered separately; (*b*) *The dangers of reduced competition* Strong representations on this ground were received from the Stock Exchange and Discount Houses, (*c*) *The danger of monopoly, i e* , the possibility of the creation of a money trust which would be detrimental to the national welfare

From the point of view of the customer the process of amalgamation is attended by the marked disadvantages involved in the disappearance of the personal element Frequently, the modern bank manager has merely a temporary interest in local affairs, and there is a tendency both for the manager and the head office to have less of that essentially specialised knowledge of local occupations, industries, customs and prejudices so characteristic of the old private banker Furthermore, there is some danger that the constant growth of the banking institutions

may result in cumbrousness and over-expansion, lack of efficiency and possibly financial instability, due to the inadequate supervision of loans, and the granting of more accommodation than is strictly justified by the nature and extent of the bank's business and cash resources.

In spite of these objections, and though the process of amalgamation has been the subject of widespread criticism, the balance of opinion is that it has, on the whole, been advantageous both to the banking system itself and to trade The Balfour Committee on Industry and Trade, which sat from 1924-1929, states in its final report that there is no evidence that the large amalgamated institutions have exerted any harmful monopoly powers, or that competition between the banks has been suppressed On the other hand, the Committee found that traders had benefited considerably from the greater financial strength of the banks, and that they had received a large measure of financial support during the long period of post-war depression without being subjected to increased charges or curtailment of essential services

The Committee of 1918 recommended the passing of legislation to make necessary the approval of the Treasury before any amalgamation was announced or carried into effect To prevent secret amalgamations by the inter-locking of directorates, it was recommended that such arrangements also should be submitted to the Treasury for approval The Committee recommended the approval of schemes of amalgamation designed to secure important new facilities for the public, but advised the rejection of schemes of amalgamation which involved an appreciable overlap of area without securing such advantages, or an unusual aggregation of deposits without adequate capital and reserves

The proposed law was never enacted, but, as a result of an agreement with the banks, all schemes of amalgamation since formulated have been laid before a Standing Committee of the Treasury for its approval In 1924, and again in 1925, the Chancellor of the Exchequer announced that no further amalgamations of the large joint-stock banks would be favoured, so that the limit of expansion by amalgamation has apparently been reached so far as the great banking institutions are concerned

The Expansion of Branch Banking.

The remarkable expansion of branch banking in this country is traceable to the intensity of competition between the leading institutions, the desire to provide every convenience for customers, the endeavour to increase business and profits by tapping new resources, and the wish to effect greater economy by saving agents' commissions and expenses

The resultant centralisation of the direction and management of the banking organisation, and the extinction of the private banker with his local interests and sentiments, has resulted in a loosening of old-established ties between the local banks and the people and industries of the relative areas To some extent the " Big Five " have endeavoured to counteract this tendency by the formation of local directorates, but the large banks must necessarily remain far more cosmopolitan than their predecessors of the Victorian era

The Expansion of English Banks to Other Countries.

For a long period of years foreign banks have had branches in London and other world centres, but prior to 1911 the interests of English banks in places outside this country were entirely served through the agency of foreign institutions In the past this policy applied even to the neighbouring countries of Scotland and Ireland, and it was consequently, a marked departure from established practice when certain leading English banks opened branches in important continental towns, and followed up by obtaining direct representation in Scotland, Ireland, and other countries by fusions with established banks in those countries.

Recent arrangements by banks in this country for acquiring interests in and establishing working agreements with overseas banks appear to have opened up a new chapter in the history of joint-stock banking, and to presage future developments on an even more extensive scale.

Such a development seems to be the natural outcome of general economic conditions The evolution of domestic industry called for a strengthening and consolidating of internal banking resources , to-day, the expansion of international trading relationships, together with the keenness of competition in international markets, demands that the fullest financial facilities shall be available not only for domestic but also for foreign business

Numerous advantages might be realised from these developments Clearly, the essential function of gathering deposits and directing them into productive channels of employment must become more efficient by the widening of the sphere of operations, while a consolidation of Empire banking resources must undoubtedly tend to closer economic relationship between the various parts of the Empire At the same time, the development is exposed to the dangers which inevitably accompany amalgamation in industry. There is a loss of personal touch, a tendency to stereotyped and unenterprising policy, while, if the advantages of consolidation are to be fully realised, increasing attention will have to be paid to the problems of management and decentralisation of control.

Those banks which have entered the foreign banking field claim that the possibility of securing precise and regular information from foreign

branches constitutes a valuable asset to trade, and that foreign connections enable this country to share in the prosperity of other areas On the other hand, those banks (notably the Midland) which are definitely against the policy of extension overseas, claim that the restriction of direct operations to the home field makes for greater safety

Experience has certainly shown that banks operating abroad have to face considerable difficulties, as for example, those which arise from exchange depreciation, price reactions and political disturbances Some British banks which have operated in foreign countries have met with opposition from local banking interests, others with harsh treatment from the Governments of the countries concerned, while in certain cases, the severe losses sustained have compelled eventual withdrawal

The Development of the Central Reserve System.

The last important feature of modern English banking which calls for notice is the unique arrangement whereby the liquid cash reserves of the great banks have come to be concentrated in the hands of the Bank of England, which thus acts as the banker's bank, and, largely by virtue of this fact, has been able to attain a position of pre-eminent importance among the central banks of the world

Practically the whole of the banking business of England is now centralised in the hands of a few large institutions, operating chiefly from London The local banks are controlled by branch managers, who are subject to the direction of officials at the various head offices, advised in many instances by local boards of directors

The branches maintain on hand only sufficient cash to meet their ordinary requirements for till money, and transfer the bulk of their surplus funds to the central offices, which maintain a current account with each local branch On the same principle each head office retains only sufficient cash on hand to meet its estimated requirements, leaving any surplus funds on current account with the Bank of England, whence they may be withdrawn in legal tender on demand As the account of the Clearing House is also kept at the Bank, the maintenance by each clearing banker of a current account with the central institution facilitates the vast transfers necessary for clearing purposes

The Bank of England is thus liable to be drawn upon at any time to meet heavy demands for legal tender in any part of the country The customer depends on the branch bank for supplies of currency , the branch banks look to their London offices, and these, in turn, depend on the Bank of England But in spite of this, the Bank conducts its business in the same way as any other banking institution, and is under no legal obligation to make special provision to meet demands from the banks as distinct from its ordinary customers Nevertheless, its moral

obligation to safeguard the nation's ultimate cash reserve is not unrecognised, and, accordingly, special precautions are taken to prevent any undue depletion of its resources.

The vast responsibility thus resting upon the Bank is accentuated by the fact that in normal times London is a free gold market, and any gold required for export is most easily obtained from the Bank of England Reserve. Foreign nations are not slow to take advantage of this ready availability of gold supplies, so that the Bank is liable to be drawn upon, not only to satisfy the needs of a multitude of banks within the country, but also to meet the requirements of a foreign nation for gold bullion, whether for currency or for other purposes. The methods which the Bank adopts to safeguard its Reserve will be dealt with in a subsequent chapter.

CHAPTER 6.

THE FUNCTIONS OF BRITISH BANKING.

THE functions and organisation of banking are intimately related to the functions and organisation of credit. The system of credit is the basis upon which is built the structure of a modern bank, while the vast extension of credit has been possible only because banking facilities have kept pace with modern requirements.

Banking institutions are an essential part of the credit mechanism of a present-day community: they organise and control the issue and circulation of credit instruments; they regulate the granting of book credit in the form of advances and loans; they facilitate the movement of loanable capital, and make possible its distribution and use to the best advantage. In supplying funds for productive purposes, the banks discharge an economic function of the first importance. In effect, if not in name, they are traders in loanable capital, buying that capital from depositors in order to sell it to borrowers.

What is a Bank?

The only statutory definition of a bank at present existing in England is that given by Section 2 of the Bills of Exchange Act, 1882, to the effect that "a banker includes any body of persons, whether incorporated or not, who carry on the business of banking." This definition, however, is vague and ambiguous, since it gives no indication of what is comprised in "the business of banking," and it serves to emphasise the surprising fact that, in spite of the unique power and opportunities to defraud the public offered by the business of banking, practically any individual, or any group of individuals, may set up an ordinary deposit and banking business in this country and be subjected to comparatively little interference or legal restriction.

In the absence of legislative guidance, well-known banking authorities have from time to time sought to provide a precise definition of the term "banker," and possibly the most widely recognised of such definitions is that of Hart[1], which runs as follows:—

> "A banker is one who, in the ordinary course of his business, receives money, which he repays by honouring the cheques of the persons from whom or for whose account he receives it".

[1] *Law of Banking*, page 1.

The reader will observe at once that this definition regards as an essential function of a banker *the acceptance of deposits of funds withdrawable upon demand by cheque*, a view which has received official support in a memorandum issued by the Ministry of Labour to the effect that the expression "bank" shall be construed so as to include only those institutions where "a substantial part of the business consists of the receipt of money on current account, to be drawn upon by cheques"

This centralisation of banking business in this country around the use of the cheque is a feature which has until recently distinguished English banking from banking in all other countries, and which also distinguishes banking as conducted in Britain from all other forms of business It follows, too, that the frequently used definition of a banker as "a dealer in money and credit" is not entirely satisfactory, for there are many other forms of financial business which may be said to deal in money and credit, as, for example, the business of a money-lender, who lends money on the "credit" or reputation for solvency of the borrowers or their sureties

Functions of the Modern Banker.

The receipt of money from customers, subject to their right to withdraw such money on demand by cheque, is, of course, the usual arrangement under which *current accounts* are opened and conducted in this country, but, in addition to accepting vast sums of money on these terms, English banks usually receive even more on *deposit account*, undertaking to pay the customer an agreed rate of interest upon the balance outstanding in return for the right to demand from him an agreed period of notice for all withdrawals The bulk of the funds so deposited are accepted subject to seven days' notice of withdrawal, and, although banks rarely insist on fulfilment of this condition, except in the case of very large sums, the stipulation is nevertheless an important safeguard in the event of the bank having to face exceptional withdrawals

Arising out of this function of accepting money from the public is that whereby the banker lends to other customers a large part of the funds so deposited, as by granting overdrafts on current account or fixed loans on loan account, or by discounting bills of exchange and promissory notes

Thus it will be seen that the main function of a modern banker is actually a dual one—he borrows with one hand in order to lend with the other While he acts as an intermediary between lenders and borrowers, he himself also functions both as lender and borrower, making his profit out of the difference between the rate at which he borrows and the rate at which he lends This essential feature of his business remains

the same whether the bank is a vast joint-stock organisation, with a wealth of resources and a network of branches and agencies, or a comparatively small private bank, or "a pioneer bank in a new country, with a stock-in-trade consisting of a tent, a safe, a trestle table, and a revolver,"[1] and though both aspects of this function are necessarily important, it is no doubt true to say that the banker's solvency and the successful conduct of business depend essentially upon his ability to "give credit" and upon the judgment which he displays in lending to others that which he himself has borrowed.

Apart, however, from this primary function of linking up lenders and borrowers of liquid capital, the modern banker performs a host of other functions which are of considerable utility to his customers and to the community generally The majority of such functions were originally undertaken by the banks solely for the convenience and benefit of their extensive clientèle, but they have naturally reacted to the greater efficiency and greater profit of the banks themselves

We may usefully distinguish these additional functions into two main groups, *viz* (1) *Agency* services, and (2) *General Utility* services

The Banker's Services as Agent.

These comprise the services rendered by the banker in collecting and paying cheques, bills, promissory notes, coupons, dividends, subscriptions, and insurance premiums as a *special* agent on behalf of his customers; in conducting stock and share transactions in respect of which the banker, as agent, shares the commission with the stock exchange broker, in acting in various other agency capacities, such as those of trustee, attorney or executor, and as agent, correspondent or representative of his customers, and of other banks and financial houses either at home or abroad

General Utility Services of British Banks.

The general utility or miscellaneous services which the banker performs are even more numerous, and include (*a*) the issue of various forms of credit instruments such as bank notes (now confined in England and Wales to the Bank of England), letters of credit, travellers' cheques and circular notes, all of which, in effect, enable the customer to benefit from the banker's reputation for solvency and prompt payment, (*b*) the transaction of foreign exchange business—the modern counterpart of the ancient business of money changing—which, while it brings considerable profit to the banker, provides the business community with invaluable facilities for its dealings with foreign nationals, (*c*) the acceptance of bills of exchange, another function whereby the banker

[1] *The Banker as a Lender*, by F E Steele

lends his name to others in return for a commission and thus enables the customer to "trade" on the banker's superior credit, (*d*) the safeguard against fire and theft of valuables and important documents in his specially constructed strong rooms, a function which makes the banker a *bailee* of the goods entrusted to his keeping, (*e*) the distribution throughout the country of supplies of legal tender currency, with the related duties which banks have assumed of withdrawing from circulation light coins and defaced notes, and, finally, (*f*) acting as referee as to the respectability and financial standing of his customers, a function which is not only very helpful to the banker himself but is also of considerable value to business men generally, furnishing them with reliable and speedy information as to the general standing of people with whom they are dealing, and enabling them to avoid incurring loss through giving credit to persons of little or no financial worth

The Utility of Banking.

A consideration of the functions discussed in the preceding paragraphs will indicate at once that bankers render services of inestimable value to the trade and industry of the country In acting as intermediaries between large numbers of depositors or lenders on the one hand and of equally numerous borrowers on the other, banks mobilise capital and make its use effective They may be regarded as great reservoirs of loanable money into which flow a myriad small streams of liquid funds, and from which are distributed throughout the country, at the times when they are most needed and in the places where they can be most efficiently used, supplies of productive capital rightly regarded as sources of further wealth Countless small sums of money are rendered productive which would otherwise remain in "idle hoard," and in this way the banking organisation assists the transfer of the wealth of large and small capitalists in a rich locality to other areas where that wealth can be efficiently and profitably employed, to the ultimate benefit of the community as a whole

The facility with which loans can be obtained from banks acts as a stimulus to production and as an incentive to industrial enterprise Manufacturers and traders know that they can rely upon the banks for sound advice and financial accommodation at difficult periods, while the banks, by a judicious regulation of credit, perform an economic function of first importance in checking speculation and preventing financial crises.

Moreover, the existence of a sound and competitive banking system is in itself an encouragement to saving, thrift and economy The small depositor is brought to appreciate the facilities for safe investment which the banks provide, and thus we find that, in a modern community, even the poorer classes become imbued with feelings of security and

prosperity, and cherish ambitions of one day running an account at a savings bank if not at an ordinary joint stock bank

Lastly, in Gilbart's[1] phrase, bankers act as "public conservators of the commercial virtues." In their own interest "they encourage the industrious, the prudent, the punctual, and the honest—while they discountenance the spendthrift and the gambler, the liar and the knave They hold out inducements to uprightness, which are not disregarded by even the most abandoned There is many a man who would be deterred from dishonesty by the frown of a banker, though he might care but little for the admonitions of a bishop"

Conditions such as these must ultimately react to the general well-being of the community, and when it is remembered to what extent time, money and labour are saved by the cheque system, and by the general utility services of our banking institutions, it will be readily conceded that a country with a sound banking system is possessed of one of the firmest foundations of prosperity

The Classification of Banks according to Functions.

While the functions which we have described are generally common to all banks operating in Great Britain, it is possible to distinguish a certain degree of specialisation based on the transaction of a special type of business

THE BANK OF ENGLAND.—First must be mentioned the Bank of England, by virtue of the circumstances of its foundation and of its subsequent rise to predominance in a class of its own In addition to conducting all the usual functions of a modern bank (except the acceptance of bills), it acts as banker to the State and to all the other banks in the country, assumes responsibility for the safeguarding of the nation's ultimate cash reserve, undertakes the control of the currency and the regulation of the prevailing rate of discount and of the foreign exchanges, and, finally, enjoys a monopoly of the right of issuing bank notes throughout England and Wales

THE "BIG FIVE".—In the second class are included the five leading joint-stock banks with head offices in London, already referred to as the "Big Five" Each of these is characterised by the wealth of its resources and by the vast extent of its business, both of which rival those of any other financial organisations in the world

The business conducted by each member of the "Big Five" differs in no essentials from that of the other members, and is typified by such a persistent policy of extending the sphere of business by the establishment of new branches that it appears as if the system of branch banking in this country must have almost reached the limits of healthy and profitable competition.

1 *The History, Principles and Practice of Banking*, Vol 1, pp 226-227

JOINT-STOCK BANKS WITH SPECIALISED FUNCTIONS — There are in this country several notable instances of the performance by certain banks of a specialised kind of business First may be mentioned the well-known banks of Lancashire and Yorkshire, which cater for the special needs of our great cotton and woollen industries and which have their head office in one of the large provincial towns Among these are Williams Deacons Bank, the District Bank, the Manchester and County Bank, all with head offices in Manchester, and Martins Bank, with its head office in Liverpool

In the same group may be included the Scotch and Irish banks, specialising in business with Scotland and Ireland respectively, and characterised by the power to issue notes which most of them possess

Mention may also be made of such institutions as the British Overseas Bank and the British Bank for Foreign Trade, specialising in the financing of overseas trade , the Yorkshire Penny Bank, catering for the poorer classes in the Yorkshire manufacturing centres , the Birmingham Municipal Bank, accepting small deposits from the working class population and applying the funds for municipal purposes, and the Trustee Savings Banks, whose deposits, consisting chiefly of small savings, now amount to over £150 millions

PRIVATE BANKS —The fourth class is now mainly of historical importance, as there remain only two important representatives— Messrs Glyn, Mills & Co and Messrs Charles Hoare & Co —of the once numerous class of old-established private banking firms which conducted business either as private bankers in the country, or in London itself as West End bankers or Army agents, or which conducted a city business very similar to that of the joint-stock banks, as in the case of Glyn, Mills & Co

THE DOMINION AND COLONIAL BANKS IN LONDON —These form the fifth class of banking institutions which may be distinguished by reason of their characteristic functions In this group we have, first, the banks which specialise in business with the self-governing Dominions—Canada, Australia, New Zealand and South Africa—acting as financial agents for the Dominion Governments and undertakings, and conducting most of the exchange business between London and the Dominions Some of these banks, such as the Bank of Australasia and the Bank of New Zealand, have their head offices in London, although their branches and the bulk of their business are located in one or more of the Dominions overseas

In the second subdivision of the group are the Eastern Exchange Banks, such as the Chartered Bank of India, Australia and China, and the Hong-Kong and Shanghai Banking Corporation, which are engaged primarily in the conduct of banking business (particularly bullion and exchange operations) with our Indian Empire and other Eastern countries.

MERCHANT BANKERS —A sixth class comprises the various concerns in the City which are known as " merchant bankers " or " merchant banks " Most of them are private partnerships, and they function mainly as " accepting houses " in the manner described in Chapter 8

FOREIGN BANKS —The final class embraces a large and cosmopolitan group of foreign banks, the very existence of which is not only evidence of the financial supremacy of London and the consequent need for representation therein of most of the important banks in the world, but is also a striking consequence of the " open-door " policy adopted in this country in regard to the establishment of banks, as in other directions As is natural, the foreign institutions transact business mainly with or on behalf of their own nationals, but they also play an important and undoubtedly profitable part in the cosmopolitan sphere of London banking

Classification of Banks according to their Mode of Incorporation.

Banks in this country may also be classified according to their mode of incorporation, although this aspect has necessarily become less important with the growing supremacy of the joint-stock institutions and the almost complete disappearance of the old-established private bankers

First in order of historical importance must be placed the *banks established by Royal Charter*, among which are the Bank of England, the Bank of Ireland and the Bank of Scotland, together with certain colonial institutions such as the Chartered Bank of India, Australia and China The powers and constitution of such banks are clearly defined by their charters, while the liability of each shareholder therein is limited to the amount unpaid in respect of his holding of capital

The second class comprises the *joint-stock banks with limited liability* registered under the Companies Acts Most British banks, including, of course, the " Big Five," now belong to this group, and the limitation of the liability of the shareholders to the amount unpaid on their shares has resulted in the distribution of the capital of such concerns among shareholders of almost every section of the community

The third class, comprising *private joint-stock banks with unlimited liability*, is now practically obsolete, and, in fact, only one representative —Glyn, Mills & Co —remains as an independent institution at the time of writing Another representative of this class—Coutts & Co —although still retaining its corporate existence, is now controlled by the National Provincial Bank

Finally, there is a heterogeneous class of banks, including the many merchant bankers in the City, the majority of whom trade as private partnerships, and the banks incorporated under dominion or foreign laws.

This brief recapitulation indicates that the most important of our existing banks are formed as corporate bodies under the Joint-Stock Companies Acts, in just the same way as the majority of trading and industrial concerns, and, as we have shown, this method of incorporation is of advantage both to the bank itself and to the public The former benefits directly by the absence of the formalities and delays which accompany the incorporation or the alteration of the constitution and powers of an institution formed by Royal Charter, and also obtains the advantages of limited and reserve liability and of free transferability of its shares Indirectly the bank benefits also from that wide publicity regarding its affairs which forms the public's strongest safeguard The insistence by the judicature on the periodical publication of bank balance sheets constitutes the public's most certain protection against those weaknesses which characterised our earlier private banks, at the same time, such publicity encourages every banker to rely for the extension of his business and for the enhancement of his reputation largely upon the strength of his position as evidenced by his half-yearly figures

Banking Concentration and Specialisation.

The performance by banks of the specialised functions mentioned above is an indication of the application to banking of that division of labour which exists in other branches of commerce We have seen that in Britain there are many notable instances of marked specialisation, although the degree of banking specialisation in this country is not comparable with that on the Continent, and especially in Germany and France (See Chapter 35)

The trend towards concentration or amalgamation is also everywhere much in evidence, and banking functions in most countries—with the United States as a notable exception—tend to be centralised in a few large institutions, with a large number of branches and agencies throughout the community, controlled directly from the head office In most countries also the general banking policy is determined by a central bank, which is usually under Government direction and is able to exercise a certain amount of control over all other institutions, particularly in so far as the regulation of interest rates is concerned

Branch and Independent Unit Banking Compared.

The banking system of the United States, chiefly on account of Government restrictions, differs essentially from the branch banking system of our own country in that it is preponderantly one of independent units[1] with a central banking system superimposed Not unnaturally,

[1] In June, 1928, there were in the United States 25,950 National and State Banks, only 835 of which had branches But it may be observed that attempts are being made to remove the existing restrictions on the spread of branch banking, while the difficulties are being partially overcome by the system of forming holding companies to acquire control of a number of established local banks

considerable controversy has arisen as to which type of organisation can serve the community most efficiently

Perhaps the most important argument adduced in favour of branch banking is that it permits the easy transfer of capital from regions which have a surplus to regions not so well endowed, and also that it enables funds to be distributed to different regions according to seasonal needs The result is that interest rates tend to be equalised throughout the country, whereas, in the absence of branch banking, rates would tend to be low in old, well-developed districts and high in new districts Again, a bank with many branches can spread its risks over the whole range of industries, whereas an independent local bank must rely mainly on important local industries , indeed, a bank of this kind may actually be organised and controlled by local borrowing interests Hence, it is claimed that branch banking tends to greater stability, for local "runs" and depressions can be more easily met than by independent unit banks with smaller average reserves Lastly, the advocates of branch banking point to the efficiency of the services which it is able to provide The advantages of first-class skill and business efficiency at headquarters can be given to all districts , internal and foreign exchange business can be handled economically, while adequate banking facilities can be provided in even the smallest village where no independent bank could survive

Opponents of the branch banking system urge that some of the above advantages are not realised in practice, and that others are equally available to independent unit banks Furthermore, it is contended that there are many evils incident to branch banking from which independent unit banking is either wholly or comparatively free The most important arguments, however, are directed, not against the organisation of branch banking, but against the dangers of monopoly, and experience would seem to show that the danger of a large proportion of the financial resources of the community becoming concentrated in a few hands is much greater under a continued process of amalgamation such as exists in this country than under an independent unit banking system

Other arguments put forward point to the competitive waste of branch banking, to the high rates charged in well-established localities to cover low rates in developing regions, to the preferential treatment granted to concerns situated near head offices, and to the fact that branch managers do not remain long enough at one branch to become thoroughly acquainted with local needs

Banks and the Creation of Credit.

The great importance of bankers in a modern community rests primarily on the extent to which they have been responsible for the erection of a vast superstructure of credit on the basis of comparatively

small cash reserves. In general, the basis for an expansion of credit is gold, and, if we assume that, as the result of his experience, a banker has determined on maintaining a reserve of gold equal to 33⅓ per cent. of his liabilities, then it is not difficult to understand that, for every £1,000 in gold which he receives from depositors, he can create credit to the extent of £3,000. He may do this by allowing merchants to draw upon him, or by discounting bills, or by investing in stocks and shares. If the advances are made against good security and the stocks are discreetly chosen, there is not much danger. The banker's experience teaches him that of the many amounts of £1,000 in gold which he receives, only a small proportion will be demanded within any given time.

But the remarkable fact about modern banking is that the reserve need not be kept by the banker himself in actual gold ; he may entrust it to a central or Government bank, *which carries on an ordinary banking business and itself utilises any gold left with it as a basis for creating credit.* The first banker regards his credit balance at the central bank as being as good as gold : he relies on obtaining the gold whenever he wants it, although the central bank makes no more provision for the banker in this respect than it does for any of its other customers. Thus the original £1,000 in gold may act as a basis for £3,000 in credit at the first bank, and possibly for a further £2,000 at the central bank, the actual amount depending on the proportion of reserve to liabilities which the latter seeks to maintain.

But there is a still more remarkable stage. The money received by a banker from his customers may not be gold at all : it may consist of notes issued by the Government in order to meet its liabilities. So long as these notes are legal tender they can be placed in the reserve, or added to the reserve of the central bank, and against them may be issued credits to several times their amount. If the notes are all convertible into gold there is no difference in the general result, but if they are merely inconvertible paper promises to pay, the evils are obvious. Herein, then, lies the great danger which is inherent in the credit system.

Fortunately, there are in normal circumstances definite limits to the powers of the banks to increase the volume of credit, while all modern states now recognise that effective control of the credit mechanism is an essential to stable and prosperous conditions. This important question is further discussed in Chapter 11.

CHAPTER 7.

THE BANKER'S FUNDS, THEIR SOURCE AND EMPLOYMENT.

THE success of a modern bank depends essentially upon the ability displayed by its management in employing to profitable advantage —chiefly by lending to others—the vast sums left with the bank by its customers on current and deposit account.

Now in the exercise of most of his principal functions—in accepting deposits on *current* account, in discounting bills and in granting loans—the banker incurs a liability to pay legal tender *on demand*, but in making advances and in discounting bills he acquires the right to demand repayment only *at some future time*. It is, therefore, of vital importance that the banker should not run even the slightest risk of being unable to meet any demand likely to be made upon him at a moment's notice. In fact, the world-wide reputation of British banking is based largely upon a rigid adherence to its bond to pay upon demand, and just as the Bank of England note is regarded everywhere as being as "good as gold," so a bill of exchange bearing the signature of a British bank, or a cheque drawn on a British bank by a first-class firm, is accepted without hesitation wherever men trade, as being equivalent to cash.

But while this reputation of British banks is attributable in no small degree to their punctuality of payment, the remarkable success which has attended the organisation and growth of the large joint-stock banks is no doubt due primarily to their ability and judgment in deciding *how much* they can lend and *how best* they can lend. Modern joint-stock banking has been built up and is still based upon those old-established principles, discovered long years ago by the early goldsmith-bankers, that only a small proportion of the money left by depositors with a banker is demanded at any one time, and that, provided a *sufficient* reserve of legal tender is maintained for the satisfaction of all current and probable demands, the remainder of such money can be lent out at interest or invested in various forms of securities yielding a profitable return.

The Balance Sheet of an English Joint-Stock Bank.

We can best illustrate the statements in the foregoing paragraphs by a careful analysis of the items in the balance-sheet of one of our large joint-stock banks.

NATIONAL PROVINCIAL BANK, LTD.

BALANCE-SHEET AS AT 31st DECEMBER, 1929

Liabilities.	£	s	d	Assets.	£	s	d
Capital —				Coin, Notes and Balances with the Bank of England	31,626,945	1	5
Registered, £60,000,000, subscribed, £43,617,080				Balances with, and cheques in course of collection on other banks in the United Kingdom and Ireland	10,857,758	9	6
Paid up —				Money at call and short notice	19,413,496	8	2
120,000 Shares of £25 each £3 10s paid	420,000	0	0	Bills discounted — British Government Treasury bills, £14 970,000, bills payable by British firms and institutions in the United Kingdom, £11,282 876 9s 1d, other bills, £1,937,733 10s 1d	28,190,609	19	2
1,972,354 Shares of £20 each, £4 paid	7,889,416	0	0	Investments—British Government securities, £30,162,686 1s 8d, Indian and Colonial Government securities, stocks of British and Indian railways, British Corporation and water works stocks, £4,085,656 17s 11d, canal, dock and other investments, £1,575,285 12s 10d	35,823,628	12	5
234,000 Shares of £5 each, fully paid	1,170,000	0	0	Investments in other banking companies at cost or less than market value*	938,750	0	0
	9,479,416	0	0	Investments in subsidiary companies at cost or under*	2,514,000	0	0
Reserve Fund	9 479,416	0	0	Advances to customers and other accounts	156,678,357	1	4
	18,958,832	0	0	Bank premises at cost, less amounts written off	6,076,878	3	11
Current, deposit and other accounts	271,712,336	17	6	Liabilities of customers for acceptances, endorsements, engagements, etc., as per contra	15,174,188	6	8
Liabilities for acceptances, endorsements, engagements, etc., as per contra	15,174,188	6	8				
Balance of Profit and Loss Account carried forward to 1930	849,254	18	5				
	£306,694,612	2	7		£306,694 612	2	7

*Details of these holdings are given in the published Balance Sheet

The law prescribes that all limited joint-stock banks shall draw up a balance-sheet *twice* in every year, and that they shall exhibit a copy at the Head Office and every branch, and file a duly audited and authenticated copy with the Registrar of Companies on the First Monday in February and the First Tuesday in August

Such a provision is clearly of the greatest importance and utility to all connected with a joint-stock bank, as it ensures not only a careful and punctual preparation of its figures, but also that any reputable bank will aim at placing before the public a statement which can be challenged neither on its merits as a model of clearness and correctness, nor by reason of its disclosure of any weakness in the financial position of the institution concerned

The Liabilities of a Banker.

In analysing the balance-sheet reproduced above, we will consider first the items on the left or *liabilities* side, for this side is not only the less imposing and therefore the more easily understood, but may also

be regarded as the side from which the business of the banker originates, inasmuch as the items of liabilities represent the sums received by the banker for employment in his essential business as a lender of capital

Capital Paid up.

This item represents the amount invested in the bank by its shareholders Although in banking, as in any other business, the investors or shareholders, by providing the capital, are in the nature of creditors of the concern, the amounts owing to them cannot be paid in the event of liquidation until all other claims have been satisfied

The words "paid up" are of vital significance, for they distinguish only one of the various ways in which the capital of a joint-stock bank may be described Thus the *Authorised*, or *Nominal*, or *Registered* Capital is the *total* amount of capital which the bank has power to issue (£60,000,000 in the balance-sheet given), and is to be distinguished from the *Issued* Capital, *i e*, the amount actually offered for public subscription, and from the *Subscribed* Capital, which is that sum applied for by the public and allotted by the directors of the company to sundry applicants, who thereafter become shareholders in the concern

It is not unusual for only a part of the Subscribed Capital to be "called up" Thus, for each £10 share taken up, the original shareholders may be asked to pay the bank only £3 in cash, in which case the *Paid up* Capital would represent only three-tenths of the Subscribed Capital The remaining seven-tenths is then described as *Uncalled* Capital, and this may be further subdivided into (*a*) *Callable* Capital, *i e*, a proportion (for example, three-tenths of the original Subscribed Capital) which the directors may call at any time they deem fit, subject to any conditions in the Company's Articles of Association, and (*b*) *Reserve* Capital, *i e*, the remaining balance of four-tenths which may be called up by the directors only in the event of the liquidation of the bank Most English joint-stock banks have established such a Reserve Capital, and by so doing have materially strengthened the security available to the bank's depositors

Reserve Fund.

This must be carefully distinguished from the Reserve Capital described in the preceding paragraph, for whereas the latter is a contingent fund to be drawn from the *shareholders* only in the event of liquidation, the Reserve Fund is actually an accumulation in the hands of the *Company* of sums allocated from the bank's profits and invested from time to time in first-class securities.

The Reserve Fund is, of course, available to be drawn upon at any time in the event of the bank's incurring heavy unexpected losses, and,

although it thus provides an additional safeguard for the bank's customers, it nevertheless belongs to the shareholders or proprietors of the bank and is sometimes drawn upon for their benefit in order to issue to them shares on bonus terms or to equalise the dividends paid as between one year and another This fund may, in fact, be regarded as a surplus gradually built up by careful management and representing the excess of the value of the bank's assets over its total liabilities, including its liability to its shareholders for capital paid up and for undivided profits

Current, Deposit, and Other Accounts.

This item is by far the largest, and represents the total sum deposited with the bank by its many customers on current and deposit accounts, the latter bearing interest and being subject to an agreed notice of withdrawal, while the former usually earn no interest and are repayable in legal tender upon demand

In addition, the item includes as "Other Accounts" any other *credit* balances in the bank's ledgers, such as the balances standing to the credit of the bank's Unclaimed Dividend Account and Unclaimed Interest Account, together with any hidden "Reserve Accounts" which the bank may choose to maintain for its own purposes

It is clearly a task of some magnitude to provide safe and yet profitable employment for so large an amount of money The other side of the balance-sheet will demonstrate how this is done in the case of the bank concerned and of other similar institutions

Liabilities for Acceptances, etc.

The total under this heading represents the liability of the bank in respect of bills of exchange which it has accepted or endorsed for the accommodation of its customers As, however, the latter are liable to recoup the bank for any loss it may suffer by thus lending its name, the amount is "offset" by a corresponding item on the other side of the balance-sheet

In many bank balance sheets, the total hereunder also includes the bank's contingent liability in respect of confirmed credits, forward exchange contracts and other engagements entered into by the bank on behalf of customers Sometimes, however, these are shown separately as "*Engagements*"

The Assets of a Banker.

The particulars on the other side of the balance-sheet indicate how the bank employs the sums entrusted to its keeping by its customers

and shareholders As we have shown, successful banking depends very largely on the ability of the management in apportioning the bank's funds among the various items described as its assets, and particularly in determining what proportion of the total funds must be held in the form of *liquid assets*, *i e* , cash or assets readily convertible into cash, and what proportion may safely be more or less " tied up " in first-class investments and in loans to customers

In a Bank balance-sheet the assets are always arranged in order of *liquidity* or realisability, so that customers and others interested in the concern can estimate its strength and stability almost at a glance by observing the proportion of liquid assets maintained by the management Thus " Cash " always appears first, while the item " Bank Premises," representing assets which are least readily convertible into money, usually figures last

Coin, Bank Notes, etc.

Every bank maintains at its head office and at each branch a sufficient reserve of legal tender to meet all probable demands These cash holdings are the bank's " first line of defence," and with them, as a rule, is lumped the bank's " Balance at the Bank of England," which is generally regarded as equivalent to cash

Until recent years the amount shown in the second item as " Balances with Other Banks, etc ," was also so regarded and was generally included in one sum with the cash holdings The present practice is clearly an improvement, although in ordinary circumstances there is little doubt as to the complete and instant realisability of the sum shown under this heading

The item " Balance at the Bank of England " is one which is to be found in the balance-sheets of all joint-stock banks, and represents that portion of the banks' surplus funds which is held on deposit with the central institution This practice of depositing surplus balances with the Bank of England has resulted in the establishment of the Central Reserve System, and is attended by a number of advantages, not the least of which is that it enables large transfers of funds between the banks, and particularly the heavy daily settlements arising from the " Clearing System," to be effected with the minimum of trouble and delay

Money at Call and Short Notice.

The keeping of an adequate cash reserve is, of course, as necessary to a banker's daily business as it is to the maintenance of his stability. But cash kept in a safe or on current account with another bank earns nothing, and bankers naturally sought some method of loaning which,

while it ensured that the funds would be readily available if required, provided at least some profitable return on the money employed

Happily, such an outlet was found in that intricate but remarkably efficient organisation known as the London Money Market, where, as is explained in Chapter 8, numerous bill brokers, discount houses and stock exchange operators are ready at all times (although more so at some times than at others) to borrow large sums of money, for short periods, at a low rate of interest

Bills Discounted.

A bank's "third line of defence" consists of the bills of exchange which it has discounted or negotiated for customers, or which it has itself purchased in the open market

It should be explained that "discounting a bill" simply means purchasing the bill at its face value (*i e*, the sum for which it is drawn) *less* the amount of interest on the bill for the time to elapse before it falls due for payment Thus a bill for £100 which is not payable until the expiration of three months would be worth £99 to the banker if interest is reckoned at 4 per cent per annum

A large part of a joint-stock bank's holding of discounts consists of ordinary trade or commercial bills drawn on British firms and purchased by the bank from customers (including bill brokers) A further proportion comprises "bank bills," *i e*, bills drawn, accepted or endorsed by reputable banks in this country, while a considerably smaller amount (included no doubt as "other bills" in the above balance-sheet) represents bills drawn on firms and banks in other countries

In addition, the total of Bills Discounted in the balance-sheet of an English bank always includes a considerable sum in British Government Treasury Bills, *i e*, promises by the Treasury to repay stated sums at the expiration of a given period, usually three or six months During and after the Great War the amount so invested by each bank increased considerably, and there is little doubt that in the case of most banks the holding of Treasury bills is now greater than the holding of bank and trade bills

First-class bills of exchange are frequently described as an ideal form of investment for a banker's surplus funds The accuracy of such a statement is apparent when it is remembered that bills are payable *in full* at the expiration of comparatively short periods, and, provided the financial stability of the parties responsible for payment is undoubted, the banker is reasonably sure of an automatic return of his cash as the bills fall due

Furthermore, although bills are not immediately realisable assets in that their date of maturity cannot be hastened, first-class bills can always be rediscounted if funds are urgently required, while the fact

that they can be obtained for varying sums, large and small, and for varying periods before they fall due, enables the banker to choose such bills as will suit him best He can without difficulty increase his cash reserves by simply rediscounting a portion of the bills which he already holds, or by refraining from discounting further bills from time to time, as his holdings fall due for payment Finally, he can so arrange his investments in bills that they mature and increase his cash balance at those times when he most requires additional funds, as, for example, at the turn of the quarter or when he has heavy dividends to pay on behalf of his customers

The foregoing items of the balance-sheet comprise the banker's *liquid assets* Those which remain represent the more permanent means of employing the funds at his disposal, and accordingly include those items upon which it would be dangerous to rely in times of emergency for money wherewith to meet the urgent demands of his customers for repayment of their deposits

Investments.

These include the bank's investments in British and Colonial Government securities, in British municipal and railway stocks and loans, and in affiliated banks, *i e* , smaller banks which are intimately associated with the larger concern and in which it holds a large part of the capital

In some statements, a portion of the total is described as " lodged for public accounts " This means that, in accordance with law, investments to the amount indicated are registered in the names of joint trustees (including representatives of the bank), and are specially held (or " ear-marked ") as security for the due repayment of public money lodged with the bank on account of government departments and local authorities

While Investments are correctly regarded as a bank's fourth line of defence, they are characterised by the fact that they are difficult to realise and turn into cash in emergency, for it is just at those periods when cash is most urgently needed that securities are unsaleable or saleable only at considerable loss If, during a period of emergency, all the big banks endeavoured to realise their investments, there would be a heavy fall in security prices which would be accentuated by other sales of investments by stock exchange operators who were unable to renew their loans Furthermore, the selling of large amounts of securities by a large bank would not only be dangerous as giving rise to suspicions of weakness, but would also serve to intensify any lack of confidence which might exist On the other hand, there is little doubt that our large joint-stock banks show the totals of such investments at considerably below their real worth, and by so doing create what is in fact a secret reserve

Advances to Customers.

Under this heading are included the loans made by the bank to its customers as fluctuating overdrafts on current account, and as fixed loans on loan account The majority of such loans are payable on demand or at short notice, but to anyone at all acquainted with a bank's business, it will be clear that only a small proportion of the large total under this heading can be turned into cash at a moment's notice or even within a reasonable period The trader who has borrowed from the bank in order to purchase additional stocks, or a private individual who has obtained an advance in order to buy a house, cannot be expected to repay the debt upon demand Indeed, it would be difficult enough for such customers to wipe off their indebtedness even within the period of notice which is usually allowed in such cases At all events, it is certain that no bank of repute can rely for funds in an emergency on a wholesale demand to its customers to repay their loans Thus it follows that, while a bank may expect in an emergency to have to meet considerable demands by its depositors, it cannot look for the necessary funds to its loan account customers, for its action in demanding such repayment could have only one effect—that of still further intensifying the national financial difficulties and of destroying public confidence

Bank Premises.

The premises of a bank are among its most unrealisable assets, for, apart from the fact that the large bank offices could only with difficulty be converted to other uses, it is obvious that assets of this character can at best be realised very slowly Nevertheless, it is a well recognised fact that the value of the item Bank Premises as stated in the balance-sheets of our banks is far below its true worth, in substantiation of which we cannot do better than refer to the oft-quoted fact that the value of the premises of the Bank of England does not appear in its balance-sheet at all, although the asset must be worth several millions sterling

Liabilities of Customers for Acceptances, etc.

This item is in the nature of a contra entry to the similar item which appears on the other side of the balance-sheet, and indicates that, although the Bank has assumed liability in respect of its signature on bills to the amount stated, it is secured to an equivalent extent by the signatures of its customers on the same bills.

Other Items which Appear in Bank Balance Sheets.

Bank balance-sheets sometimes include other items in addition to those discussed in the foregoing paragraphs

NOTES ISSUED OR NOTES IN CIRCULATION.—When one of these items appears, as in the case of the Bank of England, it represents the amount of notes issued by the bank which are in the hands of the public or held by other banks

REBATE ON BILLS NOT DUE.—Such large sums are invested by modern banks in the discounting of bills that a considerable proportion of the discount is unearned by the bank at the time its half-yearly balance-sheets are made up Accordingly a banker adjusts his profits by opening an account in his books headed "Rebate on Bills not Due," to which he *credits* the total amount of discount which he calculates to be unearned at the date of the balance-sheet, and he includes that total in the balance-sheet under the heading "Rebate on Bills not Due" on the liabilities side

BALANCE OF PROFIT AND LOSS ACCOUNT.—The balance of a bank's Profit and Loss Account is not always included in the total of its current, deposit and other accounts, but is sometimes shown in the balance-sheet as a separate item on the liabilities side The balance, of course, belongs to the shareholders of the bank and represents the amount of undistributed profit after payment of the dividend and after providing for depreciation and allocations to reserves and other funds

The Test of a Bank's Strength.

As a general statement it is no doubt true to say that the balance-sheet of an ordinary commercial concern is of no great importance except to its shareholders and officials, and possibly also to a few trade rivals The case of a great joint-stock bank is, however, vastly different Not only are its balance-sheet figures of interest and importance to its numerous shareholders and officials, but they are also of vital significance to the multitudes of depositors who have entrusted their savings to its keeping, and further, to the body of potential customers of the bank represented by the public in any places wherein its business is conducted The published balance-sheet is necessarily the best means by which an outsider can judge the soundness and stability of the bank's organisation, but it is clear that the figures in themselves can convey little information which is useful, unless those perusing the items are able to form some estimation of their significance and true relation to one another

What is an Adequate Reserve?

How, therefore, is the strength of a bank to be judged? What is a true test of a bank's soundness and stability? What is a *sufficient* reserve for the satisfaction of all demands? What is an adequate proportion of cash to the total amount of a bank's deposits?

Different bankers would naturally answer such questions in different ways, but every banker is influenced by two distinct forces pulling in opposite directions On the one hand, the necessity of maintaining an adequate reserve of legal tender constantly dictates caution, on the other hand, the desire to make profits for the bank shareholders is a strong inducement to lend freely

Clearly, much depends upon the class of business conducted Banks which have considerable sums left with them on deposit at notice can safely carry smaller reserves than those which have a greater proportion of money on current account, or on deposit subject to withdrawal on demand Again, banks which are essentially deposit or savings banks must maintain a higher percentage of cash than banks such as the agricultural and credit banks of the Continent, which are formed and capitalised specially for the purpose of granting loans against land and providing capital for industrial undertakings

A bank operating chiefly in a rich residential suburb, where payments are made largely by cheque and frequently to recipients in other areas, requires proportionately less cash in its tills than a bank in a busy seaside resort where money is being spent freely and cash is being constantly demanded by incoming visitors for pleasurable disbursements. Similarly, a joint-stock bank whose business lies largely in agricultural districts requires as a rule a lower proportion of cash than a bank which operates principally in busy industrial areas, for money is turned over much more quickly in the centres of great industrial activity

There are other important factors which influence the proportion of cash held by a banker The amount of a banker's reserve varies considerably with the state of public confidence and with the general conditions of trade In times of depression and business uncertainty, when confidence is at a low ebb and people lack faith in the future, greater cash reserves are maintained by the banks than in prosperous times when faith runs high, when trade shows promise and when many customers, intent upon "making hay while the sun shines," apply to the banker for accommodation to finance new business ventures or to extend their existing operations

But whatever the conditions of trade or the circumstances of the banker's business, a sufficient reserve of legal tender must be maintained to meet all current and probable demands, normal and abnormal, otherwise the bank's reputation for solvency might be injured and its stability impaired by even momentary hesitation in meeting its obligations Happily, such dangers are fully recognised by our leading bankers, and their methods of distributing their assets in such a way as to provide what we have termed second and third "lines of defence," additional to the first line of defence, constituted by their holdings of coin and legal tender notes, have not only merited the confidence of their customers but have also gained world-wide approbation

The Proportion of Cash Held.

There are a number of different ways of calculating what is known as a bank's *proportion*, or percentage, of cash held One method is to take the total of the balance-sheet as 100, and to work out the amount of cash as a percentage of that total This is, of course, tantamount to determining what proportion of a bank's total assets is represented by cash, and it is in fact frequently employed in comparative statements drawn up to indicate the distribution of the assets and liabilities of banks in this country

Another method is to calculate the proportion between the bank's cash and its total liabilities in respect of current and deposit accounts, acceptances, capital, and reserve funds The third method, and one which has much to recommend it, is to take the proportion of the bank's cash to the amount of its liabilities on Current, Deposit, and Other Accounts , in other words, to compare the banker's first line of defence directly with the source from which spring his most frequent and urgent demands for payment This is the method adopted by the large joint-stock banks in this country, the proportion of cash to deposits maintained during recent years averaging about 11-12 per cent , and " anything from 10 per cent upwards may be regarded as sufficient for practical purposes "[1]

The Proportion of Advances to Liabilities.

The second factor of importance in estimating the strength of a bank is the relation between the total of its loans and advances, plus its discounts, and its liabilities on current and deposit account, or alternatively the proportion of the amount of its loans and advances, including discounts, to the total of the bank's assets The object of such an estimation is to determine whether the bank is maintaining a sufficiently liquid position, or whether it must be regarded as " overlending," *i e* , locking up too great a proportion of its funds in loans of a more or less fixed character

It is difficult to lay down any hard and fast rules, but it is said to be an established principle among British banks that advances, *excluding* bills discounted, should not be greatly in excess of 50 per cent of the total liabilities on deposit and current accounts.

The Quality of a Bank's Loans and Investments.

Apart altogether from the relative proportion of the various items in a bank's balance-sheet, the question of the *quality of a bank's loans and investments* is clearly one of vital importance, although it cannot, of course, be answered by any consideration of the figures disclosed by the average balance-sheet.

1 F. E. Steele, *The Banker as a Lender*

The strength of any institution as indicated by its balance-sheet is obviously merely ephemeral if its investments are largely of a speculative character, or if its loans are made without adequate security Moreover, it is clearly more advantageous if a bank's loans are well distributed both in amount and in area, than if they are made in large amounts to a comparatively small number of customers or are confined mainly to a particular area or industry, either of which may be subject to a widespread disaster

Partly as a result of the unusual development of the branch banking system in this country, but mainly as a result of deliberate policy, our large banks do not lock up their resources to any great extent in any one industry Their risks are well spread over a wide field, while the capital which they supply is lent for relatively *short periods*, *i e* , English banks supply *commercial* rather than *investment* capital If a manufacturer applied to a bank for a loan of £30,000 for the purpose of erecting a factory and installing machinery and plant, the request would probably be refused Capital of this nature is usually obtained in this country from investors who are willing to lock up their capital for long periods But if the same manufacturer applied to the bank for a temporary overdraft to pay for raw materials, *i e* , to finance production during the stages between production and final consumption, accommodation would probably be granted if satisfactory security were forthcoming

This feature of English banking is one which distinguishes it from banking in many other countries, particularly in Germany and France, where the banks supply investment capital for long periods and are frequently closely associated and interested through their boards of directors with the fortunes of particular industries (See Chapter 35)

The Sources of a Bank's Profits.

Banks exist first and foremost to earn dividends for their shareholders and to make those dividends as large and as regular as is possible and compatible with the maintenance of a sound and prosperous institution

The sources of a banker's income are numerous First in order of importance is the amount received as interest on loans, overdrafts, and money lent out at call or short notice, together with the current account charges for " commission on turn-over " and " postages " In a similar category is the sum received by the banker as discount and commission charges on bills of exchange, the total of this item being taken to the half-yearly profit and loss account only when adequate allowance has been made in respect of rebate on bills which are not then due for payment

The third important source of income comprises interest on the banker's investments in stocks and shares, a fairly stable item which can be calculated in advance within reasonable limits. Lastly, there are commissions earned by the bank for the variety of services which it renders, including acceptance commissions, commissions on stock exchange transactions, on promotion operations in connection with the flotation of new joint-stock companies, and on foreign exchange business transacted for its customers. To this last item must, of course, be added the profits made from time to time by its exchange dealers in their daily operations with foreign countries.

But the banker's business is not all profit. As in any other business, there are heavy charges and expenses to be met and inevitable losses of various kinds to be provided for, quite apart from the occasional severe losses which even the best-regulated institution has to meet from time to time. The chief item of expenditure is necessarily the sum credited to customers in respect of interest on deposits, and to this major expense must be added similar items of a heterogeneous character such as salaries, pensions and directors' fees, rent, rates, taxes and insurance of premises, postages and stationery, travelling expenses and repairs to premises. Apart from these necessary outgoings, the bank must make adequate provision to meet such ordinary trading losses as depreciation of premises, leases and securities, while the nature of a banker's business renders him liable to severe loss from bad debts, theft, mistakes of his staff involving monetary liability, and from adverse legal decisions which may give rise to heavy costs.

Happily, the business of banking in this country is conducted on such efficient and sound lines that the shares in our joint-stock banks are regarded as being among the safest, steadiest and most profitable of stock exchange investments.

CHAPTER 8.

THE LONDON MONEY MARKET.

THE London Money Market in its wider significance connotes the operations of all the bankers, brokers, discount houses and financiers in the City of London who deal in the commodity—money—and its representative, credit. In the localised sense it is taken to apply to the nucleus of world-famous financial institutions centred around Lombard Street and the Bank of England, whose business it is to borrow and/or to lend capital for short or long periods.

Market Lenders.

The lenders of funds on the market are chiefly the banks, particularly the " Big Five," which lend out at low interest for short periods (frequently overnight) the floating surplus of their deposits after reserving sufficient to meet current demands, and employing what is deemed to be a safe proportion in loans, investments, and other ways.

Much of this money is lent out to bill brokers and others either " *at call*," *i.e.*, subject to repayment upon demand, or " *at short notice* " —from six to ten days—in which case the loans are referred to as *fixtures* or *weekly money*.

Other sums, described as " *day to day money*," are left with the market operators subject to the banker's right to demand their return at a day's notice, while at times the banker will only lend " *overnight*," *i.e.*, from midday on one day to midday on the next.

Such arrangements are clearly of the greatest utility to the banks, for they not only enable a bank to employ a large proportion of its funds conveniently and profitably, but also to ensure that the " second line of defence "—described in a bank's balance sheet as " *Money at Call and at Short Notice* "—shall be immediately available in the case of emergency.

In his famous work, *Lombard Street*, written over fifty years ago, Bagehot comments on the vast " floating loan fund which can be lent to anyone or for any purpose," but the total loan fund of 1873—probably about £10 millions—cannot be compared with the total of probably £130 millions which is to-day utilised by the joint-stock banks on the Money Market.

It may be added that the loans are secured by the deposit with the bank of first-class bills or other securities (known as *floaters*), while each bank tends to deal only with certain brokers whose reputation and stability are known by the bank to be beyond question

Market Borrowers.

The borrowers of money are chiefly bill brokers and discount houses, who employ the funds borrowed in discounting bills, and stock exchange brokers and operators, who utilise the funds for dealing in securities

If, as sometimes happens, loans are "called" by the lending bank or banks, the dealers find themselves compelled to borrow from other banks or from the Bank of England In the latter event, the Market is said to be "*in the Bank*"

This usually takes place at the end of the financial year, half-year and year-end, when supplies of floating credit are severely curtailed Sometimes, too, the Bank of England forces the Market into its own hands as a means of imparting a firmer tone to the Discount Market From the point of view of the bill broker, borrowing at the Bank is an unpleasant necessity, because the Bank charges interest at $\frac{1}{2}$ per cent over Bank Rate, and will not lend for less than a week

In addition, the British, Foreign, Dominion and Colonial Governments, and the foreign and colonial banks with agencies in London, lend or borrow considerable sums, while, during the War, the British Government established itself as the largest borrower in the Market, and the aggregate of its temporary borrowings is still far in excess of the whole of the Market's short-term loans to other borrowers

The International Aspect of the Money Market.

The world-wide importance of the London Money Market is indicated by the number of specialised organisations existent therein which are occupied essentially in international finance Among these are the Discount Market, the Foreign Exchange Market, and the Bullion Market

The Discount Houses and Bill Brokers.

The Discount Market, consisting of the discount houses[1] acting in close conjunction with the bill brokers, the London accepting houses[2] and the banks, applies itself to the buying and selling of bills of exchange Its creation of a free market for good bills and its insistence on a high degree of business integrity, together with the fact that the sterling

1 Such as Alexanders Discount Co , Ltd , The National Discount Co , Ltd , and Union Discount Co of London, Ltd 2 E g , Brown, Shipley & Co , , Frederick Huth & Co , Kleinwort, Sons & Co , Lazard Bros & Co Ltd

bill can be at any time converted into cash in London, have contributed very largely to the world-wide acceptability and negotiability of the bill of exchange on London.

The Accepting Houses.

The *Accepting Houses* are a feature peculiar to the London financial organisation, and their development accounts in no small degree for the superiority of London as an international monetary centre over New York or Amsterdam These houses are now private banking firms of first-class credit who guarantee with their signature the fulfilment of contracts embodied in bills of exchange, more particularly, by accepting bills drawn by sellers of goods in return for a commission at an agreed rate per cent on the face value of the bills They make it their business to know the financial standing of traders throughout the world, and they succeed largely because they maintain a careful watch on the general course of business and on monetary conditions affecting their operations They are materially assisted in this regard by the experience and knowledge gained by those of their partners who function on the boards of the joint-stock banks, and on the Court of Directors of the Bank of England

The term "merchant bankers," sometimes applied to these well-known firms, is indicative of their origin in the ranks of merchant traders of established reputation, who found themselves able to develop a lucrative business by lending their names on the bills of less well-known firms So high is the reputation of the accepting houses that their services are used to finance not only the import and export trade of this country, but also direct trade between foreign countries in goods which never touch our shores

In recent years a considerable part of the world's acceptance business has passed to the banks, and *in London, particularly, the banks now actively compete for this work which, in the past, was confined almost entirely to the specialist institutions*

We may usefully illustrate the work of an accepting house by considering the case where a merchant in South America wishes to sell goods to a buyer in this country but knows little of the buyer's standing and resources In these circumstances, the seller may request the buyer to make arrangements with a London bank or accepting house for a *credit*, whereby the seller is enabled, instead of drawing his bill on the buyer, to draw it on a bank or accepting house of known reputation In due course, the bill is accepted by the institution concerned, and the buyer agrees with the acceptor to provide the necessary funds at maturity.

The seller reaps two big advantages by this arrangement First, he is practically *relieved of all anxiety as to due payment* for the goods

he has sold Secondly, he has *no difficulty in financing the transaction*, because the accepting houses and the banks which undertake acceptance business have such a reputation for soundness and stability that bills drawn under credits opened with them can be negotiated without difficulty

The same principle holds good in the case of exports from this country A seller on this side may know little of the standing of the foreign purchaser, but if a London bank or accepting house opens a credit in favour of the seller, by order and for account of the purchaser, then the exporter in this country can proceed with the manufacture and shipment of the goods, secure in the knowledge that the bills drawn there-against will in due course be accepted and paid by a reputable institution.

To the activities of the accepting houses is due, in no small measure, London's leading position as an international financial centre For the use of London banks and acceptance houses is by no means confined to trade with this country The prestige of sterling has led to its use in many transactions between foreign countries, and this demand is met only because adequate acceptance facilities are available in London As a result, foreign countries regularly settle for goods sold and services rendered to one another through the intermediary of what is known as "*London Reimbursement*," *i e*, acceptance and finance facilities arranged with a London bank or accepting house

The Home, Dominion, Colonial and Foreign Banks.

Working in close co-operation with the other organisations and performing functions of first importance in relation to international finance and trade, are the home, dominion, colonial and foreign banks having offices in London Apart from undertaking purely banking business, these institutions also undertake many of the functions performed by the specialist organisations mentioned above They transact the bulk of present-day foreign exchange operations They undertake acceptance business, grant loans against goods entering into international trade, provide short-term credit for the bill brokers and discount houses, and assist the underwriters and issuing houses in raising capital from the investing public.

The London Foreign Exchange Market.

Consideration of the Foreign Exchange Market is deferred to a later chapter, but at this point it may be observed that the peculiarly international character of the London Money Market proved to be a factor of considerable importance during the great post-war foreign exchange boom in enabling London to obtain a hold on the bulk of foreign exchange

business and establish herself even more firmly as the world's leading monetary centre

The London Bullion Market.

The London Bullion Market is the specialised section of the London Money Market, where dealings in gold and silver bullion are conducted by certain long-established firms of wide reputation,—Messrs Röthschild and Sons, Messrs Mocatta and Goldsmid, Messrs Pixley and Abell, Messrs Samuel Montagu and Co, and Messrs Sharpe and Wilkins

To this market a large part of the world's newly-produced gold and silver naturally gravitates for disposal, and so high is the reputation of the firms mentioned that they are entrusted not only with all dealings in the precious metals, but also with the fixing of the price of bullion from day to day

The market price of gold bullion is quoted in terms of shillings and pence per fine ounce troy for gold in the form of fine bars or ingots of approximately 400 ounces All dealings are for cash, since there is no forward market in gold as there is in silver

Prices are quoted for *fine* gold, and not for British *standard* gold, 11/12ths fine, for two reasons First, because many of the transactions are in the pure metal received from the refineries, and secondly because, standards of fineness not being the same throughout the world, it is most convenient that prices on the leading market should be quoted in terms universally applicable

On the other hand, the Bank of England prices are for British standard gold, 11/12ths fine, because the Bank's dealings in gold relate largely to British sovereigns, which are of this standard fineness

The existence in London of legally fixed prices at which the Bank of England is obliged to buy and sell gold (77/9d for buying and 77/10½d for selling) necessarily imposes limits in normal circumstances to the rise or fall in the price of gold in the open market The equivalents of the Bank's prices per ounce of *fine* gold are approximately 84/9$\frac{3}{16}$d for buying, and 84/11½d for selling, so that sellers are not likely to accept less in the open market than the former figure, while buyers who can obtain gold from the Bank are not likely to pay the bullion dealers more than the Bank's selling price

Further, so long as no abnormal circumstances interfere with the Bank's power to buy and sell gold, variations in the price of gold on the open market are possible only because the Bank of England quotes slightly different prices for buying and selling If these prices were identical, the market price could not differ from the Bank of England price, and, as in the United States, where all transactions in gold are

effected at the fixed price of $20 67183 per fine ounce, there would be no bullion market.

World Movements of Gold.

The business on the Bullion Market may be best understood by a brief consideration of the various types of international gold movements These may belong to one of several categories

First, we have *shipments of the metal from the gold-mining countries* to a gold bullion market as, for example, from South Africa or Australia to London, in which case the gold is merely an ordinary commodity import and export In this category we may also place *movements of gold from the producing countries*, or from the Bullion Market, to India or China, where the metal is sold in large quantities for hoarding purposes, for personal adornment and for ornamental uses

The second class comprises the *transference of gold from one state to another purely as a raw material for industrial purposes*, as, for example, gold imported into Switzerland for watch-case making In this case, also, the transfer is regarded by the countries, concerned merely as an ordinary trade import or export

In the third class are *gold shipments which are essentially banking operations*, as, for example, those made to strengthen or to establish the metallic reserves of a central or other bank in a gold standard country, or those which merely represent the transfer of part of a bank's gold balance or reserves from one centre to another In such circumstances the transfer takes place not purely as the result of the working of ordinary economic forces through the exchange rates, but essentially to meet the convenience or requirements of the bank responsible for the shipment

Finally, we have the most important class of all, comprising *shipments of gold which take place when the foreign exchange rates diverge* so far from the Mint parities as to render the movement of gold profitable As a rule, this means that the outgoing specie point has been reached in one of the countries concerned, although, in actual practice, bankers may undertake the export of gold before the exchange actually reaches the point which makes profitable a transfer of gold

Transactions on the Bullion Market.

Once the metal has reached the Bullion Market it will move according to the strength of the demand in one of the other three categories Since the bulk of the gold on offer on the Market emanates from the same source, there is little competition among sellers, but there is occasionally keen bidding from would-be buyers There is a fairly regular demand for industrial purposes and for shipment to India

or other Eastern countries But neither of these absorbs more than a small proportion of the weekly supply, most of which is taken, in ordinary circumstances, either by the Bank of England or by a so-called "*undisclosed*" buyer The latter term frequently occurs in newspaper reports of business on the Bullion Market, since the dealers never openly reveal the names of the buyers Often the term conceals the identity of one or other of the foreign central banks, which, usually through the agency of the Bank of England, is strengthening its gold reserves by purchases from the London Market, or converting part of its sterling balances into gold bullion

As a rule, the Bank of England automatically takes at its legally fixed minimum buying price any balance of gold left over after the requirements of the trade, of India and of other buyers, are satisfied But it sometimes happens that a strong demand from other quarters prevents the Bank from obtaining any part of the supply, either for itself or for its customers Such conditions arise mainly when one or other of the gold exchanges is so adverse to this country that exports of gold can profitably be undertaken, and bullion arbitrageurs are able to offer more than the Bank's statutory buying price In such circumstances, the gold available is taken off the market by the highest bidder or bidders, but, for reasons already given, the price will not in ordinary circumstances exceed that at which the Bank itself is compelled to sell bullion

The Bank does not usually bid for gold in competition with outside interests, but there is nothing to prevent it from buying gold at a price slightly higher than the legal minimum price at which it is obliged to take gold from other holders, and this it occasionally does to prevent the withdrawal of gold from London

Bullion Returns.

Every afternoon[1] the Bank of England issues a Daily Bullion Return giving particulars of all arrivals or withdrawals of gold during the day. The information is of the scantiest kind, and no indication is given of the origin of the arrivals or of the destination of the withdrawals, although this information may usually be gleaned from the Market, or determined by a consideration of the position of the principal exchanges

The Daily Return is concerned only with gold which is *received by or withdrawn from the Bank*, and no mention is made of gold which is purchased or sold on the Bullion Market without the intervention of the Bank of England This omission, however, is remedied in the Weekly Return of exports and imports of gold bullion issued by H M Customs and Excise. This Return not only gives the total value of all

[1] On Saturdays, about mid-day

the gold movements, but also specifies the countries of origin or destination, as the case may be.

The bulk of arrivals and withdrawals of gold are in the form of *bars*, but the Bank of England Return frequently records the receipt or withdrawal of *sovereigns* Under the Gold Standard Act, 1925, the Bank is entitled to pay out gold for export at its option either in the form of bars or of sovereigns, and the latter are sometimes preferred by foreign importers, particularly where the gold is to be held by a foreign central bank as part of its reserve Moreover, sovereigns are very frequently received direct by the Bank from other countries for the reason that only gold bullion in the form of bars (and not sovereigns) is dealt with in the London Bullion Market Again, sovereigns are frequently imported into this country from the Dominions, and especially South Africa, where they are now minted in considerable quantities

In the Daily Bullion Return sovereigns are sometimes described as "*earmarked*" or "*released*" Items "earmarked" represent withdrawals of sovereigns which are not actually moved away from the Bank, but which are set aside on account of some foreign institution which, instead of actually importing gold in order to maintain its reserves, arranges with the Bank of England to hold the gold on its account If the "earmarked" sovereigns are afterwards exported, no further record appears in the Bullion Return, but usually they return to the Bank and are then described as "released"

The London Silver Market.

The price of silver bullion is fixed in very much the same way as is the price of gold Each day a number of well-known bullion brokers meet to consider the conditions of supply and demand and to fix the prices for the metal, which are at once cabled to the world's most important monetary centres

The Market fixes two prices the "*Spot*" or "*Ready*" price, for silver which must be delivered by the seller within one week from the date of the sale, and the "*forward*" price, for deliveries which must be made by the seller two months after the date of purchase Most of the metal is received from the foreign mining countries in weekly shipments and thus, in respect of many of the sales made before the metal has actually reached the market, the silver is sold "*to arrive*" in not less than one week

Market prices are quoted in pence per oz of our *old standard* silver, 925 fine, and *not* per ounce of *fine* metal as in the case of gold As a rule the metal comes on the Market in the form of bars of standard fineness, weighing anything from 900 to 1,300 ounces

The price for forward silver is ordinarily quoted at a premium or discount on the "spot" price, the margin between the two varying

according to the anticipations of the market as to the likely state of demand and supply on the future date, when the forward contract must be completed In forward contracts in silver, as in all other types of forward contract, the price is fixed at the time the contract is made, but the silver is not actually delivered and no cash passes until the agreed future date for forward delivery

Peculiarities of the London Silver Market.

The London Market for silver is peculiar in several respects In the first place, the volume of forward business is much greater than the volume of spot business, and the forward quotation is consequently the more important Secondly, the Market is much dominated by the demand for silver from the Eastern countries, where the metal is used not only as the principal form of currency, but also very largely for ornamental purposes

A third feature of the Market is that a considerable proportion of the silver sold by the dealers is never actually received on the Market Much of it is sent direct from the producing country to the purchasing centre, as, for example, from the silver mines of Western U S A and Canada to China and India

Although the London Silver Market is necessarily overshadowed in importance by the Gold Bullion Market, the Daily and Weekly Reports of conditions and prices in the Silver Bullion Market are of considerable interest to bankers, financiers and Eastern traders The Bank of England itself, however, is not greatly concerned with movements of silver, and issues no official Return of silver withdrawals and receipts

Market Rates of Discount or Interest.

The rate charged on the Money Market for loans of *money* for short periods, chiefly by the purchase and sale of bills of exchange, is referred to as *Discount*, in contradistinction to the term *Interest*, which is used in reference to the charge made for the loan of *capital* for long periods. Discount is deducted from the amount of money advanced at the time of the loan, whereas interest charged is added to the principal amount lent, either periodically or at the time of repayment

Economically, also, there is a marked difference between the two charges Pure interest is properly considered under the heading of Distribution, because it represents the proportion of the product of industry which accrues to the capitalist Discount, on the other hand, contains elements (such as the reward for risk) in addition to pure interest, and belongs to the departments of Production and of Exchange in so far as it is an essential factor in the adjustment of the demand and supply of loanable money for productive purposes. When due allowances are made, however, there can be little or no difference

between the two rates, for any difference must result in a flow of loanable capital from one purpose to the other, *i e*, if discount is higher than interest, capital will be used for short-term discounting operations rather than for loans for long periods in return for interest

From an economic standpoint, the London Money Market proper consists of several distinct markets, each of which has its own dealers, with its own price for the commodity in which it deals, *i e*, rates of interest for loanable capital

THE BANK RATE is the official advertised minimum rate of discount at which the Bank of England discounts approved bills of exchange, though, for regular customers, the Bank may discount at slightly lower rates The Bank rate is fixed by the Bank Court of Directors on Thursday in each week, and ordinarily regulates all other rates in the Money Market

THE MARKET RATE is the rate of discount charged by the various members of the Money Market, other than the Bank, for discounting bills of exchange payable three months after date Though the "market rate" is always understood to mean the rate for three months' bills (which is the "key" rate to the state of the market), various other rates of discount are quoted in the market These vary chiefly according to the length of the period for which the loan is made as a rule, the longer the period, the higher the discount The market rate, sometimes called the "private" rate, is nearly always lower than the Bank of England rate

THE TREASURY BILL RATE, which, as is explained later, is of prime importance, is the rate at which British Government Treasury Bills are discounted

THE BANKERS' DEPOSIT RATE is that paid by the bankers on deposits left with them by their customers This rate is regulated by the Bank rate until a few years ago it was fixed at $1\frac{1}{2}$ per cent below the latter, but nowadays the difference is 2 per cent In special cases, the banks pay higher interest on deposits than the advertised rate much depends on the size of the deposit, the period for which it is left and the importance of the customer

THE BROKERS' DEPOSIT RATE is slightly higher than the bankers' deposit rate, and is paid by brokers and discount houses on money left with them at call and short notice

THE BANKERS' CALL RATE and THE BANKERS' SEVEN-DAY RATE are charged by banks for loans of money at call and at seven days' notice respectively

The relative importance of these rates and their relationship to one another will be examined in Chapter 11, but the manner in which they are quoted may be seen from the following table, taken from the *Economist* of January 11th, 1930 —

LONDON RATES.

	Jan 2, 1930	Jan 3, 1930	Jan 4, 1930	Jan 6, 1930	Jan 7, 1930	Jan 8, 1930	Jan 9, 1930
Bank rate (changed from 5½% Dec 12, 1929)	5 %	5 %	5 %	5 %	5 %	5 %	5 %
Market rates of discount—							
60 days bankers drafts	4½—⅝	4 ⅛	4½— ⅛	4 ⅜ ¼	4 ⅛—¼	4 ⅛—¼	4¼
3 months' do	4½ ¾	4 ⅛	4½— ⅛	4½— ⅜	4 ⅛—¼	4 ⅛ —¼	4¼
4 months do	4½—⅝	4¼	4 ⅛	4¼— ⅜	4 ⅛ — ¼	4 ⅛ ¼	4¼
6 months do	4⅝	4⅝	4 ⅛	4 ⅛	4 ⅛ — ¼	4 ⅛ —¼	4¼
Discount (Treasury Bills)—							
2 months	4 ⅜— ½	4 ⅛— ⅜	4½— ⅛	4 ⅜	4 ⅛	4 ⅛	4 ⅛ ⅜
3 months'‡	4½	4 ⅛	4½— ⅛	4¼— ⅜	4 ⅛	4 ⅛	4—4¼
Loans— Day to day	2½ - 3	2½ 4	2½— 4	3½ - 4	3½ — 4	3½—4	3½ 4
Short	4	3½ 4	3½ 4	3½ 4	3½— 4	3½— 4	4
Deposit allowances Bank	3	3	3	3	3	3	3
Discount houses at call	3	3	3	3	3	3	3
At notice	3½	3½	3½	3½	3½	3½	3½

‡ Additional to those offered by tender in the preceding week

Bill Discounting.

The term "discounting" a bill has already been explained in Chapter 7 as the action of buying a bill at its present value In this country, a considerable proportion of bill discounting is done by the joint-stock banks for their own customers, since the banks find this a most convenient and, at the same time, secure method of employing part of their surplus funds, because the money is constantly flowing back as the various bills are paid at maturity Also, all a banker needs to do in order to replenish his reserves is to cease discounting It is for this reason that loans for indefinite periods, though they may be technically repayable on a certain notice, represent a greater tie-up of capital than investments in short-term bills

In great produce-exporting countries, such as South Africa, Australia, U S A and Canada, service of immeasurable utility to trade is rendered by the banks in discounting the bills of merchants in the coastal ports who buy produce inland for export abroad Occasionally—as, for example, in periods of great trade activity, harvesting seasons, etc — these banks find that they are called upon to discount rather more bills than they can conveniently carry in portfolio, and at such times they resort to the practice of *rediscounting* some part of their holdings of bills with the central bank Indeed, this business of rediscounting acceptable commercial bills for the ordinary banks forms an extremely important function of the central banks in many countries In its absence, the activities of the banks would be considerably restricted, with consequent detriment to trade, and recognition of this important aspect is to be found in the fact that the constitutions of a number of central banks established since the Great War require adequate provision to be made for such rediscounting facilities

In London the quantity of so-called inland discounts forms a very small proportion of the bills circulating in the Discount Market, while such inland discounts are never rediscounted by the banks, for one

reason because the re-discounters would probably draw unfavourable conclusions regarding the positions of the banks if bills of inland traders bearing bank endorsements were to appear on the Market Apart from this, our banks prefer for investment purposes those bills which arise from the finance of overseas, rather than inland, trade

The Bill-Broker.

The importance of bills discounted as a form of short term investment by the banks ensures that the function of the bill broker, who deals in such bills, shall be regarded as being of considerable importance Bill brokers arose in the first instance to transact business which the banks, with their manifold other lines of activity, did not regard very favourably Bills were then relatively few, and the banks were not willing to seek out persons wishing to sell bills, nor were they at all times willing to buy Hence dealers with a specialised knowledge, enabling them to undertake business which the banks would not risk, and willing to quote very fine rates made possible by the magnitude of their turnover, fulfilled a very real need To-day they are equally indispensable, although the term " bill-broker " is frequently something of a misnomer Nowadays, the broker is usually much more than a mere intermediary he often discounts bills on his own account, and even accepts funds from clients on deposit account at interest

Were it not for the bill-brokers, the banks would not so easily be able to employ their surplus funds from day to day For the function of bill broking affords the banks two channels of liquid investment—

(*a*) They can *lend* " call " money against the security of parcels of bills, bearer securities, treasury bills, etc (usually known as *floaters*), deposited by the brokers who daily require large sums in order to carry their discounts , *or*

(*b*) They can *purchase* parcels of bills from the brokers, who so arrange these parcels that all their maturities will fall within the same month , *e g* , June bills

For the bulk of their investments in bills, therefore, the banks are saved the trouble of dealing direct with the real borrowers Further, even if all the discounting were in the hands of banks, it is doubtful whether they would be able themselves to reap the small turn made by the broker, and in principle, of course, the absence of the " middleman " tends to *reduce* the price paid by the consumer, and not to raise the price received for his goods by the producer

Then there is the great advantage of the present arrangements that the broker acts as a kind of clearing house between the banks who have surplus bills for disposal and those who have surplus funds for investment Each morning he visits the London offices of the various foreign branch banks which comprise his clients, and, having obtained

from them lists of bills on London which they have to offer, he thereafter finds customers who will take the bills from him among the other banks and the discount houses

From the fact that all such transactions are effected through the medium of a bill-broker, whose business it is to know the worth of the names on the paper passing through his hands, and -most important of all—to see that the instruments bear a bank endorsement, it is easy to see that the bills thereby attain a standing that they would otherwise lack Further, the banks are enabled, by dealing with a broker, to decline without difficulty bills bearing names for which they do not care, or bearing names of firms of whose paper they already hold as much as they deem expedient

It may be added that the Bank of England insists that the bills against which it lends money to the bill-brokers must be based on transactions of which the history and character are beyond reproach As the Bank is the source to which the bill-brokers must go when other supplies of money are exhausted or unavailable, the brokers are in this respect the interpreters of the wishes of the Bank An account at the Bank of England is a necessity to a bill-broker, but the Bank exercises great care in opening such accounts, accepting as customers only men who fulfil a certain standard of requirements

"Running" Brokers and Others.

There are two distinct classes of bill brokers on the London Money Market The most important class comprises those bill brokers who are really principals or jobbers trading in bills for their own account, and obtaining their funds either from the banks, in the form of short period loans on the security of approved bills and short term securities, or from deposits left with them at a rate just above Bankers' Deposit Rate The "Discount Companies" are bill-brokers of this class The bulk of their resources are loaned from the banks, and they derive their profits from the difference between the rates of discount at which they buy bills, and the cost of their loans or deposits

The loans to these bill-brokers figure in the balance sheets of the banks under the heading of "Money at call and short notice," and give a more "liquid" aspect to the balance sheets than would be the case if the banks bought the bills themselves and showed them under the heading of "Bills Discounted"

The other and less important class of brokers comprises those known as "running" brokers, from the fact that they act merely as middlemen between banks who have bills to sell and those who wish to buy bills Such brokers do not indorse the bills which pass through their hands, nor have any interest in such bills or liability on them, while they collect their remuneration in the form of a brokerage on the face value of the bills they handle, usually at the rate of about 1/32nd of one per cent

CHAPTER 9.

THE ENGLISH CAPITAL MARKET.

THE nucleus of specialised agencies constituting the London Money Market proper is to be distinguished from the far wider organisation sometimes referred to as the *English Capital Market.* This embraces not only the Money Market itself, but also the whole of that specialised machinery in the City of London primarily concerned with the transfer of capital from those who wish to invest it to those by whom it is required, together with a wide circle of other less defined agencies which perform a similar function. The Capital Market may, in fact, be regarded as comprising an inner and an outer ring.

The Outer Capital Market.

Of these two divisions, what we may describe as the Outer Capital Market is much the less centralised. It comprises the services of the solicitor, of the provincial broker and of building societies, together with the system of trade credit and all those less defined but widespread arrangements which facilitate the movement of loanable capital from investor to borrower.

While the inner capital market plays the leading part in linking up the demand for capital with its supply, it is seldom realised to what extent industry in this country is financed through the less defined but none the less important agencies constituting the outer market. Loans of large and small amount are made every day by solicitors and friends on little or no security other than faith in the borrower's integrity and ability. Professional moneylenders advance huge amounts to individuals of every class ; business men raise large sums on security, particularly on mortgage ; while, in many industries, capital is supplied for short periods through the action of merchants, dealers, and middlemen in providing trade credit.

Most of such traders have a much larger amount of capital in their business than is represented by assets, and so it may be said that the typical merchant is not merely a buyer and seller ; he is also a financier in the true sense of the word, utilising a certain proportion of his capital in advancing trade credit and accepting similar facilities in return. In some industries, particularly in the cotton industry, the provision of short term credit by such agencies is of first importance, for the intimate knowledge which traders in this industry have of their customers

enables them to afford credit facilities and perform loaning services which no banker would undertake

The Inner Capital Market.

This section of the Capital Market is highly centralised and embraces three distinct groups (*a*) the specialised institutions of the Money Market proper, dealing with *short term capital*, (*b*) the market in *new securities* or *new capital*, consisting of the many forms of trust and finance companies in the City, the company promoters, underwriters, brokers, issue and advertisement houses, all of which are engaged in company flotation, and (*c*) the market in *issued securities* or *invested capital*, represented by the highly organized London and Provincial Stock Exchanges

The joint-stock banks are undoubtedly the foremost members of the Inner Capital Market They relieve the capitalist of the entire work of management of his disposable funds, and, through an elaborate system of some 5,000 branches, establish business relations with large numbers of people who have capital available for investment and people who are desirous of turning borrowed capital to good account

The trust and finance companies comprise a large group of several hundreds of institutions, ranging from the highly reputable trust company proper to less well-known financial houses engaged in more speculative operations Many and varied are the purposes for which such institutions are formed Those which operate mainly at home invest funds, discount bills, underwrite issues of new securities, convert businesses into joint-stock companies, act as trustees and agents, purchase assets of insolvent estates, acquire and develop property, and generally assist commercial undertakings

Investment Trusts.

In recent years, Investment Trusts have become very prominent not only in this country but also in the United States, and shares therein are being increasingly favoured by the small investor The function of the trusts is to invest the funds entrusted to them in such a way that, by judicious distribution, by limiting risks incurred in any one direction, and through the advantages of specialised study of investment, a higher income return may be obtained on the money than is available to the ordinary investor.

The funds of the investment trusts are spread over a large number of varied undertakings and, as a rule, no more than 5 per cent of the capital is invested in any one enterprise It is estimated that at present about 50 per cent of the capital of the English companies is invested in undertakings in Great Britain.

As favourable opportunities arise, the holdings of a trust are varied and those showing capital appreciation are realised, but the making of profits in this way is merely subsidiary to the main business, and any profits so realised are not distributed but are transferred to reserve The distributable revenue of the trust is derived chiefly from interest and dividends on investments The investment trust proper is not a speculative concern, but seeks to obtain the maximum return consistent with the minimum of risk There are, however, many institutions, especially in the United States, which under the style of investment trusts, conduct operations in shares of a distinctly speculative character.

Finance Companies.

These companies take many forms but, unlike the investment trusts, they seek to control the enterprises in which they are interested and, with this end in view, concentrate on a small group of undertakings Their business is much more speculative than that of the investment trusts They trade in securities but treat the profits derived from purchases and subsequent sales as revenue They also assist in the flotation of foreign loans and arrange for the exchange of the sterling raised by means of the loans into the currency of the borrowing country Since these companies seek high returns, and since their holdings are not widely distributed, they take considerable risks and are liable to be seriously affected by financial depression or disturbed monetary conditions The companies which operate mainly overseas have especially varied objects They are formed to invest in all types of foreign securities, in real estate mortgages, railway bonds, rubber, tea and coffee plantations, to assist industrial development, acquire freehold land and work railways, and to carry on general financial business, and act as trustees and agents In fact, the great variety of purposes for which these finance companies are formed tends to obscure their principal function—that of supplying capital Companies of this kind which operate on a *group* basis, *i e*, finance companies which hold the shares of a group of operating companies, sometimes betray a position of extreme weakness, as was strikingly demonstrated in the London Stock Markets during the latter half of 1929, when several of these groups, involving millions of capital, were involved in an unprecedented financial crash

Issuing Houses.

The principal function of the issuing houses is to offer new issues for subscription to the investing public, not only for domestic purposes, but also to meet the requirements of foreign borrowers The objects for which such issues are made are many and varied—to construct

harbours or railways, to assist trade development or to help to restore a stable currency,—and the tendency is for certain issuing houses to specialise or concentrate in a given direction Some houses handle only domestic business, others only foreign issues , some are reputed for their handling only of first-class propositions, whilst others again are known to favour the more speculative type of transaction

The issuing houses may be said to act as pipe-lines between industry and the idle resources of the investing public Their first duty is to examine carefully the merits of any new capital issue which is proposed They decide whether the issue is justified by the position of the company or Government or other body which wishes to raise money, whether the security is good, and whether there is a reasonable likelihood of the public getting a fair deal

To borrowers, the issuing houses render a distinctly useful service Thanks to their intimate knowledge of the state of the Capital Market, they are able to advise as to *when* and *how* an issue shall be made, and, by shrewd timing of an issue, they often save the borrower considerable sums Furthermore, the borrower is relieved of all the work and worry connected with the raising of the capital because the issuing house, after taking over the loan at a price below the public issue price, transfers the ultimate net proceeds of the issue to the borrower whether the public response has been satisfactory or otherwise

The issuing house is obviously unable to *guarantee* the issues which it sponsors, and it must accept the figures and statements provided for it In most cases, however, the chief danger against which the investor needs some safeguard is not intentional deceit, but the vague optimism and oversight which are characteristic of so many borrowing operations The first-class issuing house does not sponsor any issues which it considers of a doubtful character, and, in thus preserving its own good name it performs an important function in protecting the public, and so facilitating the rapid and economical distribution of new capital In discharging their functions, the issuing houses have an important adjunct in the Stock Exchange, because, if people are to subscribe freely, they must, of necessity, have a ready means of realising their investments whenever they desire to do so

The Market for Issued Securities.

The market for negotiable securities is primarily concerned with *the supply of capital for long periods*, and, as already indicated, really consists of two distinct organisations—*the market for new securities* and the *market for old securities* The function of the first of these is to formulate the demand for capital by expressing it in the form of a large number of negotiable securities adapted both in amount and the degree of risk to appeal to a widespread public Underwriters may guarantee

the subscription of the whole or part of an issue, well-known brokers lend their names to prospectuses and open up a market among their clients, bankers receive subscriptions and issue securities in return, while the specialised machinery of the advertisement houses enables them to distribute an enormous number of prospectuses among a selected public.

The Stock Markets.

The work of the second half of the market, the Stock Exchanges, is ancillary to the main function of obtaining supplies of new capital from the public It contributes to this end by providing facilities by which securities, after they have been purchased, may be readily exchanged and realised The organisation of the market as a whole enables an immense number of small portions of capital to be collected annually from a wide public and placed at the disposal of states, municipalities, industrial organisations and commercial enterprises in all parts of the world

Important stock markets performing the functions here described are to be found in all the leading financial centres of the world, and particularly in London, Paris, New York and Amsterdam Provincial exchanges also exist in many towns both in this country and abroad, the most important in the British Isles being those at Manchester, Glasgow, Liverpool, Birmingham, Newcastle and Dublin The London Stock Exchange is unrivalled both for the efficiency of its equipment and the extent of its business, and the main features of its organisation are briefly described below

THE LONDON STOCK EXCHANGE

The London Stock Market consists of a voluntary and private association of the proprietors of the Stock Exchange building in Throgmorton Street, where the members meet to deal in stocks and shares among themselves and to conduct business in accordance with the rules laid down by the Committee for General Purposes and by the Management The latter appoints the officials of the Exchange other than the secretary, and comprises nine elected members, three of whom retire every five years

The Committee for General Purposes consists of thirty members, elected annually from among those who have at least five years' membership of the Stock Exchange to their credit Among other duties this Committee appoints the secretary, admits members or authorised clerks of members, gives authority for the transaction of arbitrage business, suspends or censures members, re-admits defaulters and notifies the public of suspensions of members

Members may be suspended if they violate or fail to comply with the Rules of the Exchange, or if they are guilty of dishonourable conduct They are required to refer all disputes among themselves to the Committee for arbitration, and may not take legal action against any other member or members over such disputes except with the prior consent of the Committee

The system of arbitration in vogue on the Stock Exchange is attended by several advantages, but is not without its disadvantages On the one hand, it permits disputes to be settled promptly and economically , it is not governed by precedent, and so judgment to suit each case is given strictly according to the notions of a body of business men, while, finally, the right of the Committee to expel or suspend a member promotes a better moral code than would be likely to result from legal enactment or legal compulsion The disadvantages are that identical and recurring issues may be decided in quite different ways, that time is needlessly lost because the results of previous findings are not recorded for future guidance in similar cases, while a member's legal rights may be waived in favour of a submission to arbitration, the issue of which is uncertain and possibly not in accordance with the law It cannot be doubted, however, that the system has worked with a remarkable degree of success, and it is universally recognised to have maintained an exceedingly high standard of business morality

Membership of the London Stock Exchange.

Entry to the London Stock Exchange is difficult and membership thereof is strictly regulated, being confined to *brokers*, *jobbers* and their authorised clerks Each member is required to seek re-election every March, and no member has a *right* of re-election In *Weinberger v Inglis*, 1919, it was held that, where the Committee had exercised their discretion fairly and honestly and in accordance with their powers in refusing to re-elect an alien enemy, the Court had no power to reverse the decision

Stockbrokers are the only members of the Exchange with whom persons outside the market may deal They act as middlemen between the jobbers and the public for a commission, and are liable to their clients as agents Stock Exchange Brokers rely for their profits on the commissions which they receive from the public, and it is not an essential part of their business to carry stocks for large amounts on their own account or for their own profit

Jobbers deal in particular stocks, act as principals and are liable as such on their transactions It is a breach of the rules of the Stock Exchange for jobbers to approach the public directly for orders They make their profits by speculation in stocks and from the "jobbers'

turn," the difference between the buying and selling prices which they quote to the brokers

The Function of the Jobber.

It is frequently argued by those without a full knowledge of the conditions that there is little justification either for the existence of the jobber or for the superlative profits which he is *supposed* to make Nevertheless, the jobber performs an economic function of first importance, his business is to *make* a market in any stock or share in which he is accustomed to deal by holding himself ready *in all reasonable circumstances* to quote prices either for buying or selling He must be prepared to take the ordinary business risks involved in buying at a reasonable market price stock which he does not want, and in selling other stock which he may not possess

The fact that a jobber "makes a price" does not mean that the quotation is dependent upon his whim or fancy Like any other price, the price of a stock or share depends mainly upon supply and demand It may be unduly raised or lowered by the operations of people dealing in the shares, but, as a rule, the jobber is not among these, and he is just as likely to lose money by reason of these operations as is any member of the public

But the jobber's willingness in ordinary circumstances to buy or to sell without knowing in which direction the man who comes to him wants to deal, offers a valuable "buffer" to the violence of rises and falls in the prices of stocks His province, in short, is to *find* stock with which to supply purchasers, and, as a necessary sequel, to *discover purchasers* who wish to take stock which is offered

"The essential functions of the jobber closely resemble those of a merchant As a specialist, he is expected to have more than ordinary knowledge of the limited range of 'wares' in which he deals He should be in a position to keep, in his 'warehouse,' a sufficiently varied and extensive 'stock' of those wares to satisfy the reasonable demands of his customers, or, if necessary, occasionally to provide a 'line' which he may not possess at the moment, but may be able to obtain before the date of delivery When trade is temporarily slack, he must be able and willing to carry an abnormally large 'stock,' which would otherwise press damagingly upon the market."[1]

"Outside" Brokers.

Outside brokers are not admitted to the London Stock Exchange, but they are not debarred from transacting business through the members Some of these outside firms are legitimate houses with

1 "The Function of the Jobber," *Economist*, 4th January, 1930

managers who have been members of the Stock Exchange but who have come out because they prefer to be free from the arbitrary rule of the Committee, and are free to advertise, which members are prohibited from doing Other outside brokers are frequently nothing more than "bucket shops," engaged not in the legitimate purchase or sale of shares, but in placing worthless shares, and in carrying on a betting business with the speculative public by paying or receiving differences in the prices of shares that have never in fact been bought or sold

Stock Exchange Securities.

There are three principal forms of Stock Exchange securities. stocks, shares and bonds

STOCK may represent a loan to the issuing body, or it may have been created by the conversion of fully-paid shares In either case, it differs from debentures and shares in that it can be sold in any quantity irrespective of any particular unit Whereas a share must be sold in its entirety or not at all, £100 stock can be sold in fractions, *e g*, of £37 10s and £62 10s Sometimes stock is subject to special regulations which prohibit its transfer except in certain units, such as £1 or £5, but in the case of shares or debentures such regulations are unnecessary With a few exceptions, stock is either *registered* or *inscribed*, terms which are explained in Chapter 18

SHARES are the right of a member of a company to a share in the profits of the company, and on the dissolution of the company to share in the assets after all loans and other debts have been paid A share certificate is a declaration by the company that the person to whom it is issued is the registered shareholder entitled to the shares included in the certificate, and that the amount stated to have been paid up thereon has actually been so paid Shares are usually "registered," but they may be "inscribed," or they may be evidenced by a share warrant which certifies that the "bearer" is the owner of a specified number of shares

The holder of bearer warrants can transfer complete ownership in the shares specified therein merely by handing the documents over to a purchaser or other person In such circumstances it is clear that the company cannot be aware of the names of the holders of its share warrants at any particular time, and it cannot therefore send the dividends (*i e*, the shares of profits) to the owners when they fall due, as it is able to do in the case of registered or inscribed securities To provide for this, the documents (which are called "bearer scrip") have attached to them sheets of small "coupons," which must be cut off when dividends are due and sent to the company's office (or bank) for payment (as a rule after three clear days for inspection) to the person

on which they are to be presented for payment, it is usual to notify the holders of share warrants by advertisement in the press that a dividend has been declared and that it will be paid on presentment of a coupon bearing a specified number

BONDS always represent a debt, never a member's right They are nearly always made payable to bearer, but are occasionally registered and may be inscribed

The Stock Exchange Official List.

The Stock Exchange Official List is published daily by the Committee of the London Stock Exchange and gives the prices of a wide range of stocks and shares Two prices are quoted for each security, the lower being the price at which a person desiring to sell could probably sell, the higher the price at which a buyer could buy In another column is given *either* a list of the various prices at which dealings actually took place during the previous business day, *or* the price quoted for the security in the last transactions therein and the date of such transactions

On the London Stock Exchange, securities are nearly always quoted at what are called "*flat*" *prices*—that is to say, the securities are bought including all accrued interest or dividend Thus, although securities may be bought only a short time before a half-year's interest is due, the purchaser will be entitled to receive the whole of that half-year's interest from the company (or government, etc) In such circumstances the purchaser is said to buy the security "*cum dividend*", or "*cum-div*"

A short time before dividends are due (generally about a fortnight) companies close their books and will not accept for registration any further transfers of the securities until the dividends have been paid A person who buys during this period will not therefore be registered as owner when the dividend is paid, so the company pays the dividend to the seller, from whom the buyer or his stockbroker must obtain payment A few days after the closing of a company's books in this way, and on and after a date shown in the Official List, prices of the security concerned are quoted "*ex dividend*", "*ex div*" or "*x d*", *i e*, without or excluding the dividend recently accrued, indicating that the buyer is not entitled to the dividend, which remains the property of the seller

In the case of a few securities, notably National War Bonds and India Rupee Paper, which are specially marked in the Stock Exchange Official List, prices are quoted "*firm*"—that is to say, the buyer has to pay, in addition to the quoted price, the proportion of interest accrued to date since the last interest payment In the United States and certain Continental countries prices are generally quoted firm except

for ordinary stocks and shares, on which, of course, the dividends vary from time to time and cannot therefore be forecast or apportioned with certainty

Method of Dealing.

The method of dealing on the London Stock Exchange is as follows A broker who has an order to execute on behalf of a client approaches a jobber, known to deal in the stock or shares concerned, and asks him for a price for a given quantity or number The jobber quotes two prices, one at which he will buy and the other at which he will sell If the quotation is satisfactory, the broker closes at the price for the transaction, and the jobber is bound to abide by his quotation, even though he may suffer loss before settlement is effected The broker forwards to his client a signed and stamped "Contract Note," specifying the price of the stock or shares, charges for commission, stamps and transfer fees, and indicating the total amount due to or payable by the client All bargains are quoted on the basis that they will be settled for at the next Stock Exchange "*Settlement*"

"Bulls" and "Bears."

Persons who buy stocks on account "for the rise" are called *bulls*, they buy, not with the intention of holding stocks or shares purchased, but in the hope of selling at a higher price before the end of the account or settlement On the other hand, those who sell stocks which they do not possess in the hope of buying later at a lower price are called *bears*, their object is to force down prices, whereas bulls operate to force up prices

The Settlement.

This name is applied to certain specified dates on which Stock Exchange transactions must be completed by delivery of securities and payment of cash Twenty-four settlements are fixed in each year, and the interval between them, known as an "*Account*," is usually a fortnight, although it is occasionally three weeks Each settlement comprises four days, the first of which is known as

CONTANGO DAY, when the parties to a transaction must decide whether the bargain is to be completed or held over till the next settlement in those cases where it is not desired to pay over the money or to deliver the securities

Contango is the name applied to the interest for the period of postponement which must be paid by a buyer who does not wish to take up the securities purchased by handing over the necesssary money

Backwardation is an allowance by way of interest which has to be made by a seller who for any reason cannot deliver the security he has sold

TICKET AND INTERMEDIATE DAYS are the second and third days of the Settlement, when "tickets" for the stock are delivered by the seller to the buyer, and the names of the actual buyer and seller are determined and disclosed so that certificates and transfers may be made out in the proper names

SETTLING DAY is the last day when payments are finally made, either for completing the transactions or for carrying over the bargain to the next settlement

The Economic Function of the Stock Exchange.

The Stock Exchange fulfils an essential economic function in providing an efficient and highly organised market for *invested* capital (as distinct from the market in *new* securities) in which the securities representing capital invested either at home or overseas can be easily graded, transferred, rearranged and realised The stock market renders securities of all kinds readily acceptable and available as cover for loans, and so contributes very essentially to the productive power of the capital available within the community Since the market is subject to rigid rules and is pervaded by a high standard of commercial morality, the facilities which it provides encourage saving, investment and the flow of new capital into production They bring great numbers of people into business relationship, and the trend of business on the market has important repercussive effects throughout the community

To a very considerable extent, the Stock Exchange, by providing a free market in stocks and shares, *facilitates their purchase and sale at true values* A security may be said to be quoted at its true value when it stands at a price which reflects its dividend or interest-earning capacity, due allowance being made, of course, for the risks involved and future prospects For example, if a stock yielding 5 per cent is quoted at 100, another stock, similar in every respect except that it yields 4 per cent , should be quoted at 80, otherwise one or other of the stocks is not at its "true" value

A stock at its true value is often said to be *fairly-valued* , stocks or securities quoted below their true values are said to be *under-valued* , those quoted above their true value are *over-valued*

There is much that is true in the oft-quoted saying that "A stock is worth what it will fetch" But the tendency is not more than a broad one and it works out only in a rough way It pre-supposes perfect knowledge of the influences which affect the value of securities on the part of investors, and that those who buy and sell securities do so only

on the basis of this knowledge. Such assumptions do not hold good in practice, because many investors are ignorant or ill-informed; there is much dealing solely for snap gains, while false rumours are often circulated and movements in either direction, upwards or downwards, are often considerably "over-done." The stock markets, probably more than any other organisation in the economic sphere, illustrate only too well the tendency of men to "flock like sheep." When optimism prevails, the market is all one way. Bullishness reigns and prices soar. When pessimism is rampant, sellers predominate and the collapse in prices is greater than is justified by the intrinsic value of the securities.

CHAPTER 10

THE BANKERS' CLEARING SYSTEM.

WITH the extraordinary development of joint stock banking and the wide use of cheques for everyday payments, it soon became evident that some organisation was necessary for the settlement of the great number of claims and counter-claims arising between the banks throughout the country This organisation took the form of a system of *clearings*, whereby the claims of each bank on the others are quickly and conveniently settled by a process of cancellation or set-off Such claims arising between banks in the same town are easily adjusted by the conduct of purely *local clearings*, but the cancellation of claims between widely separated banks and groups of banks called for a more elaborate organisation which gradually developed into the present Clearing System, having its headquarters at the London Clearing House in Post Office Court, Lombard Street, E C

English Local Clearings.

Local clearings in England and Wales are conducted between the banks in all towns where more than one bank is represented with the object of conveniently exchanging cheques drawn by their respective customers and other mutual claims In the majority of towns, the clearings are conducted without any formality at one or two fixed times during the day, when clerks from the various banks meet at one of the bank offices to exchange their claims (called " Bundles of Charges ") on each of the other banks for claims on their own banks The totals of the respective claims are agreed, and, at the end of the day, the net balance owing to or by each bank is settled in accordance with recognised arrangements by a transfer between the head offices concerned

In certain provincial centres,—Birmingham, Bradford, Bristol, Hull, Leeds, Leicester, Liverpool, Manchester, Newcastle-on-Tyne, Nottingham and Sheffield,—specially organised *clearing houses* exist for the convenient carrying out of these exchanges, in which case the principal local branch of each bank acts as a local clearing agent for all branches of that bank in the clearing area, receiving from those branches cheques drawn on all other banks for exchange and distributing among the branches cheques drawn thereon and received from the other banks Each branch is debited or credited through the head office with the

amount due to or payable by it, and the net balance owing to or by each bank in respect of the local clearing is settled by transfer through the Clearing House Account at the local branch of the Bank of England

A collecting banker must present local cheques for payment not later than the business day following that upon which the cheques are received As a general rule, such cheques are presented wherever it is possible on the day of receipt, but cheques which are received too late for presentation on that day must not be held over longer than the following day

Omission by the collecting banker to present and collect local *crossed* cheques in accordance with the recognised customs governing the local exchange will amount to negligence sufficient to deprive him of the protection afforded by Section 82 of the Bills of Exchange Act, 1882 (Chapter 24) But it rests upon the party seeking to hold the banker liable to prove that the recognised practice has not been followed

The London Clearing House.

The great majority of cheques drawn on English banks are now presented and collected through the London Clearing House This clearing was originally established in 1775 between the London private bankers, and it was not until 1854 that the joint-stock banks, who are now the only members, were admitted

The general principle of the clearing is that cheques and certain other items payable at the City offices and branches of the ten English clearing banks are brought into one central depôt where they can be conveniently exchanged and set-off by the respective head offices Settlement of the "differences" owing to or by each bank on balance is effected by transfers between the clearing bankers' accounts at the Bank of England

Since most commercial transactions in this country are now settled by cheque or bill of exchange, the number of instruments which pass through the Clearing House, and the totals of the transactions therein, reach stupendous figures during the course of a year Nevertheless, the clearing system works with almost unerring precision, thanks both to its efficient organisation and the use of specialised machinery, and it not only effects great economy in the work of the banks, but also permits commercial transactions to be settled with a minimum of expense and delay

The London Clearing House originally dealt only with cheques payable in the City area, but it is now divided geographically into three sections (*a*) *The Town Clearing*, which embraces all banks in the central London or City area around the Bank of England, and therefore includes the head offices of most of the banks, (*b*) *The Metropolitan Clearing*, embracing all banks and branches outside the

town clearing, but within a radius of about four miles, and (*c*) *The Country Clearing*, which was established in 1858 and covers those branches and correspondents of the English clearing bankers which are outside the range of the other two collections

The Country clearing deals only with *cheques*, but cheques, bills, and other claims are collected through the Town and Metropolitan clearings. For convenience in sorting, and in order to avoid confusion, cheques belonging to the three groups are distinguished by the letters "T," "M," or "C" printed in the left-hand bottom corner

The Town Clearing.

Two town clearings are held daily The morning clearing deals primarily with cheques and bills drawn upon the town offices of the respective clearing banks, which have been received by the morning post from home and foreign branches and correspondents, or which were received at the City offices on the previous day too late for presentation through that day's Town clearing The larger afternoon clearing covers cheques and bills received at the various City offices of the clearing banks during the day, and also items received from Metropolitan and suburban branches for special presentment

The cheques and bills on other London banks which each head office receives from its branches are listed by the latter on separate sheets for each clearing bank These lists are agreed by the head office Clearing Departments on receipt, and their totals are machined or entered in a special "Out-Clearing Book" under the names of the respective banks, a grand total of the charges to be presented to each of the other clearing banks being thus obtained

These cheques and bills—referred to as the presenting bank's "Out-clearing"—are taken to the Clearing House by the "out-clearing" clerks, by whom they are sorted according to banks and handed to the "in-clearing" clerks of the banks concerned The items which each bank thus receives from all the other banks are collectively described as that bank's "In-clearing," and, upon receipt, the amounts are machined and the totals relating to each bank verified with the total supplied by that bank's "out-clearer" These totals are then carried to the settlement sheet in the manner described below.

The cheques received by each "in-clearer" are taken to the relative head office for sorting and despatch to the various City offices upon which they are drawn Any returns must reach the Clearing House before 5 p m on ordinary days or 1 30 p m on Saturdays, and must be received by the clearers and their amount credited to the returning bank on the same day by an adjustment on the Town clearing sheet If returns are received too late for inclusion in the clearing, they must be despatched at once to the banks named in the crossings.

The Metropolitan Clearing.

This deals with cheques drawn on the Metropolitan branches of the clearing banks The cheques are exchanged between the representatives of the various banks, and are thereafter despatched to the relative branches upon which they are drawn for payment or return Metropolitan cheques for any reason returned unpaid must be returned by post on the day of presentation *direct* to the bank or branch whose name appears in the crossing The totals owing to or by each bank in respect of the Metropolitan clearing are included in the Town clearing totals of the following business day

The Country Clearing.

The Country clearing deals with the exchange of cheques received by the head offices of the eleven clearing banks from their country branches and correspondents The branches list all country cheques of each of the other clearing banks on separate sheets, the totals of which are machined at the head offices on special lists in order to arrive at a grand total of the "Out" charge to be presented to each of the clearing banks The "In" country clearing received by each bank from all the other banks is sorted and machined at the relative head office, and the cheques of each branch are thereafter forwarded by post for payment or return The totals of the country clearing are agreed between the "In" and "Out" clearers of each bank, and a grand balance is struck as between each bank and all the other banks, which is included in the Town clearing settlement of the next business day but one

Country clearing cheques which are for any reason returned unpaid must be sent *direct* by the drawee branch to the branch of the presenting bank indicated in the crossing on the face of the cheque, a voucher giving the necessary particulars being forwarded on the same day to the head office of the drawee banker so that the amount may be allowed for in the settlement The branch to which the unpaid cheque is returned credits the amount to its head office or its clearing agent on the day of receipt, so that the head office or clearing agent may in due course credit the drawee banker in respect of the return

Since bills of exchange on country branches cannot be included in the Country clearing, they must be presented direct through a branch or agent in the town of payment.

The Clearing Settlement.

The grand totals of the morning Town clearing are agreed between each bank before the clearing clerks leave the Clearing House The afternoon clearing proceeds until the door of the Clearing House is

closed at the appointed time, when the total of the cheques presented in the second clearing is ascertained and verified, and the balances which are owing to or by each bank are carried to a *Clearing Summary Sheet*

On this sheet is entered also the balance of the Country clearing for the previous day but one, together with the balance of the Metropolitan clearing for the previous day, allowance for returns having been made in both cases When the two columns of this sheet are totalled, the difference between the two totals gives the amount owing to or by each bank from or to the Clearing House as a whole, and this difference is settled by a transfer at the Bank of England between the account of that bank and the Clearing House account

Collection of Cheques on Offices of the same Bank.

Cheques upon the head office of a joint-stock bank which are received by its branches for collection are listed separately by the receiving branch, settlement being effected directly between the head office and the branch by transfer in the head office accounts

As a rule also a special *Branch Clearing* exists for the collection of cheques drawn upon its various branches and received by other branches of a joint-stock bank Each branch forwards all cheques drawn upon other branches of the same bank to the head office, where they are sorted and forwarded for payment to the branches upon which they are drawn Settlement is effected by transfer between the relative branch accounts in the head office ledgers, cheques returned unpaid being forwarded direct to the crossing branch, and the amount thereof debited or credited in the accounts of the relative branches

Collection of Cheques, etc., on Banks outside the Clearings.

Cheques and bills on the many banks, discount houses, etc , which have offices in the City, but which are not members of the Clearing House, are described in practice as "*Walks*," by reason of the fact that they are collected individually by "Walks" clerks whose business it is to make a round of the City from the respective head offices The items to be collected in this way are listed by the various branches and correspondents of the banks on special "Walks" Clearing forms, and settlement of the totals involved are made between the banks either by transfers in their accounts or by bankers' payments which are passed through the town clearing for payment

Cheques, dividend warrants, interest warrants and bank post bills on the Bank of England are dealt with by other banks in much the same way as 'Walks" The totals of such items received by the clearing

banks from their branches and correspondents are recorded by the respective head offices in the *Bank of England Book* or *Goldsmiths' Book*, together with any other articles which it is proposed to pay in to the Bank, as, for example, surplus or defaced Bank notes, gold and silver coin, etc The articles are thereafter presented direct to the Bank, and their total, after verification, is credited to the account of the presenting bank The Bank of England itself presents cheques on other banks through the Clearing House in the ordinary way in other words, the Bank clears "outwards" but not "inwards"

Items Drawn on Scotch and Irish Banks.

Cheques and bills drawn upon the London offices of Scotch and Irish banks are collected by individual presentation at the offices of the drawee banks much in the same way as "Walks" cheques, and settlement is effected either by banker's payment or by current account transfers

Cheques and bills drawn upon the offices of Scotch and Irish banks in Scotland and Ireland are listed by the collecting branches of the English banks on special forms, and are thereafter forwarded to the respective head offices as part of the day's clearing After machining, the articles are forwarded by the head office of each English bank for collection and credit to the London office of the Scotch or Irish bank which acts as a clearing agent in its own country on behalf of the English bank

Cheques and Bills Payable at Bank Offices in Scotland.

The articles so received by the London office of a Scotch bank are sorted into three groups (*a*) Articles payable at its chief offices in Edinburgh, Glasgow, Aberdeen or Dundee, or payable at the offices of other banks in these four cities These are sent to the office of the bank in the city concerned for payment or collection (*b*) Articles payable by the bank's own branches or by branches of other banks in towns where the collecting bank has a branch These are sent by the agent to its various branches for payment or collection (*c*) Articles payable in towns where the collecting bank has no branch These are listed upon separate lists according to the bank upon which they are drawn, and are forwarded to Edinburgh to be passed through the Edinburgh Clearing House to the principal offices of the drawee banks.

The Edinburgh Banker's Clearing exists for the exchange of cheques between the respective Scotch banks, and although the mode of settlement differs considerably from that in London, the essential method of clearing is the same

Cheques and Bills Drawn Upon Bank Offices in Ireland.

Cheques and bills payable in the Irish Free State or in Northern Ireland are dealt with by the London banks in much the same way as they deal with articles payable in Scotland The articles received by each clearing bank from its various branches and from its City office are machined at the head office and presented to the London office of the Irish Bank, which acts as clearing agent on behalf of the English bank To these cheques, etc , are added any Irish cheques and bills received by the London office of the Irish bank, and thereafter the various articles are sorted into a number of groups according to the method of collection which is adopted

As there are in Ireland two distinct central clearings, one at Dublin for the Irish Free State and one at Belfast for Northern Ireland, at least six distinct groups are required, and these may be as follows (*a*) Cheques and bills payable in and around Dublin , (*b*) Articles payable at towns in the Irish Free State where the collecting bank has an office , (*c*) Articles payable at towns in the Irish Free State where the collecting bank has no office , (*d*) Cheques and bills payable in and around Belfast , (*e*) Articles payable in towns in Northern Ireland where the collecting bank has an office , and (*f*) Articles on towns in Northern Ireland where the collecting bank is not represented

All articles payable in Dublin and Belfast are forwarded to the office of the clearing bank for collection through the Dublin or Belfast Town Clearings, while those payable at towns in the Irish Free State or Northern Ireland where the clearing bank has *no* branch are sent to its Dublin or Belfast office for collection through the Dublin or Belfast Country Clearing The articles payable in provincial towns at which the clearing bank has a branch are usually sent direct to the respective branches for payment or collection

The Collection of Articles received at Offices of the Scotch and Irish Banks.

Cheques and bills on English *clearing* banks received at the London offices of Scotch and Irish banks are collected through the clearing agents of the latter banks, but items on *non-clearing* English banks are presented direct Cheques received by the London offices of the Scotch and Irish banks on banks and branches in Scotland and Ireland are remitted by them for collection in the manner already described

In the provincial towns of Scotland and Ireland local clearings exist between the various banks as is the case in England, but in addition, it is usual for the branches of each bank to exchange with other banks in the same town articles drawn upon the respective head offices of provincial branches, the branch thus receiving cheques being responsible for forwarding them for payment either to its head office

or direct to the branches concerned. In Ireland, articles which cannot be cleared in this manner because no local branch of the relative bank exists, are forwarded for collection through the Dublin or Belfast offices of the collecting branch, according to whether the cheques are payable at towns in the Irish Free State, or in Northern Ireland In Scotland such cheques are forwarded to the Edinburgh office for presentment through the clearing

Cheques and bills payable at English banks and received by Scotch and Irish banks are remitted for collection through the London office of the receiving bank, by which they are presented through a clearing agent to the head office of the English bank concerned

Time Allowed for Collecting Cheques.

In practice, City banks endeavour to present all Town clearing cheques on the day of receipt, for it is the custom to assume that all cheques paid in by customers at the City offices of the clearing banks are paid unless they are returned unpaid on the same day Accordingly, if one of the Town clearing banks is too late in presenting a cheque or cheques at the Clearing House, it is usual to present the cheque for *marking* at the bank upon which it is drawn The marking is effected by an official of the drawee bank, who writes the word " good," the date, and his initials on the cheque to indicate that it is, at the time, good for payment Such cheques are invariably paid on subsequent presentation

Cheques received by country banks are forwarded for collection on the day of receipt, and are assumed paid if they are not returned after the lapse of *three* clear days in the case of Country cheques, and after *two* days in the case of Town and Metropolitan cheques Scotch and Irish cheques usually take four or five days for presentment and payment, and it is therefore not safe to assume that they are paid until the lapse of at least a week

Any cheques which the drawee banker does not intend to pay should be returned *direct* to the crossing banker on the day of receipt, while any cheques which are received unpaid from other bankers should immediately be sent to the customer, or advice of the non-payment given to him, and the relative amount should be debited to his account.

CHAPTER 11.

THE BANK OF ENGLAND AND THE MONEY MARKET: CENTRAL BANKING.

THE relationship between the Bank of England and the London Money Market is a matter of paramount importance, for modifications in the financial arrangements which spring from that relationship have repercussive effects not only in our own country but also in all important financial centres.

The Bank of England is, of course, the most important institution in the London Money Market, exercising a predominant influence both on the transaction of business and on the rates of interest which prevail therein. As the central bank, as banker to the State and to all the other banks, and as guardian of the ultimate cash reserve of the nation, it carries responsibilities of the gravest kind, and it is necessary that its financial position should be frequently and clearly disclosed.

The Bank of England Return.

Publicity in this regard is ensured by the provision in the Bank Charter Act that the Bank must issue a weekly report or *Return* in prescribed form showing separately the liabilities and assets of its two Departments. The statement is issued on Thursday in each week after the meeting of the Bank Board of Directors, and it is of such supreme importance to all connected with banking and finance, and gives such significant indications of the state of monetary conditions generally, that it has been well described as the "Barometer of the London Money Market." An understanding of the meaning of each of its items and of their variations is, in fact, essential to a proper understanding of the working of the banking and currency system of this country. The following is a specimen of recent date:—

BANK OF ENGLAND.

Return for Week ended Wednesday, January 8, 1930.

ISSUE DEPARTMENT.

	£		£
Notes Issued—		Government Debt	11,015,100
In Circulation	362,921,772	Other Government Securities	234,083,363
In Banking Department	46,139,365	Other Securities	10,431,484
		Silver Coin	4,470,053
		Amount of Fiduciary Issue	260,000,000
		Gold Coin and Bullion	149,061,137
	£409,061,137		£409,061,137

BANKING DEPARTMENT.

		£			£
Proprietors' Capital		14,553,000	Government Securities		69,885,615
Rest		3,503,660	Other Securities—		
Public Deposits*		17,210,657	Discounts and Advances	£15,[illegible],971	
Other Deposits—			Securities	15,284,733	
Bankers	£75,701,298				30,366,704
Other Accounts	35,574,069		Notes		46,139,365
		111,275,367	Gold and Silver Coin		153,732
7 Day and other Bills		2,732			
		£146,545,416			£146,545,416

*Including Exchequer, Savings Banks, Commissioners of National Debt and Dividend Accounts

The Bank of England Return first appeared in its present form in November, 1928, when the arrangement which had previously remained unchanged since 1844 was slightly modified to meet the position created by the Bank's assumption of control of the Treasury note issue, and to meet the widespread demand for more complete information respecting the Bank's financial position How this information is gleaned from the published statement will be apparent after a consideration of the significance of each of the items

The Issue Department.

GOLD COIN AND BULLION —The stock of gold in the Issue Department represents practically all the gold in the country at the present time which is available for the discharge of obligations No other bank keeps gold in its tills, and there is now none in general circulation

NOTES ISSUED —This item represents the Bank's liability in respect of notes in the Banking Department, and in the hands of the public and other banks

The Bank's active circulation, at the date of the Return reproduced, was nearly £363 millions But since bank notes are largely held by banks and others as part of their ready cash, some proportion of the £363 millions does not actually pass from hand to hand

THE GOVERNMENT DEBT has been unchanged since 1833, and is represented by a book entry at the bank

OTHER GOVERNMENT SECURITIES and OTHER SECURITIES respectively comprise the Issue Department's holding of Government Securities (largely Treasury Bills), and other first-class securities, including prime bank and commercial bills of exchange

SILVER COIN —This now forms part of the *fiduciary* backing, and not of the metallic backing, and its amount in the Return given is less than the authorised figure of £5,500,000

The Banking Department—Liabilities.

THE PROPRIETORS' CAPITAL —Like the Government Debt, this also has been unchanged since 1833 It is represented by fully-paid stock, which earns about 9 or 10 per cent. on the nominal amount

THE REST is a general reserve of the Bank, representing the accumulation of undivided profits, and the balance of Profit and Loss Account It is never allowed to fall below £3,000,000, and its gradual increase during the year gives stockholders some indication of the profit likely to be available for distribution

PUBLIC DEPOSITS represent the sums standing to the credit of the Government Departments They vary with the collection of income tax, payment of dividends on Government stock, etc

OTHER DEPOSITS are the deposits of the Bank's other customers, including the balances of the other banks whose business is primarily domestic in character, shown separately as " Bankers' Accounts "

Movements in the item " Bankers' Accounts " afford a fair indication of the disposable funds of the Money Market, and of the trend of financial affairs Usually, Public Deposits and Bankers' Accounts vary inversely Amounts paid by the Government as dividends out of the former help to swell the latter, whereas Bankers' Accounts are decreased and Public Deposits swollen when income-tax payments begin to flow in The relation between these two items was very marked on the issue of the War Loans, for these added enormous amounts to Public Deposits at the expense of the balances of the other banks At times, however, the relation has been obscured by heavy borrowings on the part of the Government from the Bank, causing Public Deposits and Government Securities to increase together

In general, a high level of Bankers' Accounts indicates that the banks have a large surplus of unemployed funds, and is usually coincident with low interest rates and cheap money If a monetary crisis or a disturbance of credit is impending, Bankers' Accounts may rise suddenly at the same time as the Bank rate , the rise in the Bankers' Accounts indicates that bankers are strengthening their position by calling in loans or realising securities, whilst the rise in the Bank rate indicates that the Bank finds it necessary to raise the rate of interest in order to protect its Reserve, check borrowing and restrict credit

SEVEN-DAY AND OTHER BILLS are chiefly Bank Post Bills at seven or sixty days' sight issued by the Bank of England and requiring acceptance They are nowadays used mainly by persons travelling abroad and occasionally for domestic transfers

Banking Department—Assets.

GOVERNMENT SECURITIES represent the extent of the Bank's investments in British Government stocks and Exchequer and Treasury Bills. They include also loans to the Government on " Ways and Means Advances " and " Deficiency Bills," a mode of borrowing money originally used to finance Government expenditure until the tax

payments came in, and much resorted to during and after the War to tide over temporary shortage.

OTHER SECURITIES include the investments of the Bank in securities other than those under the first heading, and also advances to bill brokers and its customers other than the State

Other Securities are sub-divided into "*Discounts and Advances*" and "*Securities*", and the sub-division makes it possible to form a clearer idea of market indebtedness "Discounts and Advances" are increased when the market borrows from the Bank, *i e*, when loans are taken or when bills are discounted *on the market's initiative* On the other hand, when the Bank buys bills *on its own initiative* as part of its open market policy, the increase appears in "Securities"—in "Government Securities" when it consists of Treasury Bills and in "Other Securities" when it comprises commercial bills

A rise in Other Securities coincident with a rise in Bankers' Accounts is generally evidence that bankers are strengthening their position This drives market borrowers to the Bank for accommodation (in which event the market is said to be "*in the Bank*"), thus causing an increase in Other Securities to coincide with an increase in Bankers' Accounts through the accumulation of funds in the hands of the banks

The Bank of England Reserve.

The last two items on the assets side of the statement of the Banking Department, amounting to about £46 millions in the Return given above, are probably the most significant of all, as they represent what is known as the *Bank's Reserve* This must be clearly distinguished from the stock of gold held by the Issue Department, for the latter is held and appropriated solely to redeem the notes in circulation and the notes which are held by the Banking Department

Gold is withdrawn from the Bank for export and other purposes by obtaining some of these notes from the Banking Department, either by drawing against an existing deposit or by obtaining an advance against securities, the notes being thereafter exchanged for gold at the Issue Department

In times of stress the Reserve has in this way been almost exhausted and the Bank has been compelled to obtain from the Government an Order in Council empowering the Issue Department to increase the fiduciary issue, and so issue further bank notes against securities in order to replenish the Reserve in the Banking Department

In pre-War days the Reserve was maintained at about 45-55 per cent of the total liabilities, but during and since the War the proportion has varied considerably In the Return quoted above, the proportion stands at about 36 per cent, considerably below the pre-War figure

The item Bankers' Accounts on the liabilities side of the Return consists to a large extent of that item which is described in the balance-sheets of the banks as "Money at the Bank of England" Now, in calculating the ratio of their cash on hand to their liabilities, the banks treat their funds at the Bank as *cash*, but the Bank Return shows that "Other Deposits" are treated by the Bank as an ordinary liability, and no special cash reserve is set aside to meet the demands of the banks for repayment As the ratio of the Bank's Reserve to its liabilities stands, in the specimen Return, as low as 36 per cent, only about one-third of the bankers' "Money at the Bank of England" is represented by bank notes or coin, and of this 36 per cent about two-thirds are backed by securities in the Issue Department It follows, therefore, that of the bankers' "Cash at the Bank of England," totalling nearly £76 millions, only about 12 per cent, *i e*, about £9 millions, is represented by actual coin and bullion

The Protection of the Reserve.

The Bank of England Reserve is liable to be depleted by demands from two sources (*a*) Demands for internal requirements, and (*b*) Demands from foreign sources and for export purposes

Generally speaking, inland demands are fairly regular and periodic, as when money is required for half-yearly dividend payments, for the harvests and holidays, and so on Consequently, the Bank is enabled to make adequate and timely provision to meet these demands upon its resources, and so to maintain the proportion of its Reserve On the other hand, the liability of the Bank to a foreign drain is not only spasmodic, but also more important in its effects on the Reserve in the Banking Department

There are three recognised contingencies which may result in a serious depletion of the Reserve first, when a monetary crisis abroad causes a world-wide demand for gold and seriously affects London's position as a free gold market, secondly, under abnormal conditions, such as the outbreak of war or a failure of national credit, when the Reserve is again threatened by the foreign demand for gold and the pressure to encash the numerous foreign claims on London, and thirdly, when a heavy periodic drain for internal purposes coincides with a drain for external purposes

In any of these circumstances the Bank is compelled to resort to measures to protect its holding of gold, otherwise excessive withdrawals may endanger its financial stability and that of the country as a whole, The method usually adopted is the raising of the Bank's official rate of discount, the effect of which is to raise all other rates of interest in the Money Market, thereby attracting foreign floating balances for investment in this country (as explained in Chapter 30), restricting the outflow of gold and inducing its inflow

The Influence of the Bank Rate.

The Bank rate is ordinarily effective as a lever for modifying rates of interest in the Market chiefly by reason of its relation to the bankers' deposit rate, which by custom is fixed at a rate of two per cent below Bank rate When Bank rate rises, depositors expect to get more for their money, and the banks, being thus compelled to pay more for their borrowed funds, necessarily attempt to recoup themselves by charging higher rates of interest for loaning that surplus money which, as we have shown, forms the bulk of the short loan fund on the Market Further, the bill brokers and other market borrowers, who have thus to pay more for loans, increase their own charges for discounting bills and making loans So in ordinary circumstances, the Bank is enabled to raise interest rates, not only in the London Market, but also in the country at large

Conversely, a fall in the "official minimum" has usually the effect of reducing rates of interest both on the Money Market and in the country at large

But the influence of the Bank rate is by no means absolute The Bank of England, as the authority responsible for monetary policy in this country, may consider it desirable to bring about a contraction of credit by decreasing borrowing and encouraging saving through a higher rate of interest, but its action in raising the Bank rate may not be followed by an all-round rise in rates on the Money Market and elsewhere

A rise in Bank rate is most effective when money is scarce, for then lenders are anxious to make the best of the shortage in the supply of loanable capital and to get as high a rate as possible for their advances, while borrowers are frequently compelled to resort to the Bank for such accommodation as they require, obtaining it, of course, on the Bank's own terms When, however, supplies of money are plentiful, the effectiveness of the Bank rate is less marked, for at such periods the banks and other lenders endeavour to get whatever they can for their surplus funds, with the result that competition between them keeps down their rates for loans

Movements in the Bank Return.

It will now be understood why the appearance of the Bank Return is eagerly awaited by the London Money Market, and why its weekly figures are carefully scrutinised by bankers and other members of the financial world whose business is intimately concerned with the lending and borrowing of money The trained eye can appreciate at once the significance of any important changes in the figures, and can discriminate between periodical fluctuations and those abnormal movements which are likely to affect the supply of floating money and so to react on financial conditions generally

The supply of money on the market depends chiefly on any factors which combine to influence the amounts deposited with bankers, such as trade conditions, the political and industrial outlook, foreign affairs, the prospects of peace or war, the state of the foreign exchanges, and the general state of credit both at home and abroad These are contingent or unforeseen causes, but there are certain periodic or regular influences

Regular Influences on Market Supplies of Money.

The Market expects to find considerable changes in the totals of " Public Deposits " and of " Other Deposits " at the end of each quarter, for the payment of the heavy dividends on government stocks (and especially upon the loans raised during the Great War) results in considerable transfers from " Public Deposits " to " Bankers' Deposits," thus increasing the surplus funds of the banks and causing rates of interest on the Money Market to fall or to " ease," as it is technically termed On the other hand, contrary influences are at work in the March quarter and in July, when the payment of income and other taxes causes heavy transfers to be made from " Bankers' Deposits " to " Public Deposits "

Again, the Market has learned to anticipate each half-year the effects of the so-called " window-dressing " operations of the banks, whereby they endeavour to present a strong position in their balance-sheets by calling in part of their loans at short notice and thereby increasing their balances at the Bank of England Such operations tend to reduce the supplies of floating capital, causing interest rates to harden and forcing market borrowers to resort to the Bank for accommodation, which, on being granted, is followed by a rise in Other Securities

Finally, there are the regular Autumn influences At this season, trade is brisk and extra money is required for harvesting wages and for paying for imports of cotton and corn from N America The result is that the Bank Return reflects the demand for currency for both home and foreign payments

In addition to the foregoing, experienced financiers can forecast, with a fair degree of accuracy, the effect on the Bank Return of such important factors as the issue of a great war loan (when Public Deposits are swollen by the millions received from public subscriptions) or the payment of a large instalment of war debt and interest by the British Government to our American creditors Expected movements of this kind, or the periodical fluctuations which we have described, are regarded with equanimity since future arrangements can be made with due regard to the anticipated effects upon market conditions generally.

Unexpected Factors affecting Monetary Conditions.

Frequently, however, the appearance of the Bank Return is the first intimation received by the Market that anything unusual has taken place or that unexpected monetary conditions are likely to prevail. The figures in the Return may be the Market's first warning of a heavy fall in the "proportion" of the Bank's Reserve to its outside liabilities, and dealers may not be entirely prepared for the stiffening of interest rates which may be expected to ensue

In a similar way, a marked increase in the "proportion" of the Bank's Reserve may result in a period of monetary ease which may not have been anticipated in view of the prevailing conditions As a general rule, a high level of Other Deposits indicates that the banks have a surplus of unemployed funds, and is usually a precursor of low interest rates and "cheap money" Occasionally, however, a sudden increase in Other Deposits accompanies a rise in the Bank rate and in the total of Other Securities, factors which apprise the Market that for some reason the banks find it necessary to strengthen their position by calling in loans, thus forcing market borrowers into the Bank, causing Other Securities to rise and inducing the Bank to stiffen rates of interest in order to decrease borrowings and protect its Reserve

Unexpected movements of this kind naturally result in a considerable disorganisation of market arrangements, and when it is realised what vast sums are lent and borrowed on the Market at extremely fine rates involving only a very small margin of profit, it will be readily appreciated that the appearance of the Bank Return is often the signal for an immediate adjustment of commitments

General Effects of Changes in Discount Rates.

Changes in discount rates are of first importance, because they lead to considerable changes in the quantity of credit instruments which are issued and brought forward for discount, and because they influence the demand for and the supply of loanable capital.

On the one hand, high charges for accommodation discourage fresh borrowing, while those who have already borrowed endeavour to reduce their commitments The consequent reduction in the volume of credit, including bank money and credit money, causes a general fall in the level of prices Speculation on borrowed money is discouraged, for high rates of interest reduce the possible margin of profit and make speculative enterprises less attractive Consequently, the prices of stocks and shares tend to fall as a result of realisations by those who carry speculative positions Moreover, since the raising of the Bank rate forces up the general level of interest rates, the necessity of adjusting the yield of fixed-interest bearing stocks to this higher level brings about a fall in their value The same effect is seen in the case

of more speculative stocks, such as industrial securities, but here the fall is accentuated by the decrease in speculation on borrowed money and by the realisation that high interest rates must curtail enterprise, damp down business activity and reduce profit margins Added to this is the fact that the general opinion of the business world that a rise in the Bank rate causes depression in industry has a psychological effect upon the genuine investment demand for industrial securities

On the other hand, fresh lending is encouraged by high rates because bankers and capitalists obtain a higher return, and so endeavour to arrange new loans as well as renewals of existing advances Merchants and bankers in other countries are more content to leave money in this country, and are also prepared to extend any credits they may have granted, they may even send money here for investment The raising of the rate of discount makes commercial bills cheaper to buy, and consequently induces investment therein, particularly by foreigners Higher bankers' deposit rates attract deposits and encourage saving, while the general eagerness to lend money results in less being spent on commodities, and so accentuates the fall in prices

This position is further aggravated because business men who trade on borrowed capital endeavour to realise stocks even at lower prices The general decline in the value of commodities discourages imports but encourages exports, because the country is a good market in which to buy, but a bad market in which to sell Finally, the attraction of funds to this country for investment and the tendency for exports to exceed imports influence the foreign exchanges in favour of this country and tend to attract imports of gold In this way the Bank Reserve is increased and the position of the Bank of England as the cornerstone of Britain's finances is safeguarded

The lowering of the rate of discount is followed by reverse effects, but it should be noted that the explanation given above is general Foreign investment in this country is not likely to be encouraged if interest rates here are not raised as high as they are abroad, money —other things being equal—tends always to flow to the best market Nevertheless, London's position in the international market is so supreme, and her investment facilities are so unrivalled, that the prevalence of high rates in her market is sufficient as a general rule to induce the flow of foreign capital into this country

The Bank's Open Market Policy.

In the Money Market, as in any other market, the rate or price charged for the commodity, money, depends essentially upon the relation between the supply and the demand, and no artificial lever such as the raising or lowering of the Bank rate can be relied upon always to operate effectively in the face of opposing economic tendencies

In such circumstances the Bank has to adopt other measures to influence market rates, and its usual plan is to resort to what is known as its "open market policy" This means that the Bank enters the open market as a large borrower or lender, in the former case reducing supplies of floating money on the Market by borrowing the surplus itself, against the security of Government stock, and, in the latter case, lending funds in order to increase supplies and so bring about conditions of greater ease

Frequently the Bank of England resorts to such operations in the open market in order to *obviate* a movement in its rate of discount, and thus avoid, so far as is possible, those disturbing effects on the national economy which inevitably follow changes in interest rates Indeed, it may be stated that the Bank is not now so much concerned with the state of its reserve (provided this is within reasonable limits) as with the level of prices, and its operations on the open market are accordingly directed in the interests of stability By buying and selling securities, or by borrowing and lending, the Bank secures a much finer control of credit than by arbitrarily raising or lowering its discount rate Hence, while the Bank rate still remains the basis of the other rates on the Market, its movements are far less frequent and violent than they used to be Quite recently, too, there has been evidence that rates have been maintained simply by arrangement between the Bank and financial interests in the City, *i e*, by an unofficial agreement between the Bank of England and the Market to keep rates of discount as nearly as possible at a predetermined level

The Influence of Government Borrowings.

Since the War the British Government has exerted a profound influence on money market conditions by reason of the enormous sums it has borrowed to cover its temporary needs, mainly by the issue of Treasury Bills, which are instruments signed by the Secretary of the Treasury entitling the bearer or a named payee to payment of a specified sum of money from the Bank of England on the expiration of a given period, usually three months Since these bills are backed by the credit of the whole nation, they represent the finest possible security They are held in the main by the banks, and constitute a very large part of their holdings of short term investments

As a rule, tenders are invited for these bills by advertisement in the *London Gazette*, and allotments are made to those who offer the highest price per cent, *i e*, the lowest rate of discount At times the system of sale by tender is suspended, and bills are allotted to applicants at fixed rates At other times, "additional" bills are obtainable through the Bank of England at what are known as "tap" rates, *i e*, the bills are available "on tap" (as and when required) at rates slightly less than the average rate tendered for the bills allotted in the previous week

As the amounts allotted each week are considerable, the issue of these bills must obviously exert a considerable influence on monetary conditions by absorbing a large proportion of the market surplus of floating money When Treasury Bills are offered for sale by tender, the rates at which they are discounted will depend upon prevailing market rates, and only within comparatively narrow limits can the Treasury modify market conditions If the Treasury desires to bring rates *down* it will issue Treasury Bills to an amount considerably below the amount about to mature There will then be more money flowing to the Market from the maturities than will be absorbed by the new issue Money will be plentiful and market rates will fall In the meantime, the Government will finance itself, if necessary, by Ways and Means Advances from the Bank of England If reverse conditions prevail, and the Treasury desires to force rates *up*, it will issue more bills than can be absorbed by the money flowing into the Market as the result of current maturities Market funds will consequently increase, and discount rates will tend to ease

The influence of the issue of Treasury Bills on market conditions is least pronounced when liquid funds are markedly scarce or plentiful, for then the Market tends to move independently of both the Bank and the Treasury When funds are scarce, the competition of borrowers may force rates farther than the authorities desire , on the other hand, when funds are plentiful, the competition of lenders keeps rates at a lower level than the Treasury and the Bank may think best In such circumstances, the Bank may think it wise to fortify the Treasury bill rate by resort to its open market policy

The Control of Credit.

We have seen that the business of banking has been founded on the knowledge, gained by experience, that credit may be created by the banker to an amount several times greater than the amount of the cash reserve which he sees fit to maintain The old English private banks created credit when, on the strength of their reputation, they issued notes both to depositors and to borrowers and placed no limit on such issues other than that imposed by each banker's conscience and his fear of a " run " Our modern joint-stock banks do not issue notes, but by the development of the cheque and of the central reserve system they have made possible a remarkable economy in the use of gold and the erection of a vast credit superstructure on a small metallic reserve

The cheque system enables a banker's customer to exchange his own limited credit for the wider credit betokened by a negotiable instrument bearing the bank's imprint. The customer's deposit becomes bank money—real purchasing power—which increases the quantity of money in circulation And it is important to remember that such bank

money may be issued, not only against an actual deposit, but also through the making of a loan by the banker to his customer whereby the customer is enabled to issue bank credit in the form of cheques in favour of third parties, who, in turn, may place the amounts on deposit with the right to issue cheques thereagainst For this reason, it is frequently stated that " every new loan or purchase by a bank creates an equivalent deposit, thus increasing the quantity of money "

Is there a Traditional Ratio of Cash to Liabilities ?

Yet the power of the banks to add to the volume of credit is not unlimited The banks will and must cease to create credit at the point where the proportion of their cash to liabilities reaches the figure which is sometimes described as a bank's " traditional " ratio But while there may be a minimum below which the banks would not let this ratio fall, it requires little demonstration to show that the banks, in this country at any rate, can vary and have considerably varied the total amount of credit by altering the proportion of cash to their liabilities

Such conditions have undoubtedly resulted from the widespread amalgamations among English banks, for the policy has brought about such a remarkable concentration and economy of cash resources that deposits and advances have increased more than proportionately This important fact is indicated by the following figures showing the variation between 1914 and 1926 in the proportion of cash held by the banks in the United Kingdom —

Banks in the United Kingdom.

(EXCLUDING THE BANK OF ENGLAND)

Proportion per cent of Cash (including Money at Call, etc) to Liabilities, on Deposit and Current Account, and Notes Issued, 1914–1926

1914	1915	1916	1917	1918	1919	1920	1921	1922	1923	1924	1925	1926
29	25	30	31	29	23	22	21	21	21	22	22	22

It will be observed that between 1914 and 1926 the proportion of cash held by these banks fell from 29 per cent to 22 per cent In the same period the amount of cash and money at call, etc , *increased* from £345 million to £550 million, *i e* , by 59 per cent , but the total liabilities increased *more* than proportionately, from £1,174 million to £2,531 million, *i e* , by 116 per cent In other words, we may say that if the 29 per cent proportion of 1914 had been maintained in 1926, the total liabilities could not have exceeded £1,900 million, whereas the banks had, in fact, permitted a creation of credit to the extent of a further £630 million.

These figures afford scant evidence that the banks rigidly adhere to any " traditional " ratio of cash to liabilities, and there is little doubt

that by varying this ratio, they can exercise a marked influence on the volume of credit

At the same time, the figures for the period 1920-1926 exhibit a remarkable steadiness, and it is quite possible that a proportion of about 22 per cent will henceforward be maintained by these banks If this is the case, and we may regard the ratio as being definitely fixed, then, and only then, may we safely conclude that it is not within the power of the banks to create credit to any appreciable extent In such circumstances, their power to make further loans is governed by their ability to *secure additional cash*

It will still be true, from a book-keeping point of view, that " every bank loan creates a deposit " , but the fact which has to be remembered is that bank loans do not create *cash* When one bank makes a fresh advance, the money is almost invariably paid over to a customer either of the same bank or of another bank Hence the effect is that " Advances to Customers " on the assets side of one bank's balance-sheet are increased while " Deposits " either of the same or of another bank are increased to a corresponding extent If the advance is taken by the borrower in cash, the loaning bank's ratio of cash to deposits is to that extent decreased, so that such advances cannot continue indefinitely if the bank is to maintain its customary ratio of cash to liabilities Moreover, the amount of cash available for the reserves of all the joint-stock banks is not unlimited, so that while one bank may for a time obtain control of additional cash which enables it to increase its credit facilities, the likelihood is that another bank is being compelled to restrict its advances

Credit is Regulated through the Control of " Bank Cash."

It follows, therefore, that, *at any particular time*, so long as bank cash ratios are fixed, the power to create further credit lies, not in the hands of the banks, but in the hands of the authority which controls bank cash From 1914 to 1925 that authority in this country was the Government itself, and, until 1920, it was largely responsible for the great expansion of credit which followed the issue of treasury notes The banks were able to create credit to an unparalleled extent because the Government made available supplies of legal tender currency by the simple process of turning the handle of the printing-press The currency notes so made available found their way into the reserves of the joint-stock banks, which were not slow to take advantage of the opportunity to increase their advances and respond to the ceaseless demand of the business community for additional loans So long as additional supplies of legal tender currency were forthcoming, the power of the banks to create credit was limited only by their desire to maintain a minimum ratio of legal tender to liabilities After the adoption of

the Cunliffe Limit in 1920, the issue of treasury notes was gradually reduced, and in so far as that reduction was not counterbalanced by an increase in our holdings of gold, or by an alteration in the ratio of bank cash, it necessarily involved a corresponding contraction in the volume of credit

Under the effective gold standard which exists in this country to day, the control of credit is in the hands of the Bank of England, which, by raising or lowering its discount rate, and within narrower limits, by its open market policy, regulates the credit situation through its control of that amount of "bank cash" which is represented by the joint-stock bank "Balances at the Bank of England" When the Bank of England makes a loan, or discounts bills, or buys gold or securities, the sums which it pays become bank cash because the balances of other banks in its hands are increased Conversely, when a loan is repaid, or the bills discounted fall due, or gold or securities are purchased from the Bank, bank cash is correspondingly diminished and the volume of credit is to that extent contracted

Gold Movements Ultimately Control Credit.

Thus the gold standard is by no means the "automatic" mechanism it is commonly alleged to be, since the Bank, merely by buying or selling, lending or calling in loans, can *within limits* prompt an expansion or contraction of credit *regardless of gold movements* But the powers of the Bank in this respect are not unlimited its note issue is strictly controlled, and even such freedom for the exercise of policy as it might possess is limited by the rigidity of its system An increase in bank cash without an increase in gold holdings would not be ordinarily regarded in this country with equanimity

Hence the fundamental truth is that, under an effective gold standard, although to some extent the ordinary joint-stock banks can create credit by varying their cash ratios, and, to a greater extent, the Bank of England can regulate the national credit situation, yet the real determining factor is the movement of gold, which reflects the state of trade and the international credit position

The "Vicious Circle" of Currency and Credit.

The foregoing explanation will indicate to some extent the so-called "vicious circle" in which credit and currency work The Cunliffe Committee and others desirous of effectively regulating our credit and currency position were insistent that the remedy lay in a rigid control of the currency note issue They said, in effect, "Take care of legal tender currency, and credit will take care of itself" But it is a nice point as to how far the treasury notes issued during the inflationary

period were actually made necessary through the increase in credit by the banks, for as prices rose there was necessarily a constant increase in the demand for legal tender currency Hence the converse argument, "Take care of credit and legal tender currency will take care of itself" The exponents of the principle expressed in this statement contend that credit should be controlled directly by a rigid regulation of banking policy and not indirectly through the control of legal tender The remedy clearly lies, as is usual in such cases, not in drastic action in one direction or in the other, but in the "half-way house"—a careful regulation of the issue of legal tender currency combined with an equally careful control of the volume of credit by the banks, acting in close co-operation with the central institution

CENTRAL BANKING

In performing the functions we have described in previous paragraphs, the Bank of England is said to act as a *Central Bank*, by which is meant a central banking institution which is the focus of the money market of a country and exercises wide powers as the regulator of credit

The fundamental principle underlying the *establishment* of a central bank is that it shall be distinct from the ordinary commercial banks in that its policy must be directed, not merely to making profits and to maintaining its own solvency, but to regulating the credit machine and maintaining the solvency of the banking system as a whole Consequently the central bank avoids, as far as possible, competing with the commercial banks for ordinary business, and aims at maintaining as liquid a position as is practicable For these reasons, central banks do not ordinarily allow interest on deposits, or make advances on fixed property, or grant unsecured overdrafts

The Principles of Central Bank Operation.

The main principle underlying the *operation* of a central bank is that it must not rely on other banks, or upon the market, to supply it with cash or to take bills or securities off its hands in case of need Instead, it must always stand ready to perform these services itself It must function as a reservoir of credit, always willing to provide accommodation *at a price* – its own price—which it must fix with due regard to national and international monetary conditions

To achieve such objects, a central bank must hold among its assets what to a competitive bank would be an unduly high proportion of idle gold and legal tender currency It must always be in a position to meet both external drains and variations in the country's internal monetary requirements.

The assumption of such responsibilities necessarily means that a central bank cannot pursue a passive policy On the contrary, it must be constantly alert to prevent the exhaustion of its reserves by gold exports or by internal demands To protect its position it has recourse to one of two weapons First, it may *raise its official rate of discount*, and thereby, as we have seen, check the demand for loans, encourage saving and induce the investment of foreign funds Alternatively, the central bank may adopt the *open market policy*, already explained in relation to the Bank of England, *i e* . it may sell securities to the Money Market for cash, thus diminishing its cash liabilities to other banks, increasing its own holdings of money, and lessening market supplies of liquid funds

Conversely, of course, the central bank may create easier conditions, and encourage an expansion of credit, by lowering its discount rate or increasing market funds by the purchase of other assets, as, for example, bills or government stock

Central Bank Equipment.

In order to perform these special functions, a central bank must have certain special powers and equipment First, it should have a monopoly of note issue, so that it can meet variations in the demand for currency without having too great a recourse to its reserves In any event, it is essential that no other bank in the same country should have an unrestricted and elastic power of note issue, otherwise it could flout the central bank's authority Secondly, all the other banks and the Government should keep their floating balances with the central bank, which should hold the nation's ultimate cash reserve, so combining the functions of the " bankers' bank " with those of banker to the State

The final and fundamental principle is that a true central bank should be largely independent of political influences It cannot be entirely independent, but, as the currency authority, it should be given as free a hand as possible, and should not be tied to any political machine If this is not the case, currency policy is placed in danger of becoming the plaything of party politics and of being swayed by class interests

During the half-century before the War most European countries built up strong centralised banking systems on these lines , in England the Bank of England, in France the Bank of France, in Germany the Reichsbank, and so on Since the War, the urgent necessity for a strong guiding hand in monetary matters has resulted in a considerable extension of the principle, which is now adopted in nearly all important countries Moreover, the actual power of central banks has been greatly extended as a result of the War, and the co-operation of the leading central banks of the world is now one of the most powerful factors in the world monetary situation (See Chapter 30)

CHAPTER 12.

TRADE CYCLES AND FINANCIAL CRISES.

We could scarcely expect the wonderfully complex credit and financial mechanism of the modern community to function continuously without at least some symptoms of derangement and even occasional breakdown. For, apart from the fact that the credit machine is most delicately adjusted and most sensitive to outside influences, we have to recognise that credit and finance are merely the handmaidens of trade, and that trade itself is subject to alternating periods of buoyancy and depression which inevitably disorganise the monetary structure.

This instability is due to two principal factors : (*a*) the imperfect anticipation of demand by producers ; and (*b*), the imperfect co-operation between various producers.

Imperfect Anticipation of Demand.

In a modern producing community, many industrial processes, involving an infinite range of commodities, have to be initiated months, and sometimes years, before the commodities can be marketed. The gap between original producer and ultimate consumer tends ever to widen, and with each additional stage the liability to error becomes more pronounced. A sudden change in style, custom or fashion may upset the most carefully laid plans of the producer ; the death of a monarch or a legal enactment may sweep away every hope of anticipated profit ; a new invention or the sudden appearance of an improved article or efficient substitute may entirely supersede a commodity which, after years of labour, is just about to be marketed. In these and in many other ways, the anticipations of the producer are likely to be totally disappointed, or at least his profit is likely to be much below his estimate.

Imperfect Co-operation between Producers.

Imperfect or incomplete co-operation between producers may have like results. Each successive process in the production of an article depends on the prompt and efficient completion of the previous process. In a factory subject to a centralised control, it is possible to ensure

harmonious working between the various departments But when the work of a number of independent producers is necessary to provide a given article, when several distinct and specialised but widely separated industries have to co-operate to produce a single commodity, then the risk of failure at some point becomes of vital importance A breakdown at one stage may result in widespread disorganisation The repercussive effects lead to a *synchronism* of trade depression throughout industry, just as in prosperous times they produce a synchronism of activity and profitable employment

Imperfect co-operation may be due to a variety of factors to unfavourable climatic conditions, to floods or earthquakes, to the depredation caused by an insect (such as the boll-weevil cotton pest of the United States), or to the countless imperfections which may be summed up as the failure of the human element This imperfection may not only lead to a shortage of material It may result also in inadequate supplies of labour or of fixed capital at one stage, or in too great an accumulation of these factors at another stage. Possibly supplies of an essential raw material may fail or demand may decrease before a new plant is actually in working order, so that the anticipated utility of buildings and equipment vanishes even before they are available for productive use It takes time to prepare an industry to meet increased demand, and to attract to that industry the capital and labour necessary for expansion The disadvantages are accentuated because, once capital and labour have been specialised, it is difficult to convert them to other uses, and consequently depression tends to remain for a considerable period

The Trade Cycle.

The history of trade during the last century and a half reveals a remarkable peculiarity about these periods of depression and activity, and that is, their tendency to alternate with striking regularity So marked is this tendency that a *trade cycle*, extending over a period of from seven to ten years, is now recognised Starting from depressed conditions, when industry is stagnant and unemployment is rife, confidence gradually revives and a period of growing prosperity follows Prices rise, profit margins are widened, and production is stimulated The prices of raw materials and basic commodities like coal and iron are sensitive, moving with, or even in anticipation of, prices in general, but wages, interest, and credit charges lag behind Expanding markets and increased demand cause entrepreneurs to institute production on an extended scale, many enterprises are developed and conducted on borrowed capital, speculation tends to spread to all classes of the community and credit is expanded to meet the growing demands for trade requirements

Presently, however, prosperity begins to generate its own checks Labour costs are increased with the forcing up of wages, the payment of overtime rates, and the absorption of less efficient workers, production costs rise as old equipment is strained, while competition for new equipment and raw materials sends up their prices disproportionately, finally, charges for credit and capital are raised A point is reached when it becomes evident that costs are going to catch up receipts, and when this is perceived the boom is over

As a rule, the breaking-point is reached when some event occurs which shakes confidence in one branch of industry or in the community as a whole or even in the world at large It may be an earthquake, a violent tempest, a great flood, the failure of an important crop or of a large financial house, or the outbreak of war In any case, there is usually a crisis marked by a sudden curtailment of credit, and the order of events is reversed Selling prices fall more rapidly than costs can be reduced, wages can be forced down only with difficulty, and labour bears its share of the prevailing depression mainly in unemployment

But the depression, like the boom, produces its own correctives Labour, credit, and capital charges are gradually forced down, production costs are reduced by the elimination of the less efficient firms and workers, and the commitments of the boom period are gradually liquidated Thus, the time arrives when costs again fall below selling prices, and the conditions of profitable enterprise are restored

Commercial Crises.

What we may call the "apex" of a trade cycle is marked by a convulsion of commerce and finance known as a *commercial* or *financial crisis* As we have seen, the critical phase of the cycle is a wide expansion of credit and an orgy of speculation on borrowed capital, and the immediate effect of the operation of the factor immediately responsible for the disturbance is a sudden contraction of credit due to the apprehensions of bankers and of merchants, who endeavour to consolidate their position by demanding payment of debts As a result, some firms experience difficulty in meeting their commitments and their failure involves many others in loss

The collapse of credit makes itself felt in another way Less faith is placed in all forms of credit documents, so that fewer are issued and those outstanding are pressed for sale or conversion into legal tender The media of exchange shrink in number and amount, there is an increasing demand for legal tender currency, which is rarely forthcoming in the quantity desired, and the resultant insufficiency of money almost invariably causes a run upon the banks, a rush to realise securities, and a general financial panic

In times past these conditions have been accentuated by the inability of banking institutions to stand the sudden strain on their resources by the demand for cash, the failures among their customers, and the difficulty under generally unfavourable conditions of converting securities into money or of obtaining increased supplies of liquid funds Not infrequently many banks have themselves failed and have thus increased the difficulties of the community as a whole

Crises in Great Britain.

Crises of this type occurred in this country in 1763, 1773, 1783, 1793, 1810, 1814, 1825, 1837, 1847, 1857, 1866, 1878, 1890, 1900, 1907, 1914, 1920, and 1929 The periodicity of occurrence is obvious, although it should be added that in some cases the years given were characterised rather by monetary stringency than by an actual crisis

The history of these crises has been intimately related to the development in the organisation of the banking and credit systems While the acute stage of each paroxysm has been usually marked by the revelation of some weakness in the banking structure, it has generally been followed by some distinct improvement in the organisation based on the knowledge and experience gained as a result of the crisis The following brief survey of the crises which have occurred in this country during the last hundred years or so should therefore help us to appreciate the manner of growth of that experience which has enabled British banking to establish its international reputation

1814. Speculation follows Peace after long Wars.

The declaration of peace with France after the downfall of Napoleon was followed by violent speculation, which ended eventually in industrial disaster and the failure of a great number of note-issuing banks The consequent contraction of the currency caused widespread inconvenience, but there was some compensation for this since the resulting deflation permitted the Bank of England in 1821 to remove the restriction on cash payments which had been existent since 1797 (See page 59)

1825. Speculation in Foreign Mines.

The resumption of cash payments by the Bank was preceded by England's definite adoption of the gold standard in 1816 This and the period of peace after prolonged war led to an increase in public confidence and an expansion of trade Speculation ensued, particularly in foreign mining companies and in South American enterprises, resulting in an inflation of prices The year 1825 was marked by a violent crisis, during which the Bank of England issued £1 notes in an endeavour to remedy the deficiency in the currency.

1836–7. Uncontrolled Note issues.

After the usual period of prosperity, over-speculation in new mining and railway companies following the exploitation of our mineral deposits and the application of steam to railway haulage, resulted in a crisis and widespread failures of private note-issuing banks This crisis was the immediate cause of the Bank Charter Act of 1844, which sought to provide a remedy for the condition of the currency and for the evils of the uncontrolled note issues

1847. Rash Capitalisation of Railways, etc.

At this period Britain's industrial development was proceeding apace, and railways were being built in various parts of the country The great increase in the wealth of the nation and the prevailing low rate of interest led to rash speculation in railway and similar enterprises yielding a slow return There was consequently a scarcity of funds on the Money Market Credit was contracted, prices fell, and a crisis was precipitated by the failure of the potato crop in Ireland and of the cotton crop in the United States, and by the prevalence of bad harvests in Europe The immediate causes were a demand for money for foreign payments and for calls on railway shares The Bank of England was compelled to raise its rate from 3 per cent to 8 per cent It refused to lend on Public Securities, and was finally obliged to obtain government sanction for the suspension of the Bank Charter Act in order to increase its fiduciary issue Public confidence was at once restored by this step and the Bank did not find it necessary to take advantage of the powers granted

1857. Rash Speculation following Gold Discoveries.

At this period the gold discoveries in California and Australia stimulated enterprise of all kinds , a great extension of railway construction was followed by over-trading and speculation in mining, railway, and shipping companies Gold replaced the silver currency in France and U S A , but banks in the latter country could not keep pace with the demand for loanable capital In August, 1857, a panic occurred on the New York exchange, and many banks and railway companies failed The effect was felt in Britain, and particularly in Liverpool and Glasgow This resulted in a drain on the Bank of England for gold exports to America, Scotland, and Ireland Several English and Scotch banks stopped payment, the Bank of England discount rate rose to 10 per cent , and its Reserve fell below half a million Accordingly the Bank Act was again suspended, and £2,000,000 excess fiduciary notes were issued but were not all used, for public confidence was restored as soon as the Bank was freed from restriction

1866. The Overend and Gurney Crisis.

When confidence had been restored after the 1857 crisis trade revived The American Civil War led to issues of inconvertible paper in the U S A in 1861, and in consequence of the operation of Gresham's Law gold was driven to Europe, while the reduction of the cotton supply caused purchases at high prices to be made in India, China, and Egypt, which were paid for in silver Many new companies were formed under the Companies Acts of 1858-62, and much speculation took place, particularly on the part of finance companies, one of which, Overend, Gurney & Co , lent money for enterprises all over the world Deficient crops, adverse exchanges, and a continental crisis caused a contraction of credit, which was followed in 1866 by one of two failures and a run on country bankers, who fell back on London for supplies The Bank rate remained at 10 per cent for three months, and on May 10th Overend & Gurney stopped payment with liabilities exceeding £10,000,000 On May 11th—"Black Friday"—the Bank of England increased its loans by four millions, and in consequence of the depletion of the Reserve, the Bank Act was suspended and the panic was allayed by the following day

1878. The Failure of the City of Glasgow Bank.

Great prosperity existed in England during 1870-72, and was followed by speculation and reckless expenditure in U S A and Britain The Franco-German War had caused much capital to be transferred to this country for safety, and had resulted in disturbed conditions on the Continent A crisis in Vienna and another in America in 1873, when many banks failed, caused a subsequent drain of gold to Germany and a dullness of trade as a result of the loss of our best customer, America The Russo-Turkish War accentuated the difficulties, so that many failures followed in 1876-78, including that of the City of Glasgow Bank, with liabilities of six millions, and of several other banks and large firms of bill brokers A great depression in trade followed, with prevalent lack of confidence and stagnation

1890. The Baring Crisis.

The crisis was preceded by a great increase in the number of joint-stock companies, excessive speculation, and inflation of prices Baring Bros , who had invested huge sums in South American securities, were on the eve of failure with liabilities of twenty millions, as a result of a sudden fall in the value of these securities The failure was prevented by the action of the Bank of England and leading bankers, who guaranteed the liabilities of the firm to the extent of fifteen millions.

1893. Uneasiness among Land Speculators.

This crisis was a result of that of 1890 The Baring failure led to a movement to withdraw part of the millions of British money which had been invested in land speculation in new countries, causing stringency in Australia and the United States Several banks failed as a result of uneasiness among British depositors

1900. Disturbance from Germany and U.S.A.

The crisis of 1900, which originated in Germany and spread to the United States, did not much affect this country, although it was characterised by the failure of the London and Globe Insurance Company

1907. The Banking Crisis in U.S.A.

In the United States the failure of banking facilities, hoarding, and high rates of discount led to a scarcity of money and an extensive credit collapse, which was severely felt in London Continental countries refused American bills, so an insistent demand for metal from New York caused by a heavy premium on gold had to be met by the Bank of England By raising its rate the Bank attracted three millions in gold from France, and the situation was relieved by the issue of Panama Bonds and Treasury Notes in the United States This crisis was particularly noteworthy because it evidenced the power of the Bank to attract large sums of gold by raising its rate of interest, and because it marked an unprecedented demand for gold in London as a result of the premium offered thereon by America, although the exchanges warranted the passage of gold from New York to London

1914. The Outbreak of the Great War.

The crisis of 1914 was the greatest in point of seriousness and effect which the world has ever seen In practically every country apprehension was felt as to the future, and London's position as a free gold market and as the world's leading monetary centre exposed this country to considerable financial danger, mainly because foreign nations were exerting every effort to withdraw their British assets in the form of gold Great quantities of London bills were in circulation throughout the world, and the sudden presentation of many of these for discount and payment naturally caused considerable monetary difficulty on the part of the London accepting houses, discount houses, and banks, while the inability of stock-exchange operators and of the bill brokers to repay their loans borrowed from the bankers deprived the latter of their "second line of defence", *i e*, money at call, etc The acceptances of

enemy firms and banks were necessarily thrown on the hands of holders with little hope of payment The apprehension which prevailed led to a rush to realise all forms of credit documents and to call in loans of every kind The widespread demand for cash created a considerable shortage of currency, for which there was no provision under the existing law

To relieve the position the Stock Exchanges and banks were closed for several days, the former to prevent the " dumping " of securities for sale, and the latter to prevent a " run " , the Bank rate was raised to 10 per cent to restrict the outflow of gold and reduce the demand for loans , to meet the demands for currency, the Treasury arranged to suspend the Bank Act to enable the Bank of England to increase its fiduciary issue, but the issue of treasury notes rendered this step unnecessary ; finally, the pressure on acceptors of bills and other debtors was relieved by the establishment of a three months' moratorium

In the following weeks the position was still further relieved when the Government undertook to guarantee certain bills for discount at the Bank of England, and, through the Foreign Debts Committee, undertook to advance to drawers up to 50 per cent of the amount of outstanding foreign debts The Bank also assisted acceptors of bills and stock exchange operators by granting them loans, and in this way unlocked part of the liquid resources of the other banks

It says much for the inherent soundness of the British monetary system that it was so well able to withstand the unprecedented strain on its resources during this inordinately difficult period

1920. The Post-War Crisis.

The depression during the war period was quite naturally followed after the armistice by widespread feelings of buoyancy and optimism There was much leeway to make up in regard to the supply of goods, and the reaction was sufficient to cause a considerable activity in internal trade and in production for home and foreign markets War profiteers and demobilised soldiers spent money with great freedom For a time mills and factories were working to their full capacity Speculation on the stock markets particularly was very pronounced, induced largely by the substantial distributions of profits and bonuses by those enterprises which had benefited by the war conditions

For some time the banks created extensive credits against the great amounts of paper currency and of Government and industrial securities which passed into their hands Prices were consequently forced up, and each successive rise in prices necessitated a further expansion of the exchange media Further, the rise in prices was followed, as is usual, by rising wages, and the consequent additional purchasing power in the hands of the workers tended to react again on prices and force them still higher Thus a vicious circle was created.

High prices caused higher wages, the latter caused an increased demand for goods, which could not be satisfied except at an increasing expense of production, because of the scarcity of material and the enhanced cost of all articles in the post-war period Hence prices were again forced up and the workers given another justification for demanding increased remuneration Eventually a "boom" resulted, and when, in March 1920, wholesale prices were approximately 163 per cent above the level of July, 1914, conditions were ripe for a crash

The subsequent collapse cannot be attributed to any outstanding event of a disturbing nature, it was due rather to a sequence of influences The principal factor was undoubtedly the recognition by producers and consumers that a fall had to come Consequently, very little was required to start its course, and this was provided by the attempts of producers and of the Government Disposal Board to unload vast stocks on a rising market Many orders for goods were cancelled by foreign merchants, who found themselves unable to make the necessary payments This feature was accentuated by the policy of deflation adopted in the United States and in Japan Prices accordingly fell away, and consumers withheld their funds in order to buy at lower levels Once the ball was set rolling it gathered impetus, and the rapid fall was accentuated by the Government's declared policy of deflation and by the action of the banks in calling in advances and in restricting credit facilities Traders and the public lost confidence, the German reparations difficulty especially causing considerable uneasiness, one fall led to another, until by December, 1921, prices were only 82 per cent above the pre-war level, and industry everywhere was characterised by depression and uncertainty

1928–9. Speculation in Industrials : The Hatry Crisis.

The period of depression which began its course in 1921 continued for several years, and, indeed, is still well marked in our basic industries, especially those connected with coal, shipbuilding, iron, steel, cotton, wool and agriculture, all of which have experienced a distressing set back from their War-time prosperity The years 1928-29, however, were marked by an almost unprecedented boom in certain British Industrial securities, particularly those connected with newly developed industries, such as artificial silk manufacturing and the gramophone and wireless trades The movement on this side of the Atlantic was accentuated by an unexampled boom on the New York Stock Market, and prices of certain international issues reached greatly inflated levels The high rates of interest offered on the New York call-money market led to a vast transfer of funds to the United States from Europe, and this, combined with certain other factors, led to a heavy drain of gold from the Bank of England, which in the Autumn of 1929 was forced to put up its rate to 6½% The inevitable contraction of credit and

collapse of stock exchange prices followed very quickly, and so accentuated the difficulties already engendered by the world-wide fall in commodity prices

In this country, the crisis was marked by the crash of certain financial groups, notably those connected with a financier, Clarence Hatry, whose operations involved the unprecedented loss of £13½ millions In the United States, Wall Street suffered the greatest collapse in its history, and millions of dollars were lost by speculators, large and small, throughout the country

The collapse and depression in America had the effect of relieving the strain on European financial resources, and liquid balances were transferred in such quantities from New York to London that sterling rose to a substantial premium over the dollar By gradual stages the Bank of England was able to reduce its rate to 4½%, and, at the time of writing (March, 1930) there are indications that the resourceful measures taken by the monetary authorities both here and in U S A are bringing about conditions of greater ease and stability

Is the Periodicity of Trade Cycles Explainable?

Many people regard the periodicity of trade cycles merely as a matter of coincidence, but it has long been recognised by economists that their peculiar regularity must be attributable to some explainable cause or causes Some theorists have sought an explanation in climatic factors Others, with Socialistic leanings, attribute the periodic disturbances to the under-consumption (or the over-production) of goods resulting from the fact that too high a proportion of income and capital is concentrated in the hands of the producing or capitalist classes, and that the working classes receive too small a proportion of the net product of industry and so have less to spend on produced articles Others, again, argue that trade cycles are due to over-capitalisation of industry following excessive competition between independent producers and a greater volume of production in anticipation of demand than is justified by the resources and need of the community Ultimately, some industrial enterprises find themselves in the position of producing at a loss and are compelled to cease business Production consequently falls off and the resultant restriction of credit facilities causes general depression

Monetary Theories of the Trade Cycle.

Then there are those who attribute the trade cycle to monetary conditions, and it is with this aspect of the problem that we are mainly concerned in this book From the foregoing observations, it is apparent that the economic fabric is remarkably dependent on its financial organisation, and particularly upon the arrangements of its credit

structure, and the conditions which eventually culminate in a boom and result later in a crash can be attributed almost entirely to financial or monetary causes

In the nineteenth century crises were chiefly attributable to the excess issue of credit in the form of bank notes More recently, crises have invariably been preceded by an " over-issue " of credit facilities by the banks in the form of overdrafts and discounts In both cases speculation has been encouraged by the comparative ease of obtaining accommodation, and such speculation has forced up prices and involved business in that vicious circle which inevitably leads to a sudden contraction of credit, a collapse of speculation, and a violent recoil in prices

While bankers cannot be accused of initiating or of encouraging speculation, they undoubtedly do exercise a most profound influence upon the extent to which it spreads Through their hands pass most of the credit operations which characterise a period of speculative activity, and they unquestionably have the power, on most occasions, of discriminating between the use of credit facilities for speculative and for legitimate business purposes It is therefore not surprising to find it frequently stated by monetary theorists that the ordinary type of crisis could be altogether avoided by a united and determined policy on the part of the bankers, aimed at preventing too violent a movement by the gradual and timely application of counteracting measures

Purchases, it is pointed out, are made largely with borrowed capital, *i e*, bank discounts, loans, and advances When people expect a rise in prices they buy in order to sell, and their action strengthens the upward tendency in prices which, in turn, justifies their action But the power to purchase in this way is made possible by the readiness of banks to grant accommodation at comparatively low rates

So long as production can be expanded to keep pace with the increased volume of money (including bank advances) all is well, and the price-level is held in check But after the limits of genuine productive expansion have been reached, the banks continue to lend freely and manufacturers and merchants continue to expect prices to rise The result is that a speculative boom is superimposed on a production boom and prices rise rapidly Now this speculative boom might be prevented if the banks would refuse accommodation at the point at which the limit of true productive expansion is reached On the other hand, if the banks would lend more freely and not restrict credit so suddenly when depression sets in, the depression might be made less intense and prolonged

The history of crises proves unmistakeably that the violence of the impact may be considerably lessened by a courageous policy on the part of the banks as a whole, and of the central bank in particular, of lending freely on satisfactory guarantees to legitimate traders who are

involved in temporary difficulties This gives such merchants time to reorganise their arrangements to meet the altered circumstances The beneficial effects of this procedure are accentuated if the State or the central bank can intervene to provide acceptable currency in sufficient quantity to meet legitimate trade requirements But the special credit facilities afforded in such circumstances must be made available only at relatively high rates , otherwise demand may be unduly extended and speculative activity again encouraged

Moreover, the history of trade cycles shows that a steady increase in prices is a necessary corollary of a revival of trade after a period of depression But the problem to be solved is How can the expansion of credit be restricted as far as is possible according to the needs of trade ? How can currency and credit be regulated so as to ensure stability in the general level of prices ?

One group of theorists suggests as a means of achieving this object the conscious manipulation of the discount rate by the central bank so that credit would be regulated according to the movements in prices Another group proposes the careful rationing of bank credits and a rigid discrimination between various types of borrowers The third and most important proposal is that stability in the general level of prices should be achieved by the substitution of a *managed currency* for the usual gold standard The practical objections to this proposal have already been discussed in an earlier chapter

Monetary theories of the trade cycle are criticised mainly on the grounds that the fundamental causes of fluctuations arise out of the conditions of industry itself rather than finance, and that, although monetary influences are important, they are not the *primary* cause of fluctuations Credit and currency inflation make a boom *possible* and condition the *extent* of the boom, but they do not cause it A more important objection is that the trade cycle, being a world phenomenon, cannot, on the one hand, be attributed to the internal conditions of one or two countries, nor, on the other hand, can it be remedied by isolated attempts at monetary reform *International* and not merely national action is clearly necessary if international stability is to be achieved

The Psychological Theory.

In the theory developed by Professor Marshall, Professor Pigou, and Mr F Lavington, and now widely accepted, the psychological factor, stressed by Ricardo, J S Mill, and other classical economists, is given first importance Briefly, the theory asserts that changes in the state of mind of the leaders of industry and commerce are more important than all such haphazard factors as harvests, floods and inventions, although these undoubtedly exert a great influence upon the psychological factor Business men vary between errors of optimism and

pessimism If the minds of business men worked *independently*, these movements would tend to cancel out, and fluctuation would not be very great But the minds of business men do not move independently, the swing from one type of error to another is a common swing, a sort of crowd movement Consequently, moods of optimism and pessimism tend to move in waves over large areas and have a natural rhythm, the period of which approximates to that historically applicable to the trade cycle

The psychological theorists do not deny the influence of monetary factors, but Professor Pigou points out that it would be a "gross fallacy to infer, as is sometimes done, that, because the trade cycle always presents itself in a money garment, therefore the forces that underlie its movement necessarily reside in the money system" . "It may be—and indeed it certainly is—the fact that the monetary and banking arrangements current at the present time cause errors of optimism and errors of pessimism to be larger than they would be in a régime of stabilised general prices But to grant this is not to grant that errors of optimism and of pessimism are merely monetary phenomena"[1]

The Psychological Theory is criticised on the grounds that what are called optimism and pessimism are substantially correct anticipations of rises or falls in prices, that if price stabilisation were attained through a bolder use of discount policy, the effects of optimism and pessimism would be corrected whether or not they were errors, and finally, that it does not satisfactorily explain the approximate fixity in the period of the trade cycle nor the difference between the wants of consumers in good and bad times

Proposed Correctives of the Trade Cycle.

The great number of theories of the trade cycle which have been put forward, each stressing different aspects of the phenomenon, suggests at once that there is no single explanation The causes are many and complex, and probably only a combination of all the theories would offer a complete solution

Fundamentally, there is the difficulty that production in modern industry must be based upon an estimate, psychological influences produce errors of optimism and errors of pessimism, sometimes those errors may be influenced by climatic factors, competition fosters excessive production, banking and monetary policy exaggerates the "swings" of trade But although there seems to be no single explanation of industrial fluctuations, the theories which we have discussed serve a most important purpose in that they point the way to various measures whereby the harmful effects of such fluctuations may to some extent be mitigated

[1] *Is Unemployment Inevitable?* pages 92 and 98

In view of the fact that the imperfect anticipation of demand has an important bearing on the trade cycle, attempts have been made during recent years, *e g*, by the Cambridge and Harvard (U S) Economic Services, to provide reliable statistical data upon which the business man may base his estimates of the probable future course of general economic conditions In return for an annual payment subscribers are supplied, from time to time, with comprehensive reports on the economic situation, and also with a chart (*e g*, the Harvard Business Barometer), showing graphically indexes of the figures of various items, such as bank clearings, prices, banks loan and deposits, interest rates, imports, the prices and turnover of stocks and shares, and so on, all of which are indicative of the trend of commercial activity, and enable a reasonable prediction to be made of the future course of events

Another proposal which has considerable merit is that the Government, local authorities and large private organisations, which employ large numbers of workers, could do much to even out employment and increase stability by adjusting their activities so that employment on constructional works is increased in times of depression and diminished in more prosperous periods, when the workers are required for the general purposes of industry Closely allied to this proposal is the suggestion that business firms generally could do much to smooth out fluctuations by pursuing a more stable policy, as, for example, by planning capital expenditure far ahead, by advertising strongly in bad times, by following a cautious dividend policy, avoiding over-capitalisation, and utilising reserves accumulated in prosperous periods for extensions and improvements during times of depression

Encouragement of Consumption.

In other directions, it is claimed that consumers can be encouraged to assist in the stabilisation of price levels With this object, attention has been directed to the desirability of developing the hire purchase or instalment buying system, with a view to stimulating demand, and so increasing production and causing prices to fall Moreover, apart from increasing demand, the movement would also have the effect of *stabilising* demand, and so reducing the incidence of the *trade depression*

The efficacy of this system as a remedy for cyclical movements of trade is uncertain, and recent experience in America appears to indicate that, if it is intended to mitigate industrial fluctuations, it should be used only sparingly in times of booming trade The reduced purchasing power and the reluctance, if not incapability, of would-be purchasers to incur further obligations make it doubtful if current obligations will be met punctually Any curtailment in purchases,

particularly where the system is so wide-spread as in America, means a curtailment of business activity, and with a contraction in home markets effects are likely to have international momentum.

Complexity of the Problem.

Whether complete stability is or is not desirable is still a subject of controversy, but all economists are agreed that much greater industrial and commercial stability is desirable than that which has at present been achieved. But it is clear that, as the trade cycle is a world phenomenon due to many complex causes, there can be no simple remedy. More accurate and widespread knowledge of economic factors would undoubtedly modify its effects ; it should be possible for private producers to assist to some extent in stabilising production, while the Government and public bodies, by suitable timing of capital expenditure, could do much to ameliorate depression in private trade. Finally, it is now generally agreed that the violence of upward movements of prices, and consequently the severity of the reaction, can be checked by a conscious and deliberate use of the discount rate by the central bank. But the extent to which such policy can be adopted is limited by practical considerations. It involves checking trade prosperity when it is on the up-grade, and consequently implies great confidence on the part of the business community and the workers in those responsible for monetary policy.

PART II.

BANKS AND THEIR CUSTOMERS.

CHAPTER 13.

THE CUSTOMER'S ACCOUNT.

In spite of the weighty decisions which, at times, depend on the exact meaning of the term "customer of a bank," there exists no legal definition No definition is given by the Bills of Exchange Act, 1882, although certain important sections of that Act depend essentially upon the exact application of the term The majority of legal decisions upon the point are conflicting to a bewildering degree, and afford us little clear guidance Probably the nearest approach to a definition was the statement of Lord Davey in *The Great Western Railway Company* v *London and County Bank*, 1901, to the effect that a customer "is a person who has some sort of an account with a banker" From this it follows that any person or corporation may become a customer of a bank by opening a deposit or current account (See Chapter 24)

The Relation of a Banker to his Customer.

The relation of banker and customer is primarily that of debtor and creditor, with the superadded obligation on the part of the banker to honour the customer's cheques up to the amount of any available credit balance, or up to the limit of any overdraft which the banker has agreed to allow

A banker does not become a *trustee* of the money left with him by the customer, nor does he become an *agent* responsible for its disposal, although, as we shall see later, a banker often undertakes duties which make him both agent and trustee for his customers

On the contrary, money left with a banker on deposit or current account is *at his absolute disposal* to do with as he pleases, for it is really *lent* to him by the customer, subject to the banker's undertaking to repay the amount on demand, or, in the case of a deposit account, after stipulated notice has been given

Moreover, the debt which is created by the deposit of funds with a bank resembles any other debt in the fact that, if the bank becomes insolvent, the customer has no rights other than those of an ordinary

creditor He must prove in the winding-up or bankruptcy proceedings for the amount standing to his credit and accept a dividend (if any) out of the realised proceeds of the bank's assets

Demand for Repayment is Necessary.

It was, however, decided by the Courts in the case of *Joachimson* v *Swiss Bank Corporation*, 1921, that the debt due by a banker to his customer differs from ordinary commercial debts in one important respect not previously recognised Whereas, in the case of ordinary debts, *a request for payment* is *not* necessary before a creditor can take steps to enforce payment, unless the parties have stipulated that such a request shall be made, a *demand* on the bank for repayment is necessary before the debt owing to a customer becomes what is known as "actually and accruing due"

In the absence of such a distinction between a banker's debt and an ordinary commercial debt, a banker owing money to a customer would have the right to tender the full amount of the customer's credit balance in repayment of the debt *at any time* or *at any place*, thus summarily closing the account without reasonable notice and possibly injuring the customer's credit through the subsequent dishonour of his cheques On the other hand, the customer could demand repayment of his balance *at any branch* of the bank, and *at any time*, conditions that would be clearly subversive to the established principles of banking, which require a customer to draw cheques only upon the branch where he keeps his account, and also to demand payment only during recognised business hours

The foregoing applies equally to a current account or to a deposit account, except that, in the latter case, it has always been a well-recognised principle that the giving of notice, where notice is stipulated for, and the production of the deposit receipt, where such is issued, are *conditions precedent* to the right of the customer to demand repayment of a deposit account balance due to him

Current Accounts and the Statute of Limitations.

The decision in the case of *Joachimson* v *Swiss Bank Corporation* is of technical though not of great practical importance in its bearing upon the effect of the *Statute of Limitations* on the debt owing by a banker to his customer This statute (properly designated the *Limitation Act*, 1623) provides that an action to enforce a simple contract debt must be commenced before the expiration of *six years* from the time when right of action first arose 'Right of action arises on ordinary debts from the date when the debt is payable, or from the date of the last written acknowledgment of the existence of the debt, importing a

promise to pay, made by the debtor[1] or his duly authorised agent,[2] or of the last payment on account of the principal amount owing, or of payment of interest thereon

The judgment referred to clearly demonstrated that since a debt owing by a banker does not become *due and payable* until the customer has made a specific demand for repayment, the six years required by the statute would not commence to run until such a demand had been made.

Actually, of course, no bank in this country would refuse payment of a balance once a demand therefor was made by the person entitled to the money

This principle does not, however, apply in the reverse case where the customer is indebted to the bank In such circumstances, the relationship is essentially that of debtor and creditor, and, in the absence of any express agreement as to demand for repayment, or as to the date thereof, the debt is one which is immediately accruing due and liable to be called for at any time after the date of the advance Accordingly, the Statute of Limitations begins to run from the date of each advance (*Parr's Bank* v *Yates*, 1898), and the customer cannot be sued for repayment of the debt if, for six years after the date of any advance, he has *not* made any acknowledgment of the obligation or repaid any part of what is due, or *paid* any interest thereon (not merely been *charged* with interest), and the banker has failed to commence proceedings for recovery

But although the Statute may thus prevent a banker from suing for the recovery of a debt which has been unacknowledged for more than six years, it does not prevent him from obtaining payment by retaining and realising any securities of the debtor which have come into his hands in the ordinary course of business Nor would it prevent a creditor from suing a person who has given a continuing guarantee for the due payment of the debt, if the guarantee contains an undertaking by the surety to repay the advance "on demand," or "three days after demand," for in such cases the Statute does not begin to run until an *express demand* for repayment has been made by the creditor and has been refused by the surety

The Appropriation of Payments.

If a customer has several accounts with the same bank he can stipulate that funds paid in to his credit are to be placed in whichever account or accounts he may select, or he may insist that some or all of the money is to be held and applied specifically to meet certain cheques, or to pay certain bills upon which he is liable as a party If the banker does not agree to such an appropriation, he must refuse the amount tendered to him at the time of the tender

[1] *Statute of Frauds Amendment Act*, 1828 , [2] *Mercantile Law Amendment Act*, 1856

In the absence of any such appropriation by the customer, the banker has the right to apply funds paid in to lessen or wipe off any debt owing to him by the customer, including even a debt which is statute-barred But when once such an appropriation is made and communicated to the customer it is thereafter binding upon both parties, and cannot be varied or revoked by the banker

The Rule in Clayton's Case, 1816.

In practice, specific appropriations of the kind here referred to are rarely made as between banker and customer, unless the customer has more than one account Hence it sometimes becomes necessary to determine how money paid into a current account shall be deemed to have been applied The general rule of law in this respect is determined by what is known as the *Rule in Clayton's Case*, 1816, which provides that, where there is a current account between two parties and no evidence of any appropriation by either party of the items therein, *the money first paid in shall be deemed to have been first drawn out*, *i e*, the credits in order of entry in the account shall be deemed to have discharged the debits in the order in which they appear

In the absence of agreement to the contrary, therefore, the Rule will operate against the banker who allows a customer to overdraw against security, since any payment into the account will be deemed to reduce the original loan, and any fresh advances will be unsecured

This principle is of particular importance in its bearing upon the rights of a banker under a guarantee, or against a deceased's estate, or against a partnership the constitution of which has been changed, for, unless in such circumstances the banker takes steps to prevent the operation of the Rule, he may be unable to recover the whole amount advanced If, therefore, a banker wishes to protect himself against the operation of the Rule—which, it should be noted, applies only in the case of a *current* or *running* account– he should *break* the account, *i e*, discontinue all entries thereon, and open a new account, at the same time informing the customer or his legal representative of the new arrangement

The Banker's Obligation to pay his Customer's Cheques.

The feature which most distinguishes the relationship of banker and customer from that existing between other borrowers and lenders is the recognised obligation of the banker to honour his customer's cheques to the extent of the customer's balance, or up to the amount of an agreed limit if an overdraft has been granted, provided such cheques are in proper form, and that no legal bar exists to prevent the banker from paying them

This obligation of the banker will be further discussed in Chapter 23, and at this point it may merely be observed that the duty arises out of two implied agreements between the parties The first is that the banker will repay what he borrows from his customer provided the latter makes a properly written demand for repayment at the correct branch The other is that the banker will not injure his customer's credit by refusing to pay cheques except upon reasonable and proper grounds, for "if a banker wrongly refuses to honour his customer's cheque, the customer is entitled to substantial but temperate damages, such as will be reasonable compensation for the injury which he must have sustained from the dishonour of his cheque "[1]

The banker's duty to pay cheques drawn by his customer does not apply to *orders for payment* issued by the customer against any balance which he may have on *deposit* account, and, although in practice bankers frequently do pay such orders for the convenience of their customers, they would be quite justified in refusing to do so Nor, in the absence of any specific agreement, is the banker bound to pay bills of exchange domiciled with him by his customer

The Banker's Duty of Secrecy.

It is part of the *contractual* relationship between a banker and his customer that the former will not disclose the state of his customer's account "except upon reasonable and proper occasion," and, in the case of *Tournier* v *National Provincial Bank*, 1924, Lord Justice Bankes pointed out that this duty of non-disclosure applies not only to information derived from the customer himself or from his account, but also to outside information concerning the customer's credit which may come into the banker's possession He suggested, however, that there are four reasonable and proper occasions upon which disclosure by a banker is permissible —

(1) Where there is compulsion of law, as, for example, where under the *Bankers' Books Evidence Act*, 1879, a banker is ordered by the Court or a judge to produce his books in Court, or to produce a certified and duly sworn copy of an entry or entries therein

In *Attorney-General* v *National Provincial Bank*, 1928, it was held that the Inland Revenue Authorities can demand listed particulars of any Stocks registered on behalf of customers in the name either of the bank itself or of its nominees, whether such stock is held by the bank in the capacity of trustee or executor or as security for an overdraft, or whether it was so registered at the customer's request

(2) Where there is a duty to the public to disclose, as, for example, where disclosure is necessary in order to avert a danger to the State

[1] *Fleming* v *Bank of New Zealand*, 1900

(3) Where the interests of the bank require disclosure, as in the case where a banker issues a writ claiming payment of an overdraft and the amount thereof must be stated on the writ

(4) Where there is an express or implied consent of the customer, as where a customer gives his banker as a reference as to his financial standing

The practice among banks of giving "*confidential opinions*" to one another concerning the credit and standing of customers is so well established that probably no customer could successfully object to it, unless he had expressly instructed his banker not to give such opinions Provided the information is given on the ordinary form and in the ordinary course of business, it seems likely that a banker would be able to claim that, when a customer opens an account, he gives his *implied* consent to this practice

When a confidential opinion is given, the information therein should be of an essentially general nature, embodying the banker's considered and truthful opinion as to the general reputation and financial position of his customer, but omitting any details which might infringe the customer's right to secrecy concerning his account "It is not the duty of a banker to make enquiries other than what appears from the books of account before him, or, of course, to give information other than what he is acquainted with from his personal knowledge A banker can be made liable only if he answers an enquiry knowing what he says to be untrue, or recklessly, without caring whether it be true or false" (Hart)

A Bank's Liability for Misrepresentation.

The liability referred to in this quotation is to damages in an action for misrepresentation in giving opinions as to the standing of customers, or in giving advice as to investments

For many years it was considered that, if an opinion or report was not in writing *signed by the bank itself*, then the bank was protected by the Statute of Frauds Amendment Act, 1828 (Lord Tenterden's Act), and could not therefore be held liable Accordingly, the general practice of bankers was not to sign letters containing such opinions But in the case of *Banbury* v *Bank of Montreal*, 1918, it was held that the protection afforded by the Act applies only to cases of *fraudulent misrepresentation* in respect of which a bank obtains complete statutory protection from the Act *unless the misrepresentation is given under its seal* A bank manager or other agent of a bank who signs a document embodying a fraudulent misrepresentation will, of course, be *personally* liable

In regard to *innocent misrepresentation*, the position appears to be that an action against a bank cannot succeed unless (*a*) there was a

duty on the part of the bank to give the opinion, *and* (*b*) the opinion was given by the bank under seal *or* on its behalf by a duly authorised official, *and* (*c*) in giving the opinion, the bank or its official was guilty of negligence amounting to a breach of duty

The Banker's Right of Set-Off.

As a general rule, a debtor is entitled at law to "set-off" against the debt which he owes any amount which is due to him by the creditor, *i e*, he may combine the credit and the debit in order to determine his *net* liability, provided that the debts are both *sums certain*, due as between the same parties *in the same right*, and provided also that there is no express or implied agreement or understanding to the contrary

If, therefore, a customer has two accounts in the same right, one in credit and the other in debit, then, *unless there is an agreement, earmarking, or course of business indicating an obligation to keep the accounts separate*, a banker is entitled, on giving reasonable notice to the customer, to set-off any credit balance against any debit balance and to combine the accounts in order to determine the net liability of the customer to the bank

At one time it was thought that two such accounts could be combined *at any time*, without giving notice to the customer—a principle which was upheld in the case of *Garnett* v *McKewan*, 1872 Now, however, a banker who, in consequence of having combined a credit balance with an overdraft, dishonours his customer's cheques without reasonable notice would probably render himself liable to an action for damaging the customer's credit, and one judge has gone so far as to suggest that the customer's *consent* must be obtained before two separate accounts can be combined (*Giving notice* does not, of course, necessarily mean that the customer's *consent* is obtained)

The necessity for giving notice does not arise if the customer's account is *stopped* by his death, bankruptcy, or insanity, or by the service of a garnishee order, for then the banker may at once combine the accounts in order to determine the net liability of the customer's estate to the bank Furthermore, a banker is entitled *at any time* to combine different accounts if he holds securities of his customer under an agreement which provides that the securities shall cover the *ultimate* balance which may be due by that customer, or if the customer does anything to depreciate the value of the bank's security, *e g*, by giving a legal mortgage of property over which the bank has an equitable charge

It is extremely important to observe that only accounts *in the same right* can be combined Thus a current account and a deposit account in the same name or names may be combined, as also may two accounts

of the same customer headed respectively "No 1 Account" and "No 2 Account," provided that the banker has no actual or constructive notice that one of the accounts is connected with a trust or agency exercised by the customer But an account, the heading of which indicates that it is a trust or agency account (*e g* , "Golf Club Account," "Y M C A Account," etc), cannot in any circumstances be the subject of set off against any other account of the same customer (unless there should be two of such accounts in the same right)

For similar reasons, a banker cannot claim to set off a partner's credit balance against a debt due by his firm, or *vice versa* Nor can he combine the private account of a customer with an account upon which the customer appears as one of the parties, nor a debit or credit balance on the account of a deceased customer against a credit or debit balance standing in the names of his executors or administrators Finally, a banker cannot in any circumstances combine the balances on different accounts of a public authority

The Banker's Right of Lien.

A further special feature of the relationship between a banker and his customer is his right of *general lien* over such of his customer's securities as come into his hands in the ordinary course of his business as a banker This important matter is discussed in Chapter 17

"The Usual Course of Business."

It is of importance that, in all his dealings with a customer, the banker should act in accordance with what is described as "the usual course of business," for if he fails to do so he may render himself liable for any loss or damage which arises and to an action by his customer for negligence As to what is the usual course of business will depend generally on the custom of bankers in this country , "it must be the recognised or customary course of business of the banking community at large, not of any particular bank or group of banks, and a Court might well reject anything which savoured of rashness or indifference to the interests of the customer or true owner The course of business must be not only usual but reasonable "[1]

Garnishee Orders and the Customer's Account.

A Garnishee Order is an order of the High Court in favour of a creditor who has obtained judgment against his debtor, attaching funds of the debtor which are in the hands of a third party, *the garnishee*

Garnishee proceedings actually comprise two distinct steps The first is the issue by the Court of a *Garnishee Order nisi*, which attaches

[1] Paget, *Law of Banking*, 3rd edition, page 241

the funds in the hands of the garnishee but gives him an opportunity of appearing before the Court to show cause why the funds in his hands should not be handed over to the judgment creditor The second step is taken when the order is made *absolute* by the Court, and the garnishee is compelled to transfer to the judgment creditor either the whole of the funds in his hands or such portion thereof as is necessary to satisfy the judgment debt

So far as bankers are concerned, several very important points arise in connection with these orders The order attaches all debts "*owing or accruing due*," and accordingly the whole of a customer's balance on current account is attached, although the amount of the debt may be considerably less than the balance standing to the customer's credit

The result is that, as from the receipt of the order, the balance on the account must not be interfered with in any way, and any cheques subsequently presented must be returned unpaid, even if they were issued before the date of the order, and even if the balance in excess of the amount garnisheed is ample to cover the payments

Where the balance to the customer's credit is *less* than the amount for which judgment has been obtained, the banker should dispose of the matter at once by paying the balance into Court as soon as the order *nisi* is served on him, if necessary exercising his right to deduct therefrom any debt which is properly due to him

If the balance to the customer's credit is in *excess* of the amount of the judgment debt, the usual course, particularly if the banker is anxious to safeguard his customer's interest, is at once to inform the customer that the order has been served and to open a new account through which all future transactions are passed, the old account being allowed to remain dormant until the judgment debt is satisfied If, in these circumstances, the order is made absolute, the banker should pay the required amount to the judgment creditor, and such payment then operates as a valid discharge as between the bank and the customer

Since a garnishee order can attach only debts which are "*owing and accruing due*," it is clear that such an order cannot touch any amounts which may in the future become due by the banker to the customer (*e g*, the proceeds of bills or coupons in process of collection, or of securities in process of realisation), nor can it touch any moneys which are not at the time of receipt of the order actually *due and payable* by the banker In the *Joachimson* case, as stated previously, it was laid down that money left with a banker is not a debt due and payable until a demand for repayment has been made by or on behalf of the customer, and at first sight it would appear that, unless this demand has been made, any balance in a banker's hands cannot be attached by a garnishee order. In the *Joachimson* case, however, the Court of

Appeal held that the garnishee order *nisi* itself operates as a demand for repayment sufficient to render money on current account accruing due

A garnishee order does not attach deposit accounts subject to notice, unless the notice has been given by the customer when the order is received, in which case the debt will be *due* if the notice has expired, and *accruing due* if the notice is still running And it does not affect money on deposit receipts repayable upon fulfilment of certain conditions—such as the giving of notice, or the return of the receipt—unless those conditions have been fulfilled But it does attach moneys on deposit account repayable on demand, or at call, or on a fixed date, for, in such cases, the funds are properly regarded as "accruing due"

County Court Garnishee Summons.

The law with regard to the attachment of debts in the High Court applies *mutatis mutandis* to proceedings in the County Court The judgment creditor may begin proceedings either by lodging with the Registrar an affidavit stating the material facts, or by entering a "*plaint*" Thereupon a summons is issued by the Court and is served upon the garnishee personally, this summons having exactly the same effect as a garnishee order *nisi* in the High Court

On service of the summons, the garnishee may either pay the sum into Court, pay the judgment creditor or appear to contest the summons at the Court If he does none of these things, or if he contests the summons and fails, the judge makes an order against the garnishee for the amount due together with costs, and this order has the same effect as a garnishee order absolute in the High Court

Entries in a Customer's Pass Book.

The importance to a banker of ensuring the correctness of the entries in a pass book will be appreciated when it is pointed out that, at law, such entries are *prima facie* evidence *against* the banker, and, if the customer can prove that he has in good faith altered his position in reliance upon the balance shown by the pass book, the banker will be estopped from denying the accuracy of the entries

The general position seems to be that if a customer, in reliance upon entries in his pass book which are actually incorrect, has been induced to draw out more money than he otherwise would have drawn, or has otherwise altered his position to his detriment, then the banker must bear the loss, and it is no defence for the banker to prove that the customer has had an opportunity of examining the pass book, for apparently there is no *obligation* upon the customer to see that the entries are correct Furthermore, even if a banker discovers that he

has wrongly credited an amount to the account of the customer, he will run considerable risk of being held responsible for injury to his customer's credit if, after discovering the mistake and before the error is communicated to the customer, he dishonours cheques drawn by the customer in reliance upon the position disclosed by the pass book

Again, if cheques are wrongly debited to a customer's account, the customer can demand that his balance be restored, even if he has received his pass book from the bank and has had an opportunity of verifying the correctness of the debits Hence, in a case where a bank over a long period had paid various cheques bearing a forged signature of its customer, and from time to time the customer had obtained his pass book but had raised no objection to the debits relating to such cheques, the banker was unable to succeed in his claim that, by so doing, the customer had acted negligently, and could be regarded as having induced the bank to pay subsequent forged cheques

As the law stands at present, therefore, the pass book is not evidence of a settled account as between banker and customer There is no duty on the customer's part to examine his pass book, and the banker cannot contend that his customer, by his silence or by refraining from criticising the entries, has virtually adopted them as being correct

As Sir John Paget points out, this position is most unsatisfactory from the banker's point of view, for the proper function of the pass book should be "to constitute a conclusive, unquestionable, record of the transactions between banker and customer" Provided the customer has had a reasonable opportunity of examining the entries, they should be regarded as final and incapable of being subsequently reopened to the bank's detriment If this view were adopted by the Courts, bankers would no doubt be able to regard the return of a pass book by a customer, without comment, as *prima facie* evidence that the customer had agreed the items and found the entries correct

At the same time, the law will certainly protect a banker against a customer who is endeavouring to take fraudulent advantage of a mistake in his pass book Before a customer can succeed he must act innocently and without negligence, but the principal difficulty appears to be in determining what acts of a customer amount to negligence

The true test would seem to be that the customer must act as a "reasonable man" would in the circumstances There would appear to be no obligation to examine the pass book, but the Courts would probably hold that, *in cases where the pass book had been examined*, a greater degree of care would be required from a business man than from a private customer

As the result of the adoption of a system of mechanical book-keeping by certain of the large banks, the written pass book has been replaced by a machined statement This form of statement contains a

docquet which the customer is requested to sign, and in which he confirms the accuracy of the statement It is possible that this system will be the means of affording bankers greater security regarding the communication of book entries to customers.

Closing an Account.

A customer may at any time close his current account with a bank by withdrawing the balance if the account is in credit, or by paying the banker what is due, plus any accrued interest and other charges, if the account is overdrawn But it is only in the customer's own interest to make sufficient provision to enable the bank to meet any outstanding cheques, and, if this is not done, the bank is within its rights in returning any such cheques marked "Account closed"

A deposit account cannot be closed by a customer and the funds thereon withdrawn, unless the requisite period of notice is given, or unless the deposit receipt (if any) is duly discharged and handed to the bank

The banker cannot at any time summarily close an account and pay back the balance to the customer, nor can he at any time he thinks desirable terminate the account and dishonour any cheques subsequently presented The customer is entitled to have reasonable notice that the banker wishes the account to be closed, and the correct procedure is to advise the customer in writing that no further credits to his account will be accepted, and that he should withdraw any balance standing to his credit, subject to his leaving with the banker sufficient funds to pay any outstanding cheques

If reasonable steps of this nature are not taken and the banker dishonours cheques of his customer without proper notice, he will render himself liable to an action for damages for injury to the customer's credit As to what is reasonable notice is a question of fact, but in *Prosperity, Ltd* v *Lloyds Bank, Ltd*, 1923, as much as one month was considered insufficient notice in the circumstances

Similarly, a banker who wishes an *overdrawn* account to be closed should give his customer reasonable notice, and he should not dishonour cheques drawn by the customer unless the limit which he has agreed to advance has been exceeded or would be exceeded by the payment of the cheques If a fixed loan has been granted and the proceeds thereof credited to a current account, the customer is entitled to draw out the *whole* of the credit balance unless he is given reasonable notice by the banker calling in the loan.

An account, whether in debit or credit, is legally closed by the death, insanity or bankruptcy of an individual customer, by the dissolution of a partnership customer, and by the liquidation or winding-up of a company customer A credit account may also be closed, as already

explained, on receipt by the bank of a garnishee order attaching the whole of the balance outstanding.

Assignment of the Balance on an Account.

The debt owing by a bank to its customer may be assigned by the customer to a third party, and, if due notice of such an assignment is given to the banker, he must pay the balance to the assignee and to him *only, unless* (*a*) the banker has any right of lien or set-off in respect of the balance, or (*b*) the assignor gives him notice not to pay.

In the former case, the banker can at once exercise his rights over the balance, paying the surplus (if any) to the assignee, but in the latter case, his best course is to pay the money into the High Court or *interplead*, *i.e.*, bring an action to determine the ownership of the balance on the account.

The assignment of a balance on current account means that the contract between the banker and his customer is at an end, and that the assignee can give the banker an effective discharge which frees him from all future liability.

CHAPTER 14

PERSONAL CUSTOMERS AND PARTNERSHIPS.

HAVING briefly reviewed the main features of the general relationship between banker and customer, we may now consider the obligations incurred by a banker, and the general rules of conduct which he must strictly observe in dealing with certain types of customer.

In the present chapter, we shall confine our attention to *personal* customers only, and leave for the next chapter the important group of *impersonal* customers, comprising corporate bodies of all kinds, such as joint-stock companies and local authorities, whose powers are largely defined by law.

The Accounts of Individuals Generally.

It is now definitely established that a banker may be held guilty of negligence unless he obtains satisfactory references before he opens a new account for a prospective customer. But provided this is done, and provided the account is conducted in accordance with arrangements made when it was opened, the banker is not concerned as to the origin of any credits paid in or with the destination of any moneys paid out, unless there are circumstances of a suspicious character or evidence that the customer's dealings involve a breach of trust.

Whether the account is to be maintained in credit or is to be a loan account, the customary banking procedure relative to the opening of accounts must be followed. A specimen of the customer's signature will be taken, and arrangements will be made in regard to the charges to be made by the banker for the conduct of the account, and in regard to the rate of interest which is to be charged or allowed, as the case may be.

If the customer wishes to have his cheques cashed at any other branch or bank, a second specimen of his signature will be taken for dispatch with the necessary authority to the bank or branch concerned.

Occasionally, a customer wishes to give authority to a certain person or persons to draw cheques on his account and/or to indorse cheques or bills in his name. In such a case, the necessary mandate will be taken on the bank's prescribed form, and arrangements will be made for the bank to be supplied with a specimen signature of each person

so authorised, who should be required to call personally at the bank so that he may thereafter be identified without difficulty by the bank officials

It is very desirable, in the absence of a special request from the customer to the contrary, that a mandate giving authority to sign should be worded so that it may apply whether the account is in credit or is overdrawn, otherwise difficulties may be experienced in holding the customer liable for any overdraft created by cheques drawn by the agent Furthermore, it must be remembered that an authority to *indorse* does not sanction the *drawing* of negotiable instruments , that an authority to draw and indorse *cheques* does not extend to the drawing, accepting, or indorsing of *bills of exchange*, and, finally, that an ordinary mandate authorising the indorsement and/or signing of cheques does not imply a power to pledge securities in respect of any advance created on the account

Infants as Customers.

Since the contractual capacity of an infant, *i e* , a person under twenty-one years of age, is strictly delimited by law, it is clearly most inadvisable for such a customer to be granted an overdraft or loan, and though no serious difficulty should arise if the relative account is kept in credit, it must not be forgotten that an infant is never liable on a bill of exchange as drawer, acceptor or indorser

As a rule, bankers do not open accounts for the very young, and the best course in *all* cases where the applicant is under sixteen years of age, is to open the account in the name of a parent or guardian, marking the account so as clearly to indicate that it concerns the infant, as, for example, " Thomas Robinson, account John Henry Robinson "

If an advance is granted to an infant, the transaction is entirely void and the banker granting the loan will be unable to succeed in an action for repayment of the money, or to retain or realise any securities deposited by the infant in respect of the advance The bank can, however, enforce its rights against any third party who has given a guarantee or deposited security in respect of an overdraft granted to an infant

There is nothing to prevent an infant from acting as an agent to bind a principal, so that a banker is safe in accepting a written authority empowering an infant to draw or indorse cheques and bills, or to accept bills, or to overdraw his principal's account Furthermore, an infant may act as partner in a firm with power to bind his co-partners, but it is not desirable to allow an infant to operate a partnership account unless specific authority in that regard is obtained from the remaining partners

Married Women.

Here, again, no special procedure is necessary and no difficulty should be experienced if the account is kept in credit, for, in the absence of notice to the contrary, a banker is justified in treating an account in the name of a married woman and any moneys therein as belonging to the individual concerned, and this is so even if it may afterwards be shown that the funds really belonged to the woman's insolvent husband Unless the banker receives express or constructive notice that funds on the account of a married woman do not belong to her, his duty is to pay cheques drawn by his customer, and, if he does so in good faith, he obtains a good discharge

As a rule, bankers will not grant an advance to a married woman unless they are specially safeguarded If the advance is granted on the strength of the husband's position, his personal guarantee should be obtained, and if deeds or securities are deposited by the married woman in respect of the overdraft, they should be taken only after consultation with a solicitor and on the execution of a formal document of charge, for, if the property concerned is subject to what is known as a " restraint against anticipation," the married woman has no right either to deposit the deeds as security or to encumber the future income therefrom

Any property or funds of a deceased married woman must be dealt with by her personal representatives appointed in the usual way as executors or administrators Accordingly, on the death of a married woman customer, the banker should require to see the relative probate or letters of administration before permitting any securities or funds in his hands to be dealt with

There is nothing to prevent a married woman from acting in all matters as an agent on behalf of another or others, as, for example, in drawing cheques on an account Moreover, she may be appointed to the office of executrix, administratrix or trustee, but, if she undertakes such duties, her husband cannot be held liable for any of her acts or obligations in the performance of the executorship, administration or trust, so long as he does not interfere therewith

Persons of Unsound Mind.

The mandate contained in a cheque is terminated by the insanity of the drawer, so that a banker who pays cheques drawn by a customer who is or has become insane may be held to have paid away money of his customer without proper authority The banker cannot, however, be held liable if the cheques were paid before receipt by him of reliable notice of the insanity

If a banker receives reliable information that a customer has become insane, he should suspend all operations upon the account until he receives definite proof of the customer's recovery, or is notified of the

appointment by the Court of a Receiver or Committee, in whom is vested the management of the affairs of the insane customer under the direction of the Commissioners in Lunacy When a person is thus found lunatic by inquisition, the sole power to transact business in connection with the estate, including the drawing of cheques on the lunatic's account, is usually vested in the Receiver or Committee, and this power continues until the inquisition is annulled by the Court

Certification of a person as insane after careful inquiry by a Master or Commissioner in Lunacy, is to be distinguished from mere temporary mental derangement or loss of memory In the latter circumstances a banker is quite justified merely in suspending operations upon the account until the customer recovers, or, alternatively, in permitting the customer's wife or other near relative to operate thereon against a satisfactory indemnity absolving the bank from liability

Joint Accounts other than Partnership and Trust Accounts.

A banker who opens a current account in the joint names of two or more persons who are not partners should take a mandate, signed by the persons concerned, embodying instructions as to how the account is to be operated, how cheques and bills are to be signed and indorsed, and clearly setting forth how the balance is to be disposed of in the event of the death of any of the parties

Unless the parties specifically indicate that they wish to delegate their authority to sign cheques to one or some of their number, or to an outside person, all cheques and other instructions to the banker must be signed by *all the parties*, and, in the absence of such authority, a banker should in no circumstances pay cheques which purport to be signed by one or some persons on behalf of all

The general rule of law is that, on the death of any party to a joint account, the balance vests in the survivor or survivors, but such survivor or survivors are in the position of trustees in regard to any portion of the funds which properly belong to the deceased's estate, and it will therefore save trouble from the banker's point of view to have the matter clearly provided for in the mandate

On the death of any of the parties to a joint account on which *all* parties have to sign, the account should be stopped until satisfactory evidence of the death is produced to the banker When this is done, the survivor or survivors should be permitted to deal with the balance, subject to any arrangements to the contrary as to the participation of the deceased's personal representatives If, however, the mandate relating to such an account specifically provides that cheques may be drawn by one or some of the parties, then on the death of one the balance may, of course, be withdrawn by the survivor or survivors and proof of the death is not strictly necessary

The mandate relative to a joint account will usually include an undertaking by the parties to be *jointly and severally* responsible for any overdraft Such an undertaking is essential if an advance is contemplated, for, in its absence, the parties will only be liable *jointly*, which means that, on the death of one of the parties, his estate is freed from liability, and only the survivor or survivors will be responsible for repayment of the advance

On receipt of notice of the insanity of a party to a joint account, the account should be stopped pending receipt of instructions from the Court, unless the other or others are given authority, in the mandate, to draw cheques and deal with the balance

If one of the parties to a joint account commits an act of bankruptcy, the banker should stop all operations on the account, and should return all cheques drawn by any of the parties which are thereafter presented Operations on the account should be resumed and future cheques paid only after the receipt of joint instructions from the solvent party or parties and the trustee in bankruptcy

The foregoing remarks apply only if the banker has no notice of any trust in connection with the joint account, for, if such is the case, the account should be dealt with in accordance with the principles relative to trust accounts which are explained below

Accounts in the Names of Husband and Wife.

In the case of a joint account in the names of husband and wife care should be taken to see that the mandate specifically provides for the disposal of the balance in the event of the death of either party If this is not done, it might be claimed by the husband's personal representatives that the balance (if any) forms part of his estate, in which event it could not be claimed by the wife for her own immediate use although it may have been the intention of the parties that the balance should revert to the wife in the event of the husband's death

Undischarged Bankrupts.

A person who has been adjudicated bankrupt suffers from a number of civil and contractual disabilities until he obtains an order of discharge from the Court From a banker's point of view, the most important disabilities are that (*a*) an undischarged bankrupt must not obtain credit from any one person in excess of £10 without disclosing the fact that he is an undischarged bankrupt, (*b*) that a banker must not conduct an account for a person whom he knows to be an undischarged bankrupt unless, having notified the trustee or the Board of Trade of the existence of the account, either (1) he receives the sanction of the

Court to the making of payments, *or* (ii) no action is taken by the trustee within *one month* of the notice

On the other hand, Section 47 of the Bankruptcy Act, 1914, protects certain transactions by undischarged bankrupts provided that the property concerned has been acquired by the bankrupt *after his adjudication*, and brings within the sphere of this protection receipts, payments and transfers by a banker of money, securities or negotiable instruments

If, therefore, a banker delivers to a bankrupt customer securities which the latter has acquired *after his adjudication*, or pays out to such a customer—or on his instructions to a third party—money standing to his credit, the transactions will be protected as against the trustee in bankruptcy, provided the transactions are completed before the trustee intervenes. But if the property or money delivered has been acquired by the bankrupt *before his adjudication*, no protection is afforded, and the banker is accountable to the trustee for the value or amount of such property or funds

This protection does not, however, release the banker from the duty of giving notice of the existence of the account of an undischarged bankrupt to the trustee in bankruptcy or to the Board of Trade *in every case*

Trustees.

Wherever a banker has information or suspicions that an account is a trust account, it is advisable to make the matter quite clear by specifying the fact in the ledger heading and upon the pass book, for if the banker becomes a party to a breach of trust, and it can be shown that he had notice of the fiduciary character of the account, he cannot escape liability merely on the ground that there is no indication of the fact in the heading of the account as it appears in his books

In the conduct of a trust account the banker must not only recognise his duty to honour his customer's cheques, he must also consider the interests of the persons entitled to the benefits of the trust. But the banker is not liable in respect of a breach of trust so long as he cannot be regarded as being a party thereto or having received notice thereof, and as to what constitutes such notice is a question of fact to be determined by the circumstances

It is definite that the banker will be affected with notice of the breach if he derives some personal benefit from the breach, as, for example, where a customer has an overdrawn private account, and, being pressed to effect a reduction of the debt, transfers thereto funds from a trust account in his name

The banker would also render himself liable for negligence if he were to credit a customer's private account with cheques payable to him in a fiduciary capacity, or payable to a trust with which the customer is

connected The banker would, in such circumstances, undoubtedly lose the protection of Section 82 of the Bills of Exchange Act in respect of the collection of crossed cheques (Chapter 24) "A banker must scrupulously abstain from being party or privy to any operation on an account known to be a Trust Account, involving benefit to the banker, even indirect and unasked for, through the medium of an overdrawn private account or otherwise, and whether or not a cheque is concerned "[1]

On the opening of a trust account in joint names a banker should take a mandate providing that cheques are to be signed by *all* the parties to the account, and, unless the trust deed expressly provides that one or some of the trustees may sign on behalf of all, the banker should refuse to accept a mandate purporting to delegate authority to sign to one or some of the trustees

Advances to Trustees.

Trustees have no right to obtain advances on the security of trust property unless specific authority is given by the trust instrument, but an exception to this general rule is made by Section 16 of the *Trustee Act*, 1925, which allows trustees to mortgage or charge trust property in order to raise funds for the purpose of the trust Moreover, if an overdraft is granted on a trust account, the banker may hold the trustee or trustees personally liable to the extent of the trust property

When a customer deposits with a banker as security for a private advance *negotiable* securities, such as bearer bonds, which in reality belong to a trust, the banker will nevertheless be able to retain them if he acts in good faith and without notice that the securities are trust property

A banker cannot in any circumstances set off a credit balance of a trust account against a private advance granted to a trustee

Effect on a Trust Account of Death of Trustee.

In the absence of anything to the contrary in the trust deed, the duties and obligations of a trusteeship become vested in the surviving trustee or trustees on the death of one of their number, but, if such an event occurs, the banker should satisfy himself that no special provisions on the matter are contained in the deed before permitting the survivor or survivors to operate the account or deal with any trust property in his hands If the deed provides for the appointment of a new trustee, the account should be stopped until the banker is notified in writing of the appointment and is supplied with the signature and description of the person appointed

[1] Paget, *Law of Banking*, 3rd ed , pp 52–56

Upon the death of a sole trustee or the last survivor of a number of trustees, new trustees may be appointed in accordance with the terms of Section 36 of the *Trustee Act*, 1925, but pending such an appointment, the personal representatives of the deceased sole trustee may exercise any power or trust which could have been exercised by the deceased trustee

Effect of a Trustee's Bankruptcy.

The bankruptcy of a trustee does not involve any trust property in his hands, for such property belongs to the beneficiaries and cannot be claimed by the private creditors of the trustee Moreover, the bankruptcy of a trustee does not affect his rights to deal with trust property for the purpose of the trusteeship, although in such circumstances it may be desirable to apply to the Court for the appointment of a new trustee in accordance with the powers in this regard given by Section 41 of the *Trustee Act*, 1925 In the case of a trustee in bankruptcy, a new appointment *must* be made if the trustee himself becomes bankrupt

Trustees in Bankruptcy and Liquidators of Companies.

Trustees in bankruptcy and liquidators of companies in compulsory liquidation are not permitted to open accounts at local banks unless authority is first obtained from the Board of Trade

The Bankruptcy Rules, 1915, provide that all cheques on the account of a trustee in bankruptcy shall bear the name of the debtor's estate and shall be drawn payable to order, being signed by the trustee and countersigned either (*a*) by such person, if any, as is appointed by the Board of Trade, or (*b*) if there is a Committee of Inspection, by at least one member of that Committee, and such other person, if any, as is appointed by the creditors or the Committee As a rule, the signature of the trustee alone is accepted by bankers—a practice of doubtful legality

Where a special account is opened by the liquidator of a company, all payments out must be made by cheques payable to order, bearing the name of the company, signed by the liquidator and countersigned by at least one member of the Committee of Inspection and by such other person, if any, as the Committee may appoint

If there is no Committee of Inspection, the Official Receiver may exercise the functions of such a committee subject to the directions of the Board of Trade A liquidator has power to raise money on the security of the company's assets if necessary for the conduct of the liquidation, but a banker should exercise care to ensure that assets so charged are free from the claims of mortgagees and debenture-holders The liquidator incurs no personal liability in respect of these advances, in the absence of specific agreement

Executors and Administrators.

The accounts of executors (which for present purposes may be regarded as including the accounts of administrators) are, of course, merely trust accounts of a special kind, subject to the important difference that, as executors may delegate their authority *to one of their number*, the signature of one executor is sufficient to bind all parties to the account, whereas such a delegation of authority can be made by trustees only in exceptional circumstances

But although executors may delegate their authority to one of their own number, they cannot empower any other person to act on their behalf, except for special business such as is transacted by solicitors, stockbrokers or auctioneers A banker should not, therefore, accept a mandate authorising any *outside* person to operate on an executorship account

Occasionally, before probate or letters of administration are granted, the personal representatives of a deceased person require an advance for the purpose of the trust, as, for example, to settle outstanding debts or to pay funeral expenses In such circumstances, a banker should satisfy himself as far as possible that the persons concerned have a right to deal with the affairs of the deceased, and he should then make all the parties jointly *and severally* responsible for the overdraft by taking their signatures to a joint and several guarantee If necessary, he should also require the deposit of collateral security

Even when probate or letters of administration have been issued, considerable care is required in granting accommodation to personal representatives Such representatives have no power to borrow money so as to bind the *general* estate of the testator, but, unless they are expressly forbidden to do so by the will, they can give the lender a charge over *specific* assets belonging to the estate Wherever possible, therefore, such a charge should be taken, for in its absence, a banker cannot retain any securities belonging to the deceased in respect of advances granted to the personal representatives, nor can he levy execution against the general assets of the estate in respect of a loan granted to the representatives

If, on the other hand, the account of a deceased person is overdrawn at the time of death, the banker is entitled to retain in respect of the advance any securities which are in his hands (other than securities or valuables deposited for safe custody), until the advance is paid off by the personal representatives If such representatives do not repay the advance, the banker can take steps to realise his security, transferring the balance, if any, to the executors If the amount of security held is inadequate to repay the loan, the banker is entitled to call upon the executors to pay the balance out of the general estate, and if this is not done, he can enforce payment of the amount due to him against the estate

Unless he is authorised to do so, a banker is not entitled to transfer from an executorship account an amount sufficient to discharge any outstanding liability of the deceased For any such transfer he should get specific authority in the form of a cheque signed by all the representatives

Persons who are Executor-Trustees.

It sometimes happens that the same persons are appointed both as executors and as trustees under the will of a deceased, the executors being required, first of all, to wind up and administer the estate and thereafter to act as trustees for some or all of the beneficiaries In such circumstances it is not always clear when the executors cease to function as such and when they become essentially trustees, a point which is of importance in view of the fact that, although one executor may usually act on behalf of all, trustees cannot delegate their authority except in special circumstances

In all such cases, therefore, a banker's best course is to require the signature of *all* the parties to any transactions other than those which clearly arise out of the winding-up of the estate, as, for example, the payment of deceased's debts, funeral expenses and pecuniary legacies.

The Accounts of Trading Partnerships.

In the case of a *trading* partnership, every partner has implied power to bind the firm by opening an account in its name and by drawing, indorsing or accepting bills of exchange, except as to any person who has notice that a partner has been restricted from so acting But, in spite of this general rule, no banker should open an account in the name of a firm consisting of several persons, or pay cheques or honour other instruments bearing the signature of one partner, without taking a mandate, signed by all the partners, authorising the opening of the account and specifying the manner of operating thereon

All partners should join in an authority to enable an *outside* person to operate the firm's account, and the mandate should distinctly provide whether or not the authority is to apply if the firm's account is overdrawn

As a rule, the partnership mandate will contain an undertaking on behalf of the partners to hold themselves jointly *and severally* liable in respect of any overdraft or loan granted to the firm, but it is usual and desirable to take the signatures of all the partners to a joint and several guarantee as well *All* the partners should also sign any document charging property of the partnership as cover for a loan or overdraft granted to the firm Such a safeguard is advisable in spite of the fact

that any partner in a *trading* firm has implied power to pledge its credit, to borrow money, and to sell or pledge its property for the purposes of the partnership business

In the case of guarantees and legal mortgages *under seal*, all the partners must sign individually, for one partner has no implied power to bind his co-partners by giving a guarantee or by executing a deed in the name of the firm, unless in the former case it is the firm's practice or business to give guarantees

Nevertheless, in the event of only one partner signing a document purporting to give the banker a legal mortgage or charge over property of the firm, all the partners will be *equitably* bound, *i e*, the banker's claim in respect of the property may be postponed to any rights of prior parties.

Non-trading Firms.

In the case of a *non-trading* firm, such as a firm of doctors or solicitors, a partner therein has no implied authority to bind the firm by bills of exchange or promissory notes, or to borrow money on behalf of the firm, or to pledge its property as security for an advance If, therefore, a partner in such a firm signs the firm's name to a negotiable instrument or seeks to bind it in any other way without having express authority to do so, that partner will be personally liable, but the other partners will not be bound This general rule is subject to the exception that a person may be able to hold the firm liable if he can prove that the act of the partner was usual or necessary in the particular business, as, for example, the drawing of cheques for payments arising out of the business of a firm of doctors or solicitors

In dealing with a non-trading partnership, a banker's best course is to make absolutely certain of his position by requiring the signature and authority of *all* the partners in respect of all operations connected with the account, but there is, of course, no objection to his taking a mandate signed by all the partners giving one of their number or an outside person authority to operate on behalf of the firm

Treatment of a Firm's Account on Dissolution.

A partnership is dissolved by any change in its constitution following the death, retirement, or bankruptcy of a partner, and, in all such cases, the banker should stop the firm's account if he wishes to preserve his rights against the estate of the partner who is dead, retired, or bankrupt If the partnership is continued by the surviving partners, they should be required to furnish the bank with a fresh mandate, and to open a new account for all subsequent transactions

If the dissolution is by death, the credit balance on the firm's account vests in the remaining partners, who can give the banker a valid discharge for the balance outstanding The remaining partners are also entitled to the credit balance in the event of the bankruptcy or retirement of a partner, but they are liable to the personal representatives of the deceased in the case of death, or to the trustee in the case of bankruptcy, or to the partner himself in the case of retirement, for that portion of the assets of the firm which belongs to the outgoing partner by reason of his interest in the partnership

Retired partners, or the legal representatives of a deceased or bankrupt partner, have no power to bind the firm in any way whatsoever But any cheques drawn on the firm's account by a deceased partner may be paid by the banker unless there are special circumstances which warrant their return marked " Partner deceased," as, for example, the fact that the account has been stopped by the banker in order to safeguard his rights against the deceased partner's estate Cheques drawn by a bankrupt or retired partner may also be paid if they are dated before the bankruptcy or retirement, although it may be advisable in such cases to obtain confirmation from the other partners

On the dissolution of a firm by the happening of any of the events referred to, the remaining partners have authority to bind the firm and continue its business so far as may be necessary for the winding up of the partnership affairs For this purpose the remaining partners may sell or pledge the partnership property, draw and indorse cheques, draw, indorse and accept bills, and perform other acts which are necessary for the proper winding up of the firm's business

If a partnership account is not stopped in the manner indicated on the happening of one of the events mentioned, any payments to the credit of an overdrawn account after the happening of the event will have the effect of reducing *pro tanto* the liability of the old firm, or the liability of a guarantor for the old firm, by reason of the operation of the Rule in Clayton's case

Furthermore, a banker cannot hold liable the estate of a deceased or bankrupt partner in respect of debts or obligations created by the partnership after the date of death or bankruptcy, but a retiring partner may be held liable for obligations incurred after his retirement, unless notice of the retirement has previously been given

The insanity of a partner does not necessarily involve the dissolution of the firm, but, on application by another partner, the Court may decree a dissolution if the insane person is found lunatic by inquisition or shown to the satisfaction of the Court to be permanently of unsound mind From a banker's point of view, it is desirable that such a dissolution should be effected, otherwise he may be involved in difficulties by reason of the issue of cheques or by other activities of the partner suffering from the mental derangement

Bankruptcy of a Partnership.

The bankruptcy of a partnership as such involves the bankruptcy of every member of the firm, and necessitates the stopping of all accounts in the name of the partnership or in the names of any of the individual partners.

If debts are due to the banker on the firm's account and also on the private account or accounts of a partner or partners, he must prove for the *private* debts against the individual estates, and for the *firm's* debt against the joint estate The partnership assets are first applied in payment of the joint debts, and the private assets of each partner are applied, first of all, in payment of his private debts Any surplus from the estate of the firm is distributed amongst the private estates of the partners according to each partner's interest, while any surplus on a separate estate is transferred to the joint estate for division amongst the firm's creditors After satisfaction of all outside creditors, the residue from the partnership estate is applied first in paying each partner what is due to him in respect of loans to the firm, secondly, in paying to each partner what is due to him in respect of capital, the remainder being divided amongst the partners in the proportion in which they share profits

If the banker is secured by the terms of a joint and several mandate or by a joint and several guarantee, he may claim against the joint estate of the firm and against the individual estates of each partner, although he cannot recover in total more than is due to him on all accounts

If the banker holds security deposited *by one of the partners* in respect of the firm's overdraft, he may treat that security as *collateral*, *i e*, he may claim against the firm's estate in respect of the whole of the debt due to him on the partnership account without, first of all, valuing his security and deducting that value from the amount of his debt

Similarly, if he holds security deposited *by the firm* to cover a private overdraft of one of the partners, he can claim against the estate of the partner concerned for the full amount of his debt without, first of all, valuing his security Again, security which is held to cover a partner's private overdraft *as well as* a debt due by the firm, may be held by the banker as collateral to whichever debt he pleases, so that he may retain his right to claim in respect of the *whole* of the other debt against the estate concerned

CHAPTER 15

IMPERSONAL CUSTOMERS.

THE powers of such customers as joint-stock companies, friendly societies, and local corporations to contract and to transact business are strictly controlled by the law under which they are constituted Hence, before entering into business relations with any of the bodies referred to, a banker should make himself thoroughly acquainted with any statutes governing their constitution and with any rules which may affect the conduct of their affairs

The Accounts of Joint Stock Companies.

As a rule, the first step in connection with the opening of the banking account of a limited company is taken by the Board of Directors, which passes a resolution to the effect that the account of the company shall be opened at a certain bank, and authorises the secretary to supply the bank with the necessary particulars regarding the company's constitution and powers

This resolution is embodied in a mandate addressed to the banker and is forwarded to him with (*a*) the company's Certificate of Incorporation, for inspection and return, (*b*) copies of the company's Memorandum and Articles of Association for the banker's information and retention, (*c*) the company's Trading Certificate for inspection and return, (*d*) a copy of the certified resolution of the Board of Directors authorising the opening of the account, together with specimen signatures of the persons authorised to sign on the company's behalf, (*e*) a copy of the company's last balance sheet, certified by its auditor

The *Trading Certificate* is not needed in the case of a *private* company, but is essential in the case of a *public* company registered after 31st December, 1900 Before the issue of this certificate a public company cannot commence business or borrow money, while any contract made by such a company before the issue of the certificate is provisional only, and is not binding on the company unless the certificate is afterwards issued

Importance of perusing the Memorandum and Articles.

The copies of the Memorandum and Articles are retained by the banker, who should carefully peruse them to ascertain the nature of the business and the extent of the powers of the company

The Articles are subsidiary to the Memorandum, but from them the banker must ascertain the rights vested in the directors to exercise the powers of the company as defined in the Memorandum He should notice especially the regulations governing the execution and indorsement of contracts, deeds, bills of exchange, promissory notes, and cheques, ascertain how the banking account is to be conducted, whether or not all acts of the directors must be done at a board meeting, and whether power is given to the directors to delegate their authority, and if so, to what extent He should also assure himself that the mandate signed on the company's behalf by its officials does not exceed any provisions contained in the Memorandum or Articles, for, if any acts of the officials go outside the powers conferred on the company by its Memorandum, they will be *ultra vires* the company, *i e*, beyond its powers and not binding upon it On the other hand, if the acts are within the provisions of the Memorandum but outside the powers of the officers as laid down in the Articles, the acts will be *ultra vires* (*i e*, beyond the powers of) the officers, and the company *may* or *may not* be bound according to the circumstances (*See the Rule in Turquand's case*, below) If the banker is doubtful upon any material point, he should take the advice of a solicitor thereon

Borrowing by Joint Stock Companies.

In the case of a *non-trading* company, express powers to borrow and pledge its property (*e g*, by Debentures) must be included in the Memorandum, otherwise the company cannot exercise any such powers even to the extent of discounting bills of exchange On the other hand, a *trading* company has *implied* powers to borrow, to invest or lend its funds, and to pledge its property to such an extent as is reasonably necessary for the carrying out of its legal objects, even if such powers are not explicitly mentioned in its Memorandum, but a banker or other lender should be most careful to determine whether the Memorandum or Articles impose any restrictions or limitations on such powers

In the absence of restrictions in the Memorandum or Articles a company's borrowing powers may be exercised in any manner which the directors think fit, as by overdraft on current account, by special loan account, by legal or equitable mortgage over specific assets of the company, by debentures or bonds, or by the giving of a floating charge over the general assets of the company

A banker should not, however, grant a company an advance without first requiring the deposit with him of a copy of the resolution of the directors authorising the overdraft and sanctioning the deposit and signing of the proposed security In addition, he should determine whether such a resolution is permissible under the terms of the

Memorandum and Articles, for such documents may empower the directors to borrow money but may debar them from *pledging* as security any property of the company, or it may be provided that the company can borrow and give security only by the resolution of its shareholders in general meeting The documents should be searched also to ascertain whether they limit the company's borrowing powers to a certain fixed amount, for if any limit so specified is exceeded by the directors, or, if the directors borrow although the company itself has taken no powers to borrow, then the borrowing will be *ultra vires* the company and void, and any security given inoperative against the company

The remedy left to the lender in such circumstances is that he is "subrogated" to the rights of the creditors or other persons who have been paid with the funds borrowed, *i e*, he may "stand in the shoes" of those who have benefited in money by reason of his having granted the advance But this right does not entitle him to any securities or priorities of any creditors so discharged

Moreover, the lender may sue the directors personally for breach of warranty of authority, or he may obtain an injunction restraining the company from parting with the money, if it can be identified and has not been so used in the company's business that it cannot be followed

If, on the other hand, the borrowing is not in excess of the powers of the company as contained in its Memorandum, but exceeds the powers of the directors as given by the Articles, the company may by special resolution ratify the act of borrowing, and so make itself liable to repay the advance

Rule in Royal British Bank v. Turquand.

In certain cases, where from a perusal of the Articles it would not be possible for the banker to discover that the directors have exceeded their powers, the company will be bound even in the absence of ratification Thus in *Royal British Bank* v *Turquand*, 1856, the directors of a company were given power by the Articles to borrow and pledge property of the company *provided* a resolution of the shareholders in general meeting was first passed The directors borrowed money from the bank but no resolution was passed It was held that the company was bound, for although the bank was deemed to have notice of the restriction in the Articles, it was not bound *to inquire* into the *internal affairs* of the company, and, in the absence of notice to the contrary, was entitled to assume that the necessary resolution had been passed

In more recent cases, the Courts have interpreted very stringently this rule of ostensible authority as applied to limited companies, and a banker will not be able to rely upon it unless (*a*) he proves that he knew of the powers of delegation at the time of the transaction, and gave value in reliance on these powers, (*b*) there was nothing in the nature

of the transaction to put him upon enquiry, (*c*) the transaction was one that could reasonably have been assumed to have been within the powers of the official or officials concerned

Registration of Mortgages and Charges.

In order to secure ample publicity regarding mortgages and charges created by a joint-stock company, Section 79 of the Companies Act, 1929, requires a company to register with the Registrar of Joint-Stock Companies particulars of any of the following charges, *within twenty-one days of their creation* —

(*a*) A mortgage or charge for the purpose of securing an issue of debentures (or debenture stock),

(*b*) A mortgage or charge on the uncalled capital of the company,

(*c*) A mortgage or charge created by an instrument which, if executed by an individual, would require registration as a bill of sale,

(*d*) A charge on any land or any interest therein,

(*e*) A charge on the company's book debts,

(*f*) A floating charge on the undertaking or property of the company,

(*g*) A mortgage or charge on calls made but not paid,

(*h*) A mortgage or charge on any ship or any share in a ship,

(*i*) A charge on goodwill, on a patent or a licence under a patent, on a trade-mark, or on a copyright or a licence under a copyright

The only important omission from this list is that a charge on documents used in the ordinary course of business as proof of the possession or control of goods need not be registered, this applies, for example, where a bank grants a loan against the security of bills of lading or other documents of title to goods

The general rule is that if any mortgage or charge requiring registration is not duly registered, the charge becomes void, and the debt concerned ranks merely as an unsecured debt, and becomes immediately repayable

It is, therefore, essential that a banker lending money on the security of such a charge should make sure that it is duly registered within the prescribed time limit

Registration is also necessary in all cases where a company acquires property already subject to a charge, although the charge was not created by the company. In this case, however, failure to register does *not* make the charge void, but merely exposes the company and the directors to certain penalties

When a charge by a company on any of its property is registered, the Registrar issues a certificate of registration This certificate affords conclusive evidence that all the requirements of the Act concerning registration have been satisfied, and the person taking the charge is fully protected by the form of the certificate, even if the particulars entered on the Register are, in fact, incorrect (*National Provincial Bank* v *Charnley*, 1924)

In addition to the foregoing, every joint-stock company is required itself to maintain an up-to-date register of all charges *specifically* affecting its property, and of all *floating charges* (see below) on the undertaking or any property of the company , but the mere omission to enter *in the company's register* particulars of a mortgage or charge which ought to be registered therein, does not invalidate such mortgage or charge, although the officers of the company render themselves liable to a penalty for the omission to register

Debentures.

Companies frequently borrow money for the purpose of their business by the issue of *debentures*, which usually take the form of a deed under the company's seal, stamped with *ad valorem* duty, and containing a promise by the company to repay the money lent with interest thereon, subject to certain specified conditions Debentures may be payable to *bearer*, in which case they are regarded as negotiable instruments transferable by delivery, or they may be *registered* debentures, *i e*. payable to a registered holder, in which case they are usually transferable by deed As a rule, interest on the former is paid against the submission to the company or its bankers of "*coupons*" detached from the debenture, while, in the case of registered debentures, interest is usually paid by warrant to the registered holder

Usually, a debenture gives the lender as security for the loan a charge or mortgage over some specific part or all of the property of the company, in which case it is described as a "*mortgage* debenture," and must be registered with the Registrar of Joint-Stock Companies Sometimes, however, a debenture is merely a promise to repay money borrowed and does not give any charge over the company's property, in which case it is referred to as a "*naked* debenture"

When a debenture contains a charge over *specific* property of the company it is usual for the property so charged to be conveyed by way of mortgage to trustees for the benefit of the debenture holders the *trust deed* containing the terms upon which the issue of debentures is made and having the effect of debarring the company from dealing with the property charged either in the ordinary way of its business or otherwise

Floating Charges.

In the absence of a deed specifically mortgaging some or all of the property as security for the loan, the debenture usually gives the lender what is called a "*Floating Charge*" over the company's property, such a charge permitting the company to deal with any of its assets in the ordinary course of its business so long as it is a going concern, and so long as the charge does not become "*fixed*" or "*crystallised*" The charge is said to become fixed when the money secured by the debenture becomes immediately repayable in accordance with the terms of the instrument, as, for example, when the company makes default in the payment of interest or when an order is made or a resolution passed for the winding-up of the company

As stated previously, all such charges are void unless they are registered, within twenty-one days of creation, with the Registrar of Joint-Stock Companies

Debentures as Security for Advances.

Considerable care is necessary on the part of a banker in taking from a company a registered or bearer debenture as security for its overdraft If such a document is to be accepted, the banker should first of all satisfy himself that it is properly executed on behalf of the company by its duly authorised officials He should then ascertain from the company's Memorandum and Articles whether the issue of the debenture and the amount of the proposed loan are within the powers of the company and its officials Furthermore, he should inspect the company's Register of Mortgages and Charges, and also the register kept by the Registrar of Joint-Stock Companies, with a view to ascertaining whether any debentures or debenture stock have already been issued by the company, and, if so, whether they have given a specific or floating charge over its property

If a prior specific charge exists over the property to be charged, the banker's security will be postponed to that of the original mortgagee and will be to that extent less valuable On the other hand, if a prior floating charge has been given, the banker will, as a rule be safe in accepting a specific charge over certain of the company's property, and, *provided* he has no notice of any stipulation in the prior charge prohibiting the company from creating a subsequent charge or mortgage on its property to rank either in priority to or *pari passu* with the existing charge, his specific security will take priority over the previous floating security But if the banker has notice of the existence of such a condition in a prior instrument of charge, he cannot obtain priority even by taking a specific charge where only a floating charge exists As a rule, the instrument creating the charge will be in the names of the bank's nominees, and it should provide that repayment of the debt shall be made upon demand

A debenture accepted as security should provide that the company shall not create any further charge over its general assets (or over the specific assets, as the case may be) which shall rank *pari passu* with, or in priority to the banker's charge, and, in the case of a specific charge, the instrument should be accompanied by the deeds or other documents evidencing the company's title to the property concerned so that the company will be prevented from giving the deeds or other documents as security to any person who has no knowledge of the existence of the debenture

A debenture, whether specific or not should be accompanied by the bank's usual memorandum of deposit, and should state the purpose of the deposit contain particulars of the property specifically charged, if any, and provide that the charge is not to be regarded as having been redeemed by reason only that the company's account has ceased to be in debit during the continuance of the charge In addition, the memorandum will usually give the banker power to appoint a receiver or manager of the company's property in respect of any debt which may be due by the company to the bank, but, if such power is exercised, the banker will incur a heavy penalty if he does not give notice of the fact to the Registrar of Joint-Stock Companies, who, on payment of a prescribed fee, will enter the fact on the Register of Mortgages and Charges

Floating Charges as Security.

If the charge created by the debenture is a floating charge, the provisions of Section 266 of the Companies Act, 1929, are of particular importance By that section it is provided that any floating charge on the undertaking or property of a company created within six months of the commencement of winding up shall, *unless* it is proved that the company was solvent immediately after the creation of the charge, be invalid, except to the amount of any cash paid to the company at the time of or subsequent to the creation of the charge and in consideration therefor, together with interest on that amount at 5 per cent per annum

Thus in the case *In re Hayman, Christy and Lilly, Ltd*., 1917, where an insolvent company within three months of its winding up (the period provided by the Companies (Consolidation) Act, 1908 which was then in force) issued debentures to a bank as security for an existing loan and for future advances on current account, it was held that the debentures so far as issued as security for the *past* debt on the loan account were invalid, and so far as issued as security for *future* advances on the current account were valid only to the extent of the amount owing on the current account at the commencement of the winding up

An important defect of a floating charge to which a banker must be alive is that he is not entirely secure, even if he obtains judgment

against the company and execution is issued on his behalf to obtain satisfaction of the debt, for the rights of an execution creditor are *subject to all equities*, *i e*, subject to any prior legal claims against the property, so that even if the property is seized on his behalf he cannot take precedence of the rights of debenture holders who have a *specific* charge over the property seized Moreover, any *preferential* creditors of the company (*i e*, creditors for rates, taxes, wages of servants and workmen, or for money due under the Workmen's Compensation Act) must be paid in full before creditors secured by a floating charge are entitled to claim upon their security

Considerable care must be exercised by a banker in his dealings with a company when he receives notice that it has made an issue of debentures or debenture stock, particularly if he has an *unsecured* overdraft on current account, for in such a case the debentures may give a charge over the company's assets which would take priority over the claims of unsecured creditors (such as the banker) in the event of the company's liquidation In such circumstances, the banker's best course is either to insist upon an immediate reduction of the company's indebtedness, or to require the directors to charge some specific property of the company to the bank as security for the advance

The Winding-up of a Company Customer.

The existence of a company is terminated by its winding up or liquidation, during which its assets are realised and the proceeds applied in payment of its debts, the surplus, if any, being distributed amongst the shareholders

As soon as a banker receives notice of the commencement of the voluntary or compulsory liquidation of a company-customer, he should at once stop the relative account, and hold any credit balance thereon at the disposal of the liquidator, who has power to operate the account If the account is overdrawn he must take the necessary steps to obtain repayment

If he is *unsecured* he will, of course, prove for the whole of the debt and charges due to him, but if he is *secured* he may either (*a*) rely on his security and not prove, (*b*) realise his security and prove for the balance, (*c*) surrender his security and prove for the whole debt, or (*d*) assess the value of his security and prove for the balance, subject in the latter case to the liquidator's right to redeem the security on payment of the assessed value

In regard to the payment of a company's cheques after the commencement of a *compulsory* winding up, the banker's position is similar to that in the case of the bankruptcy of a private individual A compulsory liquidation is deemed to commence at the date of the presentation of the necessary petition From that date the power of

the directors to draw cheques on the company's account is determined, and, unless the Court otherwise orders, the banker cannot debit to the account cheques paid by him after the date of the petition, even though he has no notice of its presentation Accordingly, a banker's only safeguard, apart from maintaining a regular search of the *Gazette*, is to exercise extreme care if he has any suspicion that the affairs of the company are not as financially sound as they might be.

As a *voluntary* liquidation is commenced by resolution of the company in general meeting, followed by a statutory advertisement in the *Gazette*, a banker is rarely without due notice of the commencement of such a winding up

The Accounts of Non-trading Corporations.

Non-trading corporations, such as railway companies, electric lighting companies, and water companies have no power to borrow money or to pledge their property as security unless such powers are conferred upon them by the statute under which they are formed Nor in the absence of express powers, can they draw or accept bills of exchange or make promissory notes, although presumably such corporations can draw and indorse cheques on a banking account properly conducted for the purpose of making and receiving payments

Accordingly, on opening an account for any such corporation the banker should safeguard himself by a careful investigation of its powers in relation to banking operations generally, and in no circumstances should he grant an overdraft unless the company is entitled to borrow If, in the absence of such powers, the banker grants an overdraft, or grants an overdraft in excess of any limit which may be imposed by the corporation's constitution, the loan will be *ultra vires*, and the banker can rely only on his right of *subrogation*

The Accounts of Building and Friendly Societies.

Before opening an account for a building society or friendly society a banker should take a mandate embodying a resolution of the governing body of the society appointing the bank as its bankers, and containing precise instructions as to the manner of signing and indorsing all negotiable instruments on its behalf, with specimen signatures of the officials authorised to sign and indorse Before acting on the mandate the banker should satisfy himself that the instructions given are in accordance with the registered Rules of the society, a copy of which should be obtained and filed for future reference

The accounts should be opened in the full name of the society the address of its registered office being given in the ledger heading A note should be added specifying the names of the principal official

and arrangements should be made for the immediate notification of any change in these particulars

Before making an advance to such a society the banker should ascertain from the Rules and from the governing statute whether the society has any powers to borrow, whether there is any limit to such powers, precisely how the powers are to be exercised and how the loans are to be secured In the case of a building society, he must also ensure that the total amount borrowed by the society, including the amount advanced by him and borrowed by the society from its members, does not at any time exceed the limits imposed by Section 15 of the *Building Societies Act*, 1874

This Section provides that any societies registered under the Act may receive deposits or loans at interest from members or other persons for the purposes of the society, provided that the amount so borrowed at any time does not, in the case of a *permanent society*, exceed two-thirds of the amount for the time being secured to the society by mortgages from its members, and, in the case of a *terminating society*, a sum not exceeding such two-thirds, or, alternatively, a sum not exceeding twelve months' subscriptions on its shares for the time being in force A " permanent " society is so described in contra-distinction to a " terminating " society, which is formed only for a given time or only for the attainment of a particular purpose

In order that he can adequately meet these provisions the banker must be in a position to ascertain at any time how much he has advanced to a building society customer Hence he should arrange for advances to such a society to be taken on a separate loan account, which should be kept quite distinct from the current account, and the latter should always be kept in credit

If such precautions are not taken, the banker will run the risk of being unable to recover from the society any money borrowed by its officials in excess of the limit imposed either by its rules or by the Act under which it is constituted

Cheques issued by a society registered under the *Friendly Societies Acts*, 1896 and 1908, are exempt from stamp duty, but before permitting a society to use unstamped cheques, the banker should satisfy himself that it is in fact entitled to the exemption

The Accounts of Trade Unions.

Here, again, the general principles governing the conduct of the accounts of a friendly society will apply The Rules of the Union must be investigated in order to ascertain the powers of its officials and the authority, if any, given to its trustees to borrow money for purposes of the Union

The account of a trade union must be opened in the name of its properly appointed trustees, all of whom should be required to sign cheques and other instruments If an advance is granted, the personal security of the trustees should be obtained in the form of a joint and several guarantee, although the trustees have a limited power to borrow against a mortgage of property of the Union

The cheques of a registered trade union are *not* exempt from stamp duty

The Accounts of Informally Constituted Bodies: Clubs, Committees, and Associations.

Included under this heading are accounts opened for associations of various kinds formed for charitable, literary, religious, political, or sports purposes Such accounts are to be distinguished from those opened in the names of private customers with an indication in the heading that the account relates to some club, association, or society, as, for example, an account headed " Thomas Robinson, re Northtown Charity Club " Accounts of the latter kind may be treated as ordinary personal accounts, subject to the fact that the bank must be deemed to have notice of the fiduciary character of the funds

If an account is to be opened in the name of an association, society, etc , the banker should require a mandate embodying a resolution of the association, or of its committee or council, appointing the bank as bankers of the association, and including instructions as to how cheques are to be signed, with specimen signatures of the persons authorised to operate The mandate should be duly authenticated by the signature of the chairman of the meeting at which the resolution is passed, and by the signatures of the officials of the association

As a rule, the accounts of the bodies here referred to are maintained in credit, but, if an overdraft is required, considerable care must be exercised to fix the responsibility for the advance

Associations of this kind have no legal entity and cannot be sued in respect of any liabilities incurred by their officials, while the officials or other persons who are deputed to sign cheques on the association's account cannot be held *individually* liable for any advance which may be created, if in signing they clearly indicate that they are acting on behalf of the association Consequently, an overdraft on an account of this nature should be granted only against a guarantee from an individual of sound financial standing, or a joint and several guarantee from two or more reliable parties

Upon the death or retirement of any person signing cheques on the account of a society or association, the account should be stopped, subject to the banker's right to pay cheques drawn before the receipt

of notice of the event in question The account need not, however, be stopped in such circumstances if the mandate authorises signature on behalf of the society by any one of two or several persons, provided that any cheques paid by the banker subsequent to receipt of notice of the retirement or withdrawal do not bear the signature of any person who has so retired or withdrawn

The Accounts of Local Authorities.

Local authorities are really trustees for the public, whose interests they are required to protect The funds which they control are trust funds, and the banker is presumed to know this He must therefore exercise in connection with local authority accounts as great a degree of care as he would exercise in the case of any other form of trust account, and, if he permits a transfer from such an account in reduction of the private overdraft of a signing official, he is liable to become a party to a breach of trust

In the majority of cases, the account of a local authority is opened in the name of a treasurer, who is usually the manager of the branch at which the account of the authority is kept, but in larger towns there may be a specially appointed official An account thus opened in the name of a treasurer is regarded as existing between the treasurer and the local authority, and not between the local authority and the bank, for apparently a joint-stock bank is not permitted, except in special cases, to act as treasurer for such an authority Accordingly, the heading on the ledger account and in the pass book should be worded somewhat as follows "Thomas Robinson, Esq , Treasurer to the Northtown Urban District Council," or "Thomas Robinson, Esq , Treasurer to the Mayor, Aldermen and Burgesses of the Borough of Southtown," and so on

Separate accounts must be opened in respect of each separate undertaking of a local authority, and the respective balances and operations thereon must be regarded as entirely distinct for all purposes Thus if an authority has a number of accounts headed "General Account," "Water Account," "Tramways Account," etc , the accounts must be kept quite distinct both by the authority and the bank, all cheques and credit slips being properly marked to indicate the account to which they refer In no circumstances can a banker exercise any right of set-off in connection with separate accounts of this nature

Upon opening an account for a local authority the banker should obtain a properly authenticated resolution of the authority appointing the treasurer, embodying precise instructions as to how cheques and other negotiable instruments are to be signed, and accompanied by specimen signatures of those deputed to act on its behalf As a rule, the mandate will be given under the common seal of the authority, and

will provide that all cheques must be signed by three members of the council and countersigned by the clerk or other authorised person

If a mandate is not thus given for certain persons to sign on behalf of the authority, it is usually arranged for the treasurer to be periodically furnished with a schedule of payments to be made by him to specified persons, the schedule being authenticated by the signatures of three members of the Council or Finance Committee, and countersigned by the clerk

The highly unsatisfactory position of both collecting and paying bankers in relation to the orders for payment issued by local authorities is discussed in Chapter 25

Advances to Local Authorities.

Before granting an overdraft to a local authority, a banker must for his own protection determine whether the Authority has statutory power to borrow, in what way and against what security the loans may be obtained, whether any limits are imposed, and whether the sanction of the controlling government department is necessary Having ascertained that the advance may be safely granted, the banker should ensure that the loan is duly charged, by a properly executed mortgage, upon the rates or other security mentioned in the borrowing power As far as possible, he should also safeguard himself by seeing that the money borrowed is applied for the purpose for which it was ostensibly obtained

The position in regard to *temporary* borrowings by a local authority has been considerably simplified by the Local Authorities (Financial Provisions) Act, 1921, and by Section 12 of the Rating and Valuation Act, 1925 The former Act authorises borrowing by *any* local authority for temporary purposes pending the receipt of revenue, *subject to the sanction* of the Government Department concerned Sub-section 12 (2) of the latter Act authorises any local authority to borrow temporarily from its treasurer (*i e* , a bank), *without any sanction* from a government department (*a*) any sum which the authority is authorised to raise by loan , or (*b*) any sum which it requires for the purpose of defraying expenses pending the receipt of rates and revenues receivable by it in respect of the period of account in which these revenues are chargeable And the authority is empowered to pay interest at a reasonable rate on any advance so obtained

Both Acts apparently relate to temporary overdrafts to meet outgoings pending the receipt of rates or other revenues Presumably, however, the object of the provisions in the 1925 Act is to enable a local authority to meet temporary *cash shortages* as opposed to an actual revenue deficiency

If an illegal advance is granted to a local authority, apparently the banker's only remedy is that he may in certain circumstances be subrogated to the rights of creditors whose claims have been satisfied with the money borrowed from him. Usually, however, this right is quite an illusory one, for a local authority which had applied money illegally borrowed could raise the necessary funds to repay the banker only by levying a rate, which, in the circumstances, it would probably be unable to do, as a rate cannot legally be levied to meet expenditure incurred more than six months prior to the date of the levy.

CHAPTER 16

SECURITIES FOR ADVANCES.

THE security offered to a banker as cover for an overdraft varies considerably according to the nature of his business and according to the neighbourhood in which the business is conducted Possibly the most common form of security consists of stock exchange securities, such as share certificates, bearer bonds and share warrants Securities of this kind usually preponderate in rich residential neighbourhoods, such as the West End of London, or in high-class seaside resorts In agricultural centres bank securities usually take the form of documents of title to land and buildings, while in a busy sea-port town the type of security will consist chiefly of documents of title to goods imported and exported, the nature of the goods to which the documents relate depending, of course, on the class of trade through the port

Just as it is to the advantage of a banker's business to have his advances distributed as widely as possible, so it is desirable that the types of security taken should be well distributed and varied In the case of the great joint-stock banks, wide distribution is almost automatically obtained, whereas banks which cater more especially for the needs of a restricted area must grant a large proportion of their advances against security of the same kind, with the result that such banks become intimately concerned with the prosperity or depression of the major industries in their respective spheres of operation

The Quality of a Bank's Advances

Moreover, in making advances to customers, the banker always keeps well before him the important question of the *quality* of his loans and overdrafts English banks aim at supplying temporary accommodation rather than advances for long periods, *i e*, they provide *commercial* rather than *investment* capital Accordingly, in considering any application for an advance, a banker makes careful enquiries in order to ascertain whether the customer proposes to use the money as floating or liquid capital in his business, or whether he proposes to apply it in the purchase of fixed assets, such as land, buildings, plant or machinery If the required loan is clearly of the nature of a long period investment, the banker will usually advise the customer, if he is an individual, that the money would be more advantageously raised

on mortgage, or, in the case of a limited company or corporation, that it would be best obtained by the issue of additional capital or debenture stock

In addition to investigating the value and effectiveness of the security offered, the banker makes careful enquiries of the customer as to the sources from which repayment will be made, and the manner and time in which repayment is to be made Wherever possible, a balance sheet or a statement of affairs is obtained from the applicant, and the banker gives the various items careful consideration so as to ascertain whether the proposed advance is likely to be of any benefit to the borrower. Clearly, a banker is likely to derive little advantage by granting accommodation to a person whose liabilities are already in excess of his available assets In such circumstances a loan would be only a temporary palliative, having the effect merely of postponing the time when the customer will have to realise his assets in order to meet his liabilities.

Nevertheless, the successful lender is more frequently he who is optimistic rather than he who is pessimistic Unquestionably, bankers stand to gain both in reputation and worth by assuming that reasonable degree of risk which may be necessary in order to accommodate customers who, although temporarily embarrassed, are known to have a sound business, to be of undoubted integrity and to bear an established reputation in the district

On the other hand, it must not be forgotten that borrowers as a class tend to take a too hopeful view of things, and that modern bankers cannot be expected to accept unreasonable and hazardous risks Such propositions belong to the sphere of the moneylender rather than the banker, for the former is in a position to charge a rate of interest which is commensurate with the risk involved, whereas a joint-stock banker is prevented by custom and tradition from charging interest much in excess of the prevailing bank rate

Personal and Collateral Security.

The types of security taken by a banker are sometimes divided into two broad classes (*a*) *personal* security and (*b*) *collateral* security.

A banker who grants an advance to a customer has always a personal right of action against that customer in respect of the debt, but as an action against a debtor is a long and tedious process frequently attended by unsatisfactory results, it is usual for the banker to safeguard his position by requiring the deposit of independent security Technically, the term " personal security " is applied to an undertaking given by the customer, or by some third person on his behalf, as a security for the due repayment of an overdraft, and may take the form of a guarantee under hand or under seal, or a bond under seal, or a properly stamped

promissory note In all such cases the remedy of the banker is a personal one, *i e*, if the undertaking is not fulfilled and the money advanced not paid in due course, the banker must take action in the Courts to enforce his rights against the person or persons who have signed the undertaking

The term "collateral security" has, unfortunately, no strictly defined application In general, it applies to all types of security which run side by side with the personal right of action which the banker has against a debtor customer in respect of an advance In this sense the term "collateral security" applies to share certificates, bearer bonds, title deeds, life policies, etc , which are deposited by the customer as cover for an advance, and also to a guarantee of a third party given as security for the customer's overdraft

In its second sense, the term "collateral security" is applied to any of two or more instruments which secure the same debt, as where the account of one customer is secured by two different guarantees, or by a guarantee and also by the deposit of documents of title

In its strict legal sense, the term "collateral security" means security which is deposited by a third party or by third parties to ensure a customer's due repayment of a loan In this sense a guarantee signed by a third person to ensure repayment of a customer's advance would be a collateral security

This distinction of security held by a banker as collateral is of particular importance in the event of the bankruptcy of the principal debtor In such circumstances, the banker may either (*a*) surrender all *securities belonging to the insolvent customer* and claim for the whole of the debt, or (*b*) he may sell or value such securities and claim against the estate for the outstanding balance If, however, *security is lodged by third parties* in respect of the overdraft of an insolvent customer, the banker may regard such security as collateral *i e*, he may for the time being ignore its existence and claim against the debtor's estate for the full amount of the advance The collateral security can then be realised and applied in payment of any part of the outstanding debtor balance which is not paid off by the dividends or composition received from the bankrupt's estate.

There is a further very important aspect of the deposit of security by a third party to ensure repayment of a customer's debt In all his dealings with the customer, the banker must exercise the greatest care to respect the relationship of principal and surety existing between the customer and the third party In the absence of an agreement to the contrary, a surety is discharged if the creditor without his knowledge or consent makes a new arrangement with the principal debtor in regard to giving time for the repayment of the advance, or in regard to the amount of the advance, or the period for which it is granted

Furthermore, considerable care must be exercised by the banker to protect himself in case any event occurs which, in the absence of special safeguards, would result in the operation of the Rule in Clayton's Case in favour of the surety Thus, the liability of the surety ceases as to any future advances on the death, bankruptcy or insanity of the principal, so that in order to safeguard his rights against the surety the banker must at once stop the relative account on the happening of any of these events If this is not done, every subsequent payment in to credit of the account concerned will operate to reduce the amount for which the surety is liable, while every subsequent debit item will create an entirely new advance for which the surety cannot be held liable Again, if a guarantee is given in respect of a partnership, the contract between the bank and the surety will be terminated by any alteration in the constitution of the partnership, such as may arise, for example, on the admission of a new partner or on the death, bankruptcy or retirement of an existing partner

It is, therefore, the invariable practice nowadays for bankers to safeguard themselves by taking from the customer and also from the third party a document in writing clearly setting forth the details of the contract and providing against any of the contingencies referred to above

Formal Security : Mortgage.

There are four main ways by which a banker may avail himself of securities for an advance (i) Mortgage, (ii) Pledge, (iii) Hypothecation, (iv) Lien

A MORTGAGE is a conveyance of an interest in property for the purpose of securing the repayment of money lent, but the term is usually reserved for a conveyance of an interest in *land* or *immovable* property A mortgage may be either *legal* or *equitable*

A legal mortgage, usually entered into when the transaction is not of short duration, is created by deed, and gives the mortgagee a legal estate in the property by way of lease An equitable mortgage, which may be created by a deposit of the deeds with or without a memorandum, or even by a memorandum of charge, gives the mortgagee only an equitable interest in the property, which can be realised only if the mortgagee has or obtains a power of sale, or obtains an order for foreclosure from the Court

As a general rule, the possession of the mortgaged property remains with the mortgagor, but the legal mortgagee is given a right of sale in the event of default on the part of the mortgagor in paying the principal or interest thereon, and in certain other circumstances On the other hand, the mortgagor is left with his equity of redemption,

i e, his power to reclaim the full ownership of the property on properly discharging the mortgage

Pledge.

Pledge means the actual or constructive delivery of goods or securities by a debtor into the possession of his creditor to hold as a security for the debt To constitute a pledge, there must be an *express* or *implied* contract between borrower and lender, by virtue of which the *property* (rights) in the security remain vested in the pledgor (he who deposits them) The rights of the pledgee (*who is in possession*) permit him to retain the securities or goods until payment of the debt, and, in case of default, to realise them

As a rule, a pledge is evidenced by a Memorandum of Deposit or a Memorandum of Charge, which gives particulars of the securities, of the purpose of the deposit and of the amount and limit of the advance, (*i e*, the consideration to be given) It provides that the security shall be a continuing one, and is usually executed by the customer in the presence of a witness over a 6d adhesive stamp

A memorandum of this kind is imperative in all cases where security is deposited by a third party, for in such circumstances it is essential to obtain the signature of the surety to clauses in the document which provide that the banker's claim against him shall not be prejudiced by any time granted to the debtor, or by any variation of the original agreement made with him and the surety If the security is given to cover the account of a partnership, the memorandum should state that the banker's position will not be affected by any change in the constitution of the firm resulting from the death, bankruptcy, insanity, retirement or admission of a partner In the case of a limited company customer, the memorandum will provide that the relationship of the banker and the surety shall not be affected by any change in the constitution of the company by reason of its absorption or amalgamation

In the case of *fully negotiable* securities, a memorandum is not absolutely necessary, since a lender who acts in good faith is established as a pledgee by mere deposit of the securities, with an absolute title against all the world to hold them until his debt is discharged, and to realise them if he does not obtain repayment This is so even if the instruments have been lost by or stolen from the true owner, and as indorsement is not necessary for the transfer of fully negotiable securities such as bearer bonds, the title of the pledgee cannot be defeated by a forgery

The pledge of documents of title to goods is in effect a pledge of the goods themselves, for delivery of the documents is legally recognised as a constructive delivery of the goods which they represent.

Hypothecation.

Hypothecation resembles pledge in many ways, but goods hypothecated do not pass into the possession of the creditor, *e g*, a debt due by a third party may be hypothecated The term is also used to describe the arrangement under which a customer is allowed to have possession of goods already pledged to the bank, under a letter of trust, or trust receipt, and agrees to hold them in trust for sale for the bank and to pay the proceeds into his account

Informal Security: Lien.

Apart from the formal or specific deposit of securities, a banker who has granted an advance to a customer may obtain a legal claim to securities of that customer which pass through his hands in the ordinary course of business, by virtue of his right of "*lien*"

"Lien" is defined as the right of one person to *retain* property in his hands belonging to another until certain legal demands against the owner of the property by the person in possession are satisfied

The right of lien does not, *as a general rule*, give the person exercising the right any power to *sell* or otherwise to realise the relative goods or securities

Lien differs from the other forms of charge in the respect that it is never the subject of a *formal* or *express* contract It is essentially an *implied* charge which arises by operation of law out of the course of dealings between the parties, and to create which no special arrangement or agreement is necessary The right of lien, however, may be and frequently is expressly excluded by mutual arrangement between the parties, or by the existence of circumstances which are inconsistent with the exercise of the right

The right of lien may be either (*a*) *particular* or (*b*) *general* A particular lien is so called because it confers a right to retain goods in connection with which a *particular* debt arose, whereas a general lien confers a right to retain goods, not only in respect of the debt incurred in connection with them, but also in respect of the *general* balance due by the owner of the goods to the person exercising the right of lien

By long established and legally recognised custom, a right of general lien accrues to certain persons who act as agents on behalf of others, as, for example, solicitors, bankers, stock-brokers, produce-brokers, factors, and wharfingers

Banker's Lien.

In the well-known and oft-quoted case of *Brandao* v. *Barnett*, 1846, it was stated "Bankers most undoubtedly have a general lien on all

securities deposited with them as bankers by a customer, unless there be an express contract, or circumstances that show an implied contract inconsistent with lien"

From this statement it is clear that a banker has a right to retain, in respect of a debt due to him, any securities of his customer which come into his hands in the ordinary course of his business as a banker, provided there are no circumstances inconsistent with lien And it has always been understood that a banker's lien is an *implied pledge*, giving him a right, not only *to retain* but *to realise* securities of his customer in case of default after due notice has been given

Banker's lien is mainly important in connection with negotiable securities which come into the banker's hands (usually for collection) in the ordinary course of his business as his customer's banker, as, for example, cheques, bills, notes, bearer bonds and share warrants to bearer

Circumstances Inconsistent with Lien.

The right of lien will be definitely excluded if the securities come into the banker's hands in any capacity *other than that of banker*, and also if there is an implied or express contract negativing the lien In order that the lien may arise the banker must act simply and solely as a banker, and the securities must be deposited by or on behalf of a customer who is in debt

Hence, although lien would apply to bills of exchange placed in a banker's hands for collection, it would not arise if the bills were handed to a banker, as an agent, for the express purpose of being presented for acceptance to the drawee Again, no lien will arise in respect of securities expressly deposited *for safe custody*, for in such a case the articles are received by the banker *as a bailee* and not in the capacity of banker In connection with coupons and bonds left for safe custody, however, it is sometimes difficult to determine the precise line of demarcation between the banker's capacity as a bailee and his essential functions as a banker (See Chapter 19)

A *general* lien cannot arise in respect of securities which are deposited for a special purpose only, although the circumstances may be such as to create an express charge over the securities Thus, a banker cannot exercise a general lien on a scrip certificate deposited by a customer with express instructions that it is to be exchanged for a bond, for in such circumstances the banker acts merely in the capacity of agent and not strictly as a banker Nor can a general lien be exercised in respect of property of a customer which is pledged as security for a *particular* debt Thus if A has two overdrafts at a bank, and specifically pledges securities in connection with one of these overdrafts, the banker's lien

is excluded by the existence of the express charge, and he has no right to retain the securities against the overdraft on the second account But if the banker had exercised his power of sale over the securities in order to wipe off the overdraft on the first account, he could, by virtue either of his right of lien or of set off, retain any remaining proceeds of the sale against the second overdraft

Moreover, no lien can arise in respect of property which comes into the banker's hands by mistake, or which is placed in his hands with the object of covering an advance which is not granted

Banker's lien over negotiable securities is so well-established that it applies even to instruments which are not actually the property of the customer, but are held by the latter in fraud of the true owner But this will not be so if it is shown that the banker did not act in good faith, or if the instruments suffer from some absolute defect of title, as for example, where a bill or cheque bears a forged indorsement, or a cheque bears a not negotiable crossing and has been stolen from or lost by the true owner

Stocks and Shares : Conveyances and Leases.

It is not quite clear whether banker's lien can be regarded as applying to stocks and shares which come into his hands in the ordinary course of business Some authorities contend that lien would apply in such cases, and point out that, in any event, the banker would have the rights of an equitable mortgagee Where stocks and shares are sent to a banker for sale, the banker would normally have a right to apply the proceeds in reduction of any moneys owing to him, but this is a question of set-off rather than of lien Frequently, stocks and shares are deposited with a banker so that the latter may collect the interest or dividends as they fall due, and there is some doubt as to whether the banker would in such cases, have a lien Much, of course, depends on the circumstances, and it is impossible to lay down any general rule on the point, although Mr Bernard Campion, K C , has expressed the opinion that the banker's lien would not apply in cases where the bank has a special stock department, since, in such circumstances, the banker would not receive the stocks and shares in the ordinary course of business *as a banker*

Banker's lien could rarely apply to conveyances of land and leases, since these usually come into the banker's hands either for safe custody or by way of express charge In common with stocks and shares, however, such securities would probably become the subject of lien if they had been deposited as security for a loan since repaid, and the customer had subsequently become indebted to the bank

Lien and the Statutes of Limitation.

A banker's right of lien is not barred by the Statute of Limitations even if the debt in respect of which the lien arises is so barred. Accordingly, if a banker holds securities against a debt which is statute-barred, he may retain and, if they are negotiable, sell them although he has no right of action on the debt itself. It is, however, provided in the *Real Property Limitation Act*, 1874, that in the case of securities relating to land, the personal remedy and also the remedy on the securities is barred after twelve years from the time when the right of action first arose.

CHAPTER 17

PERSONAL SECURITY.

THE term *personal security* is applied primarily to those classes of security which involve a right of action against the individual or individuals giving the security, in contra-distinction to securities which can be realised by sale or transfer, or which involve a right of action against a person who is entirely strange to the transaction between a banker and his customer, *e g*, shares in a limited liability company The principal forms of personal security are guarantees, promissory notes, bills of exchange and bonds

GUARANTEES

A guarantee is a contract whereby one person, called the *guarantor*, undertakes to be answerable for the payment of a debt or the performance of some act by another person, who must be legally bound to pay the debt or to perform the act concerned There can be no contract of guarantee unless there is a prior contract in existence, upon which the principal debtor is liable to the party in whose favour the guarantee is given, *i e*, the creditor, who is thus the beneficiary under both contracts The rule is that the guarantor is liable only if the principal debtor has made default The contract of guarantee is therefore a *secondary* one, and, even if the guarantor fulfils his obligation and repays the creditor, the debtor is not discharged from his liability, but may be sued for repayment by the guarantor

Form of a Banker's Guarantee.

The form in which a guarantee is given is of vital importance, particularly to a banker, who needs to be protected against a number of contingencies which may affect his relations with the customer and the guarantor In the first place, a guarantee must be *in writing*, and, in order to be enforceable, must contain at least the names of the parties, the signature of the surety, and the essential terms of the contract The consideration need not be specified, but in a banker's guarantee it is usually stated to be an agreement by the banker at the guarantor's request not to require immediate payment of the money due from the debtor Sometimes, however, the consideration is stated

to be the granting of an advance to the customer, or the opening or continuing of the debtor's account, or it may consist merely in the giving of time to the debtor in which to repay a sum borrowed

A banker's guarantee is necessarily comprehensive in form since it aims at safeguarding the banker against all possible contingencies, and is designed to cover any kind of transaction with the customer The guarantee provides that the contract shall not be prejudiced if any other securities are taken from the debtor, nor by any arrangements made with the debtor regarding the exchange or release of securities, or for the giving of time in which to pay Moreover, the agreement provides that it shall be a *continuing* security, thus protecting the banker against the operation of the Rule in Clayton's case, which is explained below It provides also that, in the event of the bankruptcy of the customer, the banker shall be at liberty to recover from the guarantor the *full* amount for which he agrees to be liable less any dividends received Finally, the guarantor promises repayment of the amount due to the bank *three* (or sometimes *two*) *days after demand*

Although the main object of a guarantee, is " to keep a free hand for the bank and a tight one on the guarantor ", there are limits to the degree to which a bank can require a guarantor to bind himself So, if the terms of the agreement are such as can be held to impose upon the surety obligations which should properly rest upon the debtor, the guarantor may not be bound But a guarantor cannot claim to be absolved from liability merely because he has misinterpreted the terms of a guarantee, provided there is no material misrepresentation on the part of the banker

The Value of a Guarantee.

As a guarantee involves a personal right of action by the creditor against the guarantor, the value of such security depends essentially on the standing and worth of the guarantor, and on his ability to pay the amount of the advance, conveniently and without difficulty, not only at the time when the contract is signed, but also for the whole time during which the guarantee is relied upon by the banker It follows, therefore, that in accepting a guarantee as security, the banker's first duty is to ascertain carefully whether the proposed guarantor can be relied upon for the amount which he undertakes to pay And even if the original position is satisfactory, the banker should at regular intervals take steps to satisfy himself that the guarantor is still to be relied upon

As a rule, a banker should not place too great reliance on guarantees by persons with limited incomes terminable at death, or by members of the lower professional classes whose incomes are ordinarily terminable at death or on their ceasing to be employed

Validity of a Guarantee : Misrepresentation.

For his own protection and to avoid subsequent difficulty, a banker should always explain to a new guarantor the exact nature of the contract into which he is entering, define precisely the liabilities which he assumes, and ensure that the guarantee is signed by the surety of his own free will, and without any pressure or coercion either on the part of the banker or of the debtor

Any enquiries addressed to the banker by a proposed surety should be answered fairly and openly But a contract of guarantee does not fall within the class of contracts described as *uberrimæ fidei*, *i e*, those which require a *full* disclosure of all material facts by the parties So long as there is no concealment amounting to fraud, the banker need not disclose the actual state of the debtor's account, or volunteer information concerning the debtor's affairs or business habits, unconnected with the contract of guarantee, which might have the effect of impelling the surety to revoke his offer to accept liability

Validity of a Guarantee : Signature.

A banker should safeguard himself by ensuring, as far as possible, that all guarantees are signed at a branch or agency of the bank, after their terms have been properly explained by a responsible official This is of first importance in the case of guarantees given by women, and it is always a wise precaution to insist that a guarantee by a woman shall be signed by her in the presence of her solicitor, who should witness the document As a further safeguard, her signature should be obtained to a " free will clause," *i e*, a declaration that she signs of her own free will and with full knowledge of the nature of the transaction This is of particular importance where the principal debtor is the husband, and it is sought to hold the wife liable as a guarantor to the extent of her separate estate

Guarantees by Companies and Partnerships.

A banker who is offered a guarantee given by a joint-stock company should ascertain whether power to give guarantees is conferred on the company by its memorandum of association In the absence of an express provision to this effect, such an agreement signed by the directors will be *ultra vires* the company and therefore not enforceable against it, although the guarantee may be enforceable against the directors *personally*, and they may be held liable for breach of an implied warranty of authority

Guarantees given by or on behalf of joint-stock companies which are absorbed or amalgamated are, in the absence of express provisions, revoked as to future transactions by the absorption or amalgamation,

so, to protect itself in such circumstances, the bank should stop the relative account and obtain the signatures of the sureties to a new agreement For similar reasons, guarantees given to a joint-stock bank which amalgamates with another are determined by the amalgamation in the absence of express agreement by the sureties to the contrary

A partner has no *implied* authority to give a guarantee in the name of his firm, so that, unless one partner is given *express* authority to do so, all the partners in a firm should be required to join in signing a guarantee given on its behalf

A guarantee signed on behalf of a partnership should expressly provide that it will not be affected by any change in the constitution of the firm otherwise, on the death, bankruptcy, retirement or admission of a partner, the contract of suretyship will be revoked as to any *future* advances, though the old firm remains liable for past advances In like manner, a guarantee given in respect of an overdraft on a partnership account is, *in the absence of agreement to the contrary*, revoked as to future transactions by any change in the firm's constitution So, unless the form of guarantee specifically covers the contingency, or unless there is a *novation* of the original contract, *i e*, an agreement between *all* the parties that the guarantee shall apply to the newly constituted firm which assumes liability for the outstanding debt, the security will be ineffective as to future advances, and the Rule in Clayton's case will apply

Another point for consideration in relation to guarantees *given by* a partnership is that the value of the security may be seriously affected by the death or withdrawal of a wealthy partner, or of a partner upon whose skill or reputation the business largely depends

Guarantees and the Rule in Clayton's Case, 1816.

The Rule in Clayton's Case is of considerable importance in connection with guaranteed accounts, for in the absence of express agreement that a guarantee is to be *continuing*, every credit paid in by the debtor after the date of a guarantee will have the effect of reducing *pro tanto* the liability of the surety, while every subsequent debit will form a new overdraft for which the surety is not liable

Even in the case of a continuing guarantee, unless there is an express agreement with the surety to the contrary, the Rule will operate in the surety's favour and to the prejudice of the bank on the happening of any event which alters the contractual status and relationship of the parties, as, for example, on the death, bankruptcy or insanity of the principal debtor, or on a change in the constitution of a partnership by whom or in whose favour a guarantee is given, or on the amalgamation of a joint-stock company by whom or to whom a guarantee is given

In any of such events, the banker should at once stop the relative account and open a new one, communicating with both the debtor and surety, and, if he deems fit, passing any new transactions through a new account in the debtor's name If necessary, arrangements should be made for the repayment of the advance, or for the signing of a new guarantee, as the case may require

The Effect of a Continuing Guarantee.

In view of these considerations bankers' guarantees are almost invariably *continuing* guarantees, that is to say, they are so drafted that the guarantor is held liable for the *fluctuating* balance *at any time owing* on the debtor's account during the continuance of the guarantee, subject to any limit which may be specified The object of this is to ensure that the guarantor shall be held liable for the *ultimate* balance due by the debtor when repayment is demanded by the banker, or when it becomes necessary to determine the balance due by the surety under the terms of the guarantee

As a rule, all continuing guarantees specifically provide that the surety's liability shall continue until *the expiration* of one calendar month (or other period) from the time when notice to terminate the guarantee is given by the surety *or his personal representatives* The effect of this is that the guarantor, or his estate in the event of his death or bankruptcy, can be held liable for the payment of any *outstanding* cheques or for any liabilities of the principal debtor entered into before notice was given but which accrue *during the period of notice*, thus enabling the banker to complete or fulfil any obligations incurred by him on the debtor's behalf in reliance on the guarantee

One eminent authority holds that, even where such a clause is inserted, the banker is not safe in making any further *voluntary* advances up to the limit of the guarantee after receipt of the notice, hence some banks in practice rule off the debtor's account on receiving notice from the guarantor, and carry all future transactions (if any) to a new account

In opposition to this view, Mr Bernard Campion, K C , maintains that a guarantee which clearly provides for a specified period of notice is not determined until the *expiration* of that period, so that the bank may continue to rely upon it for all ordinary dealings with the customer, and can hold the guarantor liable, within the amount of the guarantee, for any further advances granted during the currency of notice If the banker chooses to rely on this view, which is apparently in accordance with the strict legal position, and certainly relieves the banker of any liability for dishonouring a customer's cheques, the customer's account need not be stopped until the expiration of the notice

It is more likely, however, that a banker would take the more reasonable course of refusing to grant further advances after receipt of the

notice, unless he was under some sort of obligation, whether legal or moral, to do so.

A continuing guarantee in the form here discussed is not necessarily determined by the death of the guarantor Legally it will continue until the expiration of the requisite notice to terminate the guarantee has been given by the personal representatives of the deceased But unless it is *expressly* provided that such notice shall be given, the liability of the guarantor's estate is at once determined when the bank receives notice of his death, in which case the debtor's account should be ruled off and the legal representatives of the deceased surety advised of the amount of his liability

Upon receipt of notice from the surety or his representatives to determine a continuing guarantee, the banker should at once advise the debtor customer by registered post, informing him, if necessary, that whilst outstanding cheques will be paid, no further advances can be granted against the existing security

The Effect of a Specific Guarantee.

A continuing contract of suretyship must be clearly distinguished from a *specific* or *non-continuing* guarantee, in which the surety undertakes to be answerable only in respect of a specific transaction or in respect of a fixed amount, as, for example, a definite advance granted to a debtor on a separate loan account Such a guarantee cannot be revoked by the surety until the loan is repaid and the debtor's liability extinguished, but, when this is done, the agreement becomes void and cannot be enforced by the banker in respect of any future advances Thus if a guarantee is given in respect of an advance of £1,000, which is debited to loan account and credited to current account in the name of the debtor, the money is advanced once and for all, and the surety is liable for the *whole amount* notwithstanding that only a part thereof may have been withdrawn by the debtor Consequently, a banker cannot refuse to honour cheques drawn by a customer merely because he has received notice from the surety that he wishes to put an end to his liability

Another form of guarantee is one which is given for *a specified period* Such an agreement may be determined *at any time* within the period on the guarantor's giving notice and repaying any money then due The banker in such circumstances would grant further advances only at his own risk, but would be justified in completing any outstanding transactions and in paying any outstanding cheques presented after receipt of the notice

On receipt of the notice, or at the expiration of the period for which the guarantee is given, the relative account should be stopped, and the debtor and the guarantor at once advised of the amount due, including

interest If it is desired to continue such a guarantee for a further period, either an entirely new agreement may be taken, or the expired guarantee may be indorsed with a duly stamped agreement, signed by the guarantor, that it shall continue for the further period specified

Limit to the Surety's Liability.

Although it is usual expressly to provide that the amount *recoverable* from the guarantor shall not exceed a specified sum, the guarantee is nevertheless expressed to be a security for the *whole* amount which may be advanced, paid or incurred by the banker on the debtor's behalf The object of this is to ensure that, in the event of the customer's bankruptcy, the banker shall, if it is at all possible, receive in repayment the full amount of the debt due to him by the customer

By virtue of such a provision, the banker may prove against a bankrupt customer's estate *for the whole amount due*, without deducting any payment made by the surety and without deducting the value of the guarantee, subject, however, to his not receiving in all more than 20s in the £1

A further effect of the provision referred to is that the banker can retain as against the surety any securities of the debtor which may be in his hands until he has obtained repayment *in full*, and the fact that the surety has paid the amount outstanding under the guarantee does not entitle him to the benefit of any securities of the debtor in the banker's possession, so long as the bank's claim against the debtor remains unsatisfied

Joint and Several Guarantees.

In the event of more than one person undertaking liability for the repayment of a debt, the guarantors may be liable either *jointly*, *i e*, together as co-sureties, or *severally*, *i e*, each guarantor individually liable for the whole of the debt, or both *jointly and severally*

In practice, all bankers' guarantees taken from more than one person are both *joint and several*, so that the banker may proceed against any one of the sureties, or against some or all of them as he deems fit, until the whole of his debt has been repaid If one of several joint and several sureties thus repays the amount due, his remedy is to proceed against his co-sureties for a proper contribution, or he may, on being sued, insist upon their being joined with himself in the action But if one of such sureties repays the debt, or is released by the creditor, the others are all discharged so far as the creditor is concerned On the death or bankruptcy of a party to a joint and several guarantee, the estate of that party remains liable for the repayment of any debt contracted under the guarantee before the happening of the event concerned

Circumstances in which a Guarantee is Determined.

A guarantee is determined either (i) *at the will of one or some of the parties, i e*, (*a*) repayment by the principal debtor, (*b*) repayment by the guarantor, and (*c*) demand for repayment by the banker, or (ii) *by operation of law, e g*, on the death, bankruptcy or insanity of the surety or principal debtor, or on a change in the constitution of a firm if the guarantee is given by or in favour of a partnership, or on the amalgamation of a company if the guarantee is given by, in favour of, or to a joint stock company

Demand for Repayment.

On his part the banker may determine a guarantee by giving notice to the debtor and also to the surety that he requires payment of the advance As to whether notice will be required before the account is stopped will depend on the circumstances of the case, but if the banker has agreed to advance up to a specified amount, he cannot without proper notice suddenly dishonour his customer's cheques and thereby injure the customer's credit The banker can, however, forthwith proceed against the surety if the debtor does not within a reasonable time comply with the banker's request to repay the debt, and most bank guarantees now provide that repayment shall be made by the surety two or three days after demand

Legally, such a demand on the surety may be made without any prior application to the principal debtor for repayment, and the banker is under no obligation to realise any securities of the debtor which are in his hands before resorting to the guarantor In practice, however, an application for repayment to the customer guaranteed would almost invariably be made before recourse was had to a guarantor

Death of Surety or Debtor.

The most important circumstances in which a guarantee is affected by operation of law are (*a*) the death of the surety, and (*b*) the death of the principal debtor The actual legal position of the banker on the *death of the surety* is not altogether clear, but it would appear that, even if there is no provision to cover the point in the agreement, a contract of guarantee is not *immediately* terminated by the death of the surety Nevertheless, it is unlikely that a bank could hold the estate of a deceased surety liable in respect of voluntary advances granted after receipt of express or constructive notice of the death

As a rule, the position of the banker is safeguarded by a stipulation in the guarantee to the effect that the requisite notice must be given to terminate the agreement either by the surety himself during his lifetime, or by his personal representatives in the event of his death.

In such circumstances there is no need to stop the account until the necessary notice has expired, but if the contract of guarantee does not expressly provide for the liability of the estate of a surety on his decease, the relative account should be at once stopped on receipt of notice of a guarantor's death, and all future transactions passed through a new account in the name of the customer

Notice of the death of the principal debtor necessarily puts an end to the account between him and the banker, and therefore operates automatically to determine the guarantee In such circumstances the account should be stopped, and a formal demand should be made on the guarantor for repayment, although, of course, it may not be necessary to enforce such a demand if full payment of the debt can be obtained from the deceased's estate, or if the banker holds life policies or other securities sufficient to cover the amount advanced The guarantor can be held liable only in respect of the amount due or accruing due to the bank on the date of the receipt by the bank of notice of the death, and he cannot be required to recoup the bank for any voluntary payment made after receipt of such notice

Bankruptcy of Surety.

On receipt of constructive or express notice of the *bankruptcy of the surety*, the banker should immediately stop the relative account, and claim repayment of the loan from the principal debtor If such repayment cannot be obtained, the banker should enter a claim against the guarantor's estate, but in doing so he must take into account any part payment received from the principal debtor, although he need not value any securities of such debtor in his hands which have not been realised The liability of a guarantor under a guarantee is entirely discharged when he receives his discharge in bankruptcy

Bankruptcy of Debtor.

A guaranteed account must also be stopped as soon as the banker receives actual or constructive *notice of the debtor's bankruptcy* In such circumstances, a demand for repayment should be made to the guarantor, who should be informed that interest will run against him on the outstanding balance from the date of demand until the date of settlement Any amount received from the guarantor should be credited to a separate account until such time as the affairs of the principal debtor are wound up, and if the amount paid by the surety under the guarantee does not entirely wipe off the debt due to the bank, the banker should enter a claim against the debtor's estate for the *full amount* of the advance, assuming, of course, that he is enabled to do this by the

terms of his guarantee, as is almost invariably the case nowadays (See above) If he is thus protected, the banker in making his claim need not deduct from his proof any amount received from the guarantor, neither need he value any security *deposited by the guarantor* in respect of the debt, for he may regard any such security and also the guarantee as a *collateral* security On the other hand, if the guarantor pays the whole balance outstanding, he is entitled to any securities of the debtor held by the banker in respect of the debt, while if the banker proves against the bankrupt's estate, he must deduct the value of any securities *of the debtor* held by the bank in respect of the advance

Lunacy of Guarantor.

On the receipt of express or implied notice of the *lunacy of a guarantor,* the banker should at once stop the relative account, and claim repayment from the principal debtor, or in default from those responsible for the control of the estate of the surety In *Bradford Old Bank* v *Sutcliffe,* 1918, it was held that the lunacy of a surety is to be regarded as terminating the contract of guarantee as to *future* advances

Determination of Joint or Joint and Several Guarantees.

In general, joint or joint and several guarantees are determined by circumstances similar to those which operate in the case of individual sureties, but several special points require to be noticed

On receipt of notice, orally or in writing, from one of several sureties that he wishes to terminate his liability, the banker should at once stop the relative account until alternative satisfactory arrangements are made by the surviving sureties In the absence of such new arrangements, he should demand repayment of the advance from the principal debtor, and in default thereof claim against all the sureties jointly for the amount due

Similarly, on receiving notice of the death of one of several sureties, the banker should immediately stop the debtor's account, and pass any future transactions through a new account, which should be maintained in credit unless there are special circumstances justifying an advance thereon He should then arrange for a new surety to take the place of the deceased, or get the surviving guarantor or guarantors to accept responsibility for the outstanding balance, or, if he deems fit, demand repayment of the advance from the principal debtor, and in default, claim against the surviving guarantors and also against the estate of the deceased.

Similar steps should be taken by a banker on the *bankruptcy* of one of a number of joint and several sureties.

Rights and Obligations of the Guarantor.

A guarantor, on assuming liability, is entitled to reasonable information from the banker in reply to any enquiries which he may make concerning the position of the debtor But provided he signs of his own free will, he cannot evade liability unless he can show that there has been such misrepresentation or concealment on the banker's part as amounts to fraud

When the guarantee is obtained, the surety is entitled at any time to learn the amount for which he is liable, but he has no right to inspect the accounts of the debtor or to obtain from the banker other information of a confidential nature

Provided there is no agreement to the contrary, the guarantor may at any time terminate his contract by paying the amount due, subject to his being held liable for any uncompleted transactions, or he may at any time request the banker to demand repayment of the amount guaranteed from the principal debtor

If repayment is made by the guarantor, he may himself proceed to recover the amount from the principal debtor, and, if the claims of the bank against the debtor are entirely satisfied, the surety is entitled to any securities of the debtor held by the bank, whether he was aware of the existence of the securities or not, and whether such securities were deposited before or after the signing of the guarantee

In enforcing his remedies against the principal debtor or any co-sureties, the guarantor may, if necessary, sue in the banker's name Moreover, on the bankruptcy of the principal debtor, a guarantor, who has paid the amount for which he agreed to become liable, may prove against the debtor's estate in respect of the amount paid under the guarantee, unless, by the terms of the guarantee, he has expressly waived the right to do so in favour of the bank Nowadays, most bank guarantees provide that the banker may claim against the debtor's estate for the full amount owing on the account, notwithstanding any payment made by the guarantor, and also that the guarantor shall not prove against a bankrupt estate in competition with the bank Unless there were some agreement on this point difficulty might arise, as two independent claims in respect of the same liability would obviously not be admitted by the trustee

Discharge of a Surety.

Repayment —The surety is, of course, entirely discharged if the debt due to the banker is repaid or otherwise satisfied by the principal debtor

Alteration of Contract —In the absence of express agreement to the contrary, the surety is ordinarily freed from liability by any substantial alteration in the terms of the original contract between the

creditor and the debtor without his consent In particular, he will be released to the extent that he is injured by any action of the creditor which diminishes or destroys the value of the security , as, for example, where the creditor accepts a substituted or different security, or makes the security ineffectual by omitting to give any necessary notices, or by failure to effect proper registration

Giving Time to Debtor —The surety is also discharged by any binding arrangements made by the creditor, without his consent, to give time to the principal debtor, unless in making such new arrangements, the creditor expressly reserves his rights against the surety

The other circumstances in which a surety is entirely discharged from liability in respect of past and future debts are (*a*) where the creditor fails to take proceedings against the debtor or the guarantor within the limit of time fixed by the Statutes of Limitation , (*b*) where the surety can show that the guarantee was obtained by fraud or material misrepresentation on the part of the creditor (*i e* , the banker) , (*c*) by a change in the constitution of the bank or of the principal debtor or of the guarantor himself, which involves a novation of the original agreement if it is to remain (see page 215) , (*d*) in the case of a joint guarantee, if judgment is obtained against one or some of the *other* guarantors, and is unsatisfied , (*e*) by *absolute* release of the principal debtor or of one of a number of joint sureties , (*f*) by a total failure of the consideration , (*g*) in regard to *future* debts, by notice of the surety's death unless notice by representatives is provided for or consideration is indivisible), (*h*) by notice to terminate his liability in the case of a continuing guarantee, a surety is released from future liability on expiration of the required notice If the consideration has been given once for all, the guarantee is irrevocable except by mutual consent , (*i*) where two or more sureties have agreed to sign, and one or more fails to do so, the party or parties who have signed the contract are discharged

PROMISSORY NOTES AND BILLS AS SECURITY

In practice, bankers frequently make advances by the discount of promissory notes or bills of exchange which are signed by one or more persons in order to accommodate the party to whom the advance is made the proceeds after discount being paid over to the accommodated customer

In such circumstances, the banker should treat the persons signing as sureties in exactly the same way as he would treat them if they had signed a formal contract of guarantee Thus he should not enter into any binding agreement with the principal debtor with the object of giving him time in which to pay the instrument, nor should he vary the original arrangements regarding the deposit of security (if any) without the express consent of the surety or sureties

A banker who accepts a bill of exchange or promissory note as security, should take a memorandum of charge and ensure that the signature of each surety is witnessed and initialled by a responsible official of the bank The instrument itself should either be indorsed in blank or made payable to the banker's order If the customer obtaining the advance does not sign as an original party, he should be required to indorse the instrument as evidence of his liability thereon (Refer also to Chapter 25)

ASSIGNMENTS OF DEBTS AS SECURITY

By the Law of Property Act, 1925, a creditor may make an *absolute* assignment of a debt or other legal chose in action to another person, provided that the assignment is made *in writing*, and that *written notice* thereof is given to the debtor or the trustee holding the funds assigned If the assignment is properly made, the assignee is given power to sue for the amount in his own name, and may give the debtor a good discharge for the debt

Advantage of these provisions is sometimes taken by a customer in order to provide a banker with security in respect of an advance, in which case an assignment, under hand or by deed, is executed by the customer in favour of the banker, who may thereafter at any time claim payment from the third party or trustee

The debtor or the trustee holding the funds cannot, after receipt of the notice of assignment, pay the amount due to anyone other than the banker, but as the priority of several assignments of the same debt is determined *by the dates on which notice is given* to the debtor or to the trustee, it is desirable that notice be given as soon as the assignment is executed Moreover, a banker who proposes to accept such a security should safeguard himself by requesting the debtor or the trustee to inform him whether any previous assignments exist , at the same time, he should request a confirmation of the amount or value of the debt, and information as to whether the debtor has any counter claim against the creditor

CHAPTER 18

COLLATERAL SECURITY.

In estimating the worth of collateral security, the banker should consider at least the following seven important points (*a*) *Simplicity of title* The security should be such that the customer's title thereto is plain and unmistakable on the face of the instrument, and that, if necessary, the banker's title thereto can be perfected without difficulty (*b*) *Transfer should be cheap and easy*, so that the banker can if necessary obtain a complete transfer of the title to him or to his nominees without any great trouble or expense (*c*) *Reasonable steadiness of value* A security which is subject to wide variation in price does not form a desirable cover for an advance, since the banker cannot at any particular time ensure that he has allowed himself a sufficient margin to provide against possible default on the part of the customer (*d*) *Readiness of sale* This point is of importance if the banker is to avoid being left with property on his hands which he cannot convert into cash except after considerable loss of time, trouble and expense (*e*) *Sufficient margin for loss or depreciation* Unless the security is one whose value is fairly stable, the banker cannot at any particular time ensure that he has a sufficient margin in the event of a forced realisation (*f*) *Absence of liability* As far as possible the banker will avoid taking as security property which might involve him in liability to third parties, as, for example, shares whereon calls may be made (*g*) *Safety as to title* A final requirement is that the title (if any) obtained by the banker, or the title which the customer purports to possess, shall be secure against loss by theft or fraud Negotiable securities have the disadvantage that they may be stolen from the banker or obtained from him by fraud, in which event a finder or thief can pass a valid title to anyone who takes the instruments in good faith and for value

The most common and probably the most desirable form of security which is taken by a banker consists of what are collectively described as *stock exchange securities*, including stock and share certificates, debentures, bearer bonds, and scrip certificates, issued by joint-stock companies and other corporations, by local authorities, and by home, foreign and colonial governments.

In estimating the value of security of this kind, a banker applies the various tests already mentioned. As a rule, stock exchange securities have the advantages that they can be realised quickly and

without difficulty, that the title, while being clear and unmistakable, is readily and inexpensively transferable, and that the actual market worth can easily be determined

Among securities which should not be accepted by a banker unless the circumstances are exceptional and a very wide margin is available are (*a*) *shares and stocks in the less important foreign governments and undertakings*, which although they may be reasonably secure, may nevertheless be subject to fluctuations, as, for example, in consequence of movements in the rates of exchange, (*b*) *mining, oil and rubber shares*, which are also subject to considerable fluctuation by reason of their essentially speculative character, (*c*) *local shares*, which may be reasonably stable in value and quite effective as a security, but are not as readily saleable as the shares of nationally known undertakings

Stock exchange securities are generally divisible into two broad classes (*a*) fully negotiable or convertible securities, and (*b*) non-negotiable or inconvertible securities

Fully Negotiable Securities.

Fully negotiable securities of reputable concerns probably form the ideal type of cover for an advance As a rule, they are reasonably stable in value and are readily saleable Moreover, upon the default of the customer, the banker may obtain the full legal title to the security by virtue of his general lien, whether they are or are not deposited with a memorandum, and whether the securities actually belong to the customer or not, provided the banker has no notice of any defect in the title of the depositor In practice, a Memorandum of Deposit is invariably taken with such securities, so that the banker may be safeguarded by having the customer's express acknowledgment of the purpose for which the deposit is made, and so that the cover shall be expressly agreed to be a *continuing* security Possibly the only objection to negotiable securities is that they may be lost or stolen during the time when they are in the banker's hands, or that the banker's title may be defeated if it can be shown that he took the articles without good faith or with express or implied notice that they were not the property of the customer

As to what constitutes notice for this purpose is a question of fact depending on the circumstances The point has been raised in a number of cases, but as most bankers nowadays act in good faith and exercise reasonable precautions before accepting such securities, the majority of the decisions have been in their favour Moreover, it must be remembered that a thing may be done in good faith even though it is done negligently, so long as the negligence is not so gross as to afford evidence of bad faith when considered in conjunction with the attendant circumstances.

But a banker cannot be protected unless the securities are such as are properly recognised as negotiable, and here, again, the question is largely one of fact Thus, many instruments such as bonds to bearer, share warrants to bearer, exchequer bonds, East India bonds, treasury bills, scrip certificates to bearer, and debentures to bearer, have been recognised as negotiable by our Courts because they have been so regarded by long-established mercantile custom

In *Eckstein* v *Midland Bank Limited*, 1926, the securities in question were Mexican Electric Tramways debentures payable to bearer After receiving evidence showing that documents in similar form were ordinarily treated in this country as negotiable instruments, the judge held that these debentures were, in fact, negotiable securities, and that the true owner could not, therefore, recover from the bank which had taken them in good faith, for value, and without notice of the defect in the title of the person lodging them as security

Negotiability by Estoppel.

But difficult questions sometimes arise in connection with the principle referred to as *negotiability by estoppel* By virtue of this principle, the issuer or true owner of a given instrument may be precluded or estopped by the wording of the instrument itself, or by his conduct in the particular transaction concerned, from denying its negotiability In such circumstances, the Courts may decide that the issuers or the true owner shall be estopped from denying the title of a person who has taken the instrument in good faith, for value and without notice that the title of the transferor was defective A case in point was *In re General Estates Co*, 1868, where a company issued an instrument under the seal of the company and stamped as a deed by which the company undertook to pay to the order of J H, on a specified date, £1,000 with interest half-yearly, on presentation of annexed interest warrants While there was no evidence of negotiability by usage, it was nevertheless held that an indorsee for value and in good faith of this instrument was entitled to prove on it against the company free from equities as between J H and the company

At the same time, a security thus held to be negotiable in particular circumstances is not for that reason to be considered negotiable *for all purposes*, or necessarily to be regarded as having all the characteristics of a negotiable instrument Hence, the term "*quasi-negotiable*" is frequently applied to instruments of the kind here discussed

Non-Negotiable Securities.

Non-negotiable stock exchange securities may belong to one of two broad classes (*a*) *Inscribed* stocks or (*b*) *Registered* stocks and shares.

INSCRIBED STOCKS are so called because the title of the owner is evidenced by an entry in the books of the bank or other agent by whom the stock is issued, and transfer thereof can be effected only if the owner either attends in person, or appoints an agent under power of attorney to attend on his behalf Certain British Government stocks are so inscribed in the books of the Bank of England, and attendance at the Bank is essential before the title can be transferred The receipt or acknowledgment issued to the owner of stock of this kind is valueless as security

REGISTERED STOCKS OR SHARES, on the other hand, are evidenced by certificates given under the seal of the issuing body, and a full legal title to the property may be transferred by the delivery of the certificate accompanied by a transfer in writing or under seal

In estimating the worth of inscribed or registered stock or shares as a security, similar tests must in general be applied as in the case of negotiable securities, but, in addition, the banker should ensure that the market value is properly ascertained, and, in the case of shares, determine whether or not they are fully paid up, otherwise he may render himself liable for the payment of instalments or calls due by the depositing customer

Inscribed Stocks.

In the case of inscribed stocks, as the receipt in the holder's name is valueless, no charge can be obtained thereover by deposit with or without a memorandum As a rule, therefore, the only method by which the banker can perfect the security is by having the stock transferred into his own name or into the names of his nominees by inscription at the issuing bank In certain cases, however, stock certificates to bearer, with interest coupons attached, or registered stock certificates, may be obtained at the holder's option in respect of his holding of inscribed stock, and, wherever this option can be exercised, it affords a less cumbrous and more advantageous method of perfecting the security without the formality of inscription

Registered Stocks and Shares.

The banker's security over registered stocks and shares takes the form of either (*a*) an *equitable* mortgage, or (*b*) a *legal* transfer An equitable title is obtained by the deposit of the certificates with or without a memorandum, whereas the legal title is obtained by the execution of a transfer of the security to the bank or to its nominees, the transfer being effected in accordance with the regulations of the issuing company Such regulations may be contained either in the Articles of Association of the company or in the Statute under which it

is constituted They will usually provide that the transfer shall be *in writing*, executed by transferee and transferor, and that the transferee does not become holder of the security until his name is entered on the Company's Register of Members as a shareholder Sometimes it is provided that the transfer must be *under seal*, and, though a certificate of membership is invariably issued in favour of the transferee, the existence of the certificate is not necessary to constitute a person a shareholder

Transfer is effected by forwarding a complete instrument of transfer, together with the relative certificate, to the Company for registration

If the banker takes steps to register stocks and shares in his own name or in the name of his nominees, he will usually be well safeguarded and will obtain a good title to the property But his position will be secure only if he takes the securities honestly and for value, and without notice of any prior claims against them Thus, if a trustee lodges with a banker stocks and shares forming part of the trust property, but registered in his own name, as security for a private advance, the banker will obtain the title to the stocks and shares only if he acts in good faith and without notice of the breach of trust

A banker is, however, subject to certain risks even if he becomes registered as the transferee of the securities In the first place, he renders himself liable as transferee for an indefinite period to indemnify the company against any loss which it may incur if it should transpire that the transferor's signature to the instrument of transfer has been forged (*Corporation of Sheffield* v *Barclay*, 1905)

The second risk of liability exists in the case of partly paid shares, for a banker who registers himself as transferee of such shares renders himself liable for the payment of any calls which may thereafter be made, up to the extent of any balance still unpaid on the shares, and this liability exists, in the event of the voluntary or compulsory liquidation of the company, for one year after the bank has ceased to hold the shares, if the person to whom they are transferred is unable to meet the liability for the uncalled capital It is for this reason that bankers prefer not to accept partly paid shares as security, unless the possibility that the unpaid capital may be called up is very remote, as in the case of first-class bank shares

It must be remembered that even if registration is effected, any dividends or interest received belong to the customer, and must therefore be placed by the banker to the credit of the relative account, unless alternative arrangements are made for their disposal Moreover, the expense involved in completing registration may be sufficient to deter the banker from proceeding further than to take a blank transfer with a memorandum, while the customer may not wish the securities to be transferred out of his name

Equitable Charges over Stocks and Shares.

If the full legal title to stocks and shares deposited as security is not obtained, the banker may obtain an equitable title by (*a*) mere deposit of the certificates—a method now rarely adopted, (*b*) deposit of the certificates with a Memorandum of Deposit, or (*c*) deposit of the certificates with a Memorandum of Transfer and duly executed *blank* transfers

The object of the memorandum is to safeguard the banker as adequately as possible It provides that the security shall be continuing, that the banker shall have an immediate power of sale of the security if the customer defaults, and that he may debit the customer's account with any calls made in respect of shares which are partly paid up In cases where the stocks and shares are lodged by a third party to secure the liabilities of a customer, the memorandum will provide that the security is to be continuing, and that the surety shall not be discharged by any arrangements as to the giving of time, etc, made between the banker and the principal debtor

The mere deposit of registered stocks and shares with or without a memorandum does not give the banker the right to realise the security on the default of his customer, but he has the right to call upon the customer to execute a legal transfer, and, if that is refused, he can apply to the Court for an order to transfer and for power to sell the securities

The Effect of a Blank Transfer.

If complete registration is not considered desirable, bankers usually take a *blank transfer* of the securities together with a Memorandum of Transfer signed by the customer Such a Memorandum of Transfer is in many respects similar to a memorandum of deposit, but it acknowledges that the securities specified have actually been transferred to the banker, and that he is empowered to sell or otherwise deal with them as he thinks fit, upon default of the customer

A blank transfer is one which is incomplete in certain essential particulars, *i e*, the name of the transferee or the date, the idea being that the banker may, on default of his customer, complete the transfer and have the shares registered in the name of himself or of his nominees If, however, the regulations of the company concerned prescribe that transfer of its stocks and shares shall be by *deed*, a blank transfer is almost useless, for a deed cannot validly be completed in any material particular after its original execution, while it cannot in any event be completed by the banker unless he holds a power of attorney under seal from the depositing customer If, however, transfer can be *under hand* merely, the delivery of a blank transfer constitutes an authority to the transferee to fill up

the blanks when he deems it necessary, in which case the banker taking the transfer may insert the name of himself or of his nominees, or the name of any other party

The defect of a blank transfer as security is that the banker obtains merely an *equitable* title, so that, unless a blank transfer capable of completion at a later date is taken, the bank's only remedy, if the borrower refuses to convey the legal title, lies in the cumbrous and costly procedure of petitioning the Court for an order for sale Moreover, there is always some danger that, without the banker's knowledge, the customer may have transferred a prior equitable title or a full legal title to a third party, or that the registered owner may in fact hold the stocks or shares merely as a trustee, in which case the beneficiaries of the trust will have a prior equitable title In either of such cases the banker's rights are postponed, and he may be called upon to surrender the securities Again, if registration is not effected, the company may have a lien over the stock or shares as against the registered owner, or the company may have received notice of a prior equitable title before the banker takes steps to register himself

Finally, there is the danger that the customer may obtain a duplicate share certificate from the company on the plea that the original is lost The banker's position may, however, be to some extent protected by giving the company concerned a *Notice of Lien*, or by applying to the Court for a *Notice in Lieu of Distringas* to be served on the company

Notice of Lien on a Company's Shares.

Notice of lien is forwarded to the company in duplicate by registered post, with a request that the company acknowledge the notice by indorsing and returning the duplicate But since Section 101 of the Companies Act, 1929, debars a company from entering on its Register notice of any trust, whether express, implied or constructive, it is usual for companies to return the notice with a reply stating that it cannot be recognised

Even if such a reply is received, however, the effect of notice will be to give the banker priority over any future advances which may be made *by the company* to the shareholder, for, as was shown in *Bradford Banking Company* v *Briggs*, 1887, although *as custodian of the register* the company is precluded from recognising the charge, it is bound by such notice as regards any subsequent advances made by itself *as a trader* or any dealings the company itself, as distinct from other parties, might put forward regarding the shares Moreover, the giving of notice may reveal the fact that the shares were being fraudulently dealt with by the customer, or that they were already subject to a prior charge, for in such cases the company concerned would usually advise the banker of the position

Notice in Lieu of Distringas.

As from the date of receipt of a notice of this kind, the company on which it is served will be restrained from transferring the shares or from paying any dividends thereon without giving the equitable claimant eight days' notice of the intended transfer or payment of dividend But if after the expiration of eight days the equitable claimant takes no steps to obtain an order from the Court restraining the transfer of the shares or the payment of the dividend, the company may permit the transfer or make the payment

LIFE POLICIES AS SECURITY.

Life policies are frequently accepted in practice as cover for temporary loans, and especially as collateral security in cases where advances are granted against the deeds of property, documents of title, etc

Despite some opinions to the contrary, the assignment of a life policy is a good banking security provided the life office is a well-established and successful concern, and provided the amount of the advance does not exceed the surrender value of the policy, which may be ascertained from the office A good policy is, of course, a security which increases in value as time goes on, with the added advantage that the full sum assured, with bonuses added (if any), is payable on the happening of the event specified in the policy, *i e*, death or attainment of a certain age Cases sometimes arise where the payment received in respect of a life policy on a borrower's death is sufficient to wipe off an overdraft and thereby obviates the necessity of realising other securities As a collateral security in such circumstances a life policy is of greatest value, and is unquestionably necessary where the success and pecuniary value of a customer's business or profession depend essentially on his own personal skill, knowledge and experience

Necessary Precautions.

There are, however, a number of important precautions which must be taken before reliance can be placed on security of this kind First, the banker must ensure that the premiums are properly paid up and that future premiums will be paid as they fall due, secondly, it is necessary to have the age of the assured admitted by the company by separate letter or by indorsement on the policy If necessary, a certificate of birth of the assured, or a certificate of baptism giving the date of the birth, should be forwarded to the company with the policy as evidence of the assured's age If this is not done, and the assured's age has not been admitted by the company, the bank and personal representatives of a deceased may be involved in considerable

delay at a critical time through having to search for or obtain the necessary certificate, while, if the age was understated when the assurance was effected, an adjustment of the sum ultimately payable by the company would be made When a policy is made out in the name of a woman who has since married, a certificate of marriage will also be required in order to establish the assured's identity.

Thirdly, the banker, for his own protection, should from time to time ascertain the surrender value of the policy from the company Usually a life policy carries no surrender value until two or three years' premiums have been paid, but thereafter the value increases with the payment of each additional premium

Care should be taken to distinguish between a *whole life* and an *endowment* assurance policy, for whereas the former is payable only on the death of the assured, the latter is payable at the expiration of a certain term of years or on the previous death of the assured, and is therefore the more valuable Again, it should be ensured that the policy does not arrange that the early premiums shall be reduced to accommodate the assured, for in such a case there may be little or no surrender value Finally, any life policy taken as security should be carefully perused to ascertain whether it contains any special conditions or restrictions which may reduce its value as a security, *e g*, restrictions on foreign travel by the person assured

Disadvantages affecting Life Policies.

The disadvantages of a life policy as security are, first, that the contract between the company and the assured is one "of the utmost good faith" (*uberrimæ fidei*), so that the company may avoid liability if it can show that the assured did not disclose all material facts which might have affected acceptance of the risk by the company Secondly, there is in some cases a risk that the policy may be avoided if the assured commits suicide or dies by the hand of justice The third drawback is that if a life policy is taken out by the assured with the intention of providing for his family, it may not be good for the banker's reputation to claim the proceeds of the policy and so leave the family in need

Then there is the fact that the value of the policy depends primarily on the continued payment of the premiums, so that if the assured allows these to lapse, the banker may be deprived of his cover unless he himself pays the premiums as they fall due, in which case he will, of course, merely be adding to the amount already advanced To safeguard himself, a banker keeps a careful record of all premiums due on policies held as security, and reminds his customer if the receipts are not duly received

Finally, it should be noticed that a policy taken out by a third party, and not by the assured, is void under the Gambling Act, 1774,

unless the third party has an insurable interest in the life of the assured at the time the policy is issued A creditor or a guarantor has an insurable interest in the life of the debtor, provided the debt exists at the time the policy is obtained, and such creditor or guarantor can recover from the company even though the debt or obligation is afterwards extinguished Similarly, a wife has an insurable interest in the life of her husband and the husband in the life of his wife, but as a rule a parent has no such interest in the life of a child, or *vice versa*

Charge over a Life Policy.

A life policy may be taken as a security in two ways (*a*) by mere deposit with a memorandum, in which case the bank obtains an *equitable* mortgage , or (*b*) by *Deed of Assignment* to the bank, in which case the latter obtains a *legal* mortgage

The first method has the advantages of cheapness and simplicity The policy is handed to the bank together with a memorandum of deposit (under hand or under seal), containing an undertaking by the assured to assign the policy if required to do so, while no formality is necessary when the advance is repaid other than the cancellation of the memorandum and the return of the policy to the assured On the other hand, this method does not convey a *full legal title* to the bank, while realisation may be difficult if the assured refuses to assist by giving the promised assignment

It is more usual for banks to take from the customer a full legal assignment, which conveys the policy to the bank by way of mortgage, subject to the assured's *equity of redemption, i e*, it gives the banker power to surrender or otherwise dispose of the policy without the assignor's consent in satisfaction of any claims against him, but the assignor has a right to a reassignment of the policy on payment of the money due The assignment embodies an undertaking by the assignor to keep the policy alive by punctual payment of the premiums, and to lodge the receipts with the bank, in default of which the bank is given power to pay the premiums and to add their amount to the debt

Section 3 of the Policies of Assurance Act, 1867, provides that the assignee of a life policy shall have no right to sue thereon unless proper notice of the assignment is given to the company at its principal place of business, and that the claim of the assignee will date as from the time when the notice is received by the company, while the mere fact that notice is given will enable the person giving notice to obtain priority over a person who holds a prior assignment if that person has omitted to give notice

It is therefore most important that any banker who takes a legal assignment of a life policy should at once give notice of the assignment to the assurance company The notice should be sent in *duplicate*,

and should be accompanied by the statutory fee of not exceeding 5s , in consideration of which the company *must* acknowledge receipt of the notice by returning the duplicate to the bank Assurance companies usually add, without prejudice to themselves, information respecting any charges outstanding on the policy.

A bank's form of assignment is indorsed with a reassignment, and when the banker completes this he should give notice of the removal of his charge to the assurance company

LAND AND GOODS AS SECURITY

TITLE deeds to land and buildings and documents of title to goods are frequently taken by banks as security, the former chiefly in country towns and agricultural districts, and the latter principally in and around seaports, in which case the nature of the goods depends largely on the class of trade passing through the port concerned

In both cases the bank's security consists of the actual land, buildings or goods to which the documents relate, and not of the documents or deeds themselves The latter are merely a " symbol " of the land or goods to which they relate, so that, apart from the necessity of ensuring the validity, completeness and correctness of the documents, special precautions are necessary to ensure the proper valuation and protection of the property concerned

Although land and buildings may form a valuable and useful form of cover, neither is an ideal type of banking security As a rule, such cover is offered as security rather for long period loans than for the short period advances which afford the banker the greatest degree of security and liquidity of his funds, and return him the greatest margin of profit The successful banker is essentially a short term lender, and if it is obvious that a customer requires a " dead " loan against his title deeds, the banker will prefer, and usually advise, him to raise a mortgage either through a solicitor or a building society " Land is not a banking security, and real property should, as a general rule, be lent against only to good borrowers and for limited periods , say, to bridge over a short period when the source of repayment is known and the means of repayment is in sight , for example, pending the completion of a mortgage which the banker is satisfied is in course of arrangement "[1] Moreover, the manner in which the property in land and buildings is conveyed and taken as security is governed by one of the most complicated and extensive branches of the law, so that apart from the special precautions involved in connection with such matters, the services of a solicitor are almost invariably required, resulting usually in considerable expense and delay in completing the necessary arrangements.

In spite of these objections and disadvantages, advances against the security of agricultural land and houses or shop property are extremely

[1] F E Steele, *The Banker as a Lender*, page 83

common. In country districts, particularly, title deeds are frequently deposited as security for temporary accommodation by farmers pending the harvesting and sale of their crops, and by landowners pending the receipt of their rents The deeds frequently comprise the only available security in such cases, and country banks have no hesitation in accepting them

Mortgages as Security.

Several important matters have to be considered by a banker in accepting land as cover for advances, with a view to protecting himself against various contingencies which may have the effect of jeopardising the value and validity of his security First, he must ensure that the value placed on the property concerned is reasonable and that an adequate margin is allowed for all contingencies Secondly, the deeds must be valid, complete and in order, and the document evidencing the bank's charge so drafted as to cover all contingencies likely to arise Thirdly, if advances have been made against the security of the same property by other incumbrancers, care must be taken to ascertain and to safeguard the priority of the bank's charge Fourthly, the bank must consider the effect on its security of the possible exercise by the mortgagor of his right to remove, or permit the removal of, fixtures from the property concerned

Finally, there is the important point that a bank's security over land may be jeopardised if deeds are deposited by a person who, in so doing, acts in fraud of the true owner, as, for example, a solicitor who deposits with a bank deeds to which he has no right In such circumstances, the deeds can be reclaimed by the true owner without repayment of the amount advanced, even though the bank has acted throughout in complete good faith, and without actual or constructive notice of the fraud

Legal Mortgages.

Only in exceptional circumstances does a banker go to the trouble and expense of taking a *legal* mortgage as security, but, if he decides to do so, several important precautions are necessary In the first place, the deeds of the property must be deposited at the bank and the report of an independent solicitor obtained that the title of the customer is satisfactory The next step is to arrange for a careful valuation of the property, either by an independent valuer or by the bank manager himself The banker will, of course, proceed on a very conservative basis, and consider what the property would realise in the event of a forced sale Careful consideration must also be given to the possibility of deterioration of the value of the property in the neighbourhood

concerned, while, in the case of houses and other buildings, adequate allowance must be made for depreciation and maintenance

The *net* rental should be ascertained, after due allowance for such outgoings as ground rent and tithes Generally speaking, the security should not be favourably regarded if the net rental value of the property is not *considerably* in excess of the annual charges in respect of the proposed advance The determination of the net rental is of considerable importance as it forms a reliable basis upon which the banker can estimate the saleable value of the property, it being usual to value freehold at an amount equivalent to approximately fifteen or twenty years' purchase of the net rental, and long leaseholds at an amount equivalent to about ten times the net annual rental

Expert assistance should always be obtained in the case of the valuation of property especially adapted for particular purposes only, as, for example, textile mills, factories of various kinds, warehouses, engineering shops, wharves, mines and quarries

Moreover, even where a valuation is obtained, periodical revaluations should be conducted at suitable intervals in order to ensure that the overdraft continues to be sufficiently secured All buildings should be adequately insured against fire, and the premium receipts should be carefully kept at the bank, the customer's written order being obtained for the debit to his account of the premiums as they fall due

In the case of leaseholds, adequate allowance should be made for the depreciation of the lease, while the receipts for the ground rent should be obtained as the rent is paid and filed with the deeds, arrangements being made, if necessary, for the debit of such rent as it becomes due to the customer's account

In all cases, the deeds should be most carefully examined to determine whether they bear evidence that the property is subject to any prior incumbrances, and an arrangement made for a search of the appropriate Register [1] The latter point is of vital importance, for the banker's charge, whether legal or equitable, will be postponed to any charges against the land concerned which have been registered before his charge was created or before he made his search, whichever last happened

If these precautions are properly taken, the banker need have little fear for his security, as the standardised mortgage form now used in all banks protects him against the various eventualities to which reference has been made in the preceding paragraphs As a rule, a banker's mortgage provides that the money loaned shall be repaid *upon demand*, and that the security shall be a *continuing* one in respect of all monies which may be due or which may become due It also

[1] Usually the Land Charges Register in London In the case of *registered* land, a search should be made at the Land Registry, London If the land is situated in Middlesex or Yorkshire, the local registers must also be searched

gives the banker express power to appoint a receiver or to sell the property upon default, although such power should not be exercised unless notice is first given to the mortgagor and to any other person holding a charge of which the banker has notice

Land Charges by Joint Stock Companies.

If the banker proposes to take either a legal mortgage or a floating charge from a company customer, he must search the register at Somerset House to determine the nature and amount of any prior charges which may exist If the register reveals that debentures have already been created, the debentures should be carefully examined in order to determine whether they contain a specific or floating charge, and whether or not they preclude the company from making specific mortgages and charges of its property or from making floating charges in priority to them If the banker is satisfied on these various points, his best plan is to take a debenture embodying a specific charge by way of legal mortgage on the freehold and leasehold properties of the company Such a charge must be registered with the Registrar of Joint-Stock Companies, and will thereafter operate as a charge of which everyone will be deemed to have received notice

Legal Mortgages of Registered Land.

A banker who proposes to take a legal mortgage of *registered land* (*i e*, land registered at the Land Registry under the Land Registration Act) must obtain the relative land certificate and carefully examine it in order to ascertain whether it is indorsed with any outstanding charges He must also search the Land Register to determine whether any other charges are outstanding which are not indorsed on the certificate, and it is desirable, although not essential, to lodge the certicate with the Registrar so that it may be entered up to correspond with the Register

If the certificate conveys only a *possessory* title, the owner should be required to deposit all title deeds relative to the land prior to registration so that an investigation of the title prior to that date may be made by the banker or by his solicitor As soon as the banker has satisfied himself respecting the value of the security and the prospective borrower's title thereto, he will proceed to take a legal mortgage, *either* by ordinary mortgage deed *or* by completion and lodgment with the Land Registry of the requisite instrument of charge, in return for which a Certificate of Charge will be issued in the bank's favour

Equitable Mortgages.

These provide a simpler, more speedy and less troublesome mode of securing advances, so long as the banker's usual memorandum is

taken and arrangements are made for the deposit of the title deeds Since the passing of the Law of Property Act, 1925, the position of an equitable mortgagee who has possession of the title deeds is made fairly secure, and such a security may take precedence even of an unregistered *legal* mortgage created *without* the deposit of the deeds The banker's memorandum of deposit usually confers upon him practically the same remedies as are in the hands of a legal mortgagee, but the power of sale, or of appointing a receiver of the property, cannot be exercised without the authority of the Court unless the memorandum is given under seal and expressly conveys such rights to the banker

The defects of an equitable mortgage are that, in general, the title of the equitable mortgagee is postponed to that of a prior legal or equitable mortgagee, if he has notice of the prior charge And although a banker may defeat subsequent legal or equitable interests by possession of the title deeds, he is postponed to prior legal or equitable interests *if the latter are registered* He must therefore protect himself by a careful search of the appropriate Register for any such prior interests

Second Mortgages as Security.

Second mortgages are not usually regarded by bankers as satisfactory security for advances, for the rights of the second mortgagee are, of course, always subject to those of the first incumbrancer, while there is the danger that the first mortgagee may make further advances

If a second mortgage is to be of any great value, the margin between the value of the property and the amounts respectively advanced by the first and second mortgagees must be sufficient to afford the banker a high degree of protection, for, in realising the property, the first mortgagee is not bound to give consideration to the interests of the second incumbrancer, and he may sell the property so much below its real worth that little is left for the later mortgagee Moreover, a first mortgagee, *if under an obligation to do so*, may make further advances even after receipt of notice of the second charge

If, however, a banker accepts such security, he should protect himself against the making of further advances by the first mortgagee by giving the latter written notice of his second mortgage, and, if possible, obtaining an acknowledgment with the object of preventing further advances being granted by the first mortgagee, whose actual interest the banker should, of course, immediately ascertain

Mortgage Deeds as Security.

A banker who is offered mortgage deeds by a customer as security should either take a sub-mortgage or an assignment of the original mortgage in writing The mortgagor should be given notice and should

be requested to give an acknowledgment thereof, with an indication of the amount still unpaid in respect of the mortgage The property should also be carefully valued in order to ascertain that the amount borrowed on the mortgage is adequately secured Once such notice has been given the banker is entitled to have paid direct to him any sum or sums subsequently paid by the mortgagor in reduction of the mortgage money.

ADVANCES AGAINST PRODUCE AND GOODS.

Conflicting opinions are expressed by various authorities as to the desirability of a banker granting advances against the security of produce and goods by the deposit or pledge with the bank of such documents of title as bills of lading, delivery orders, warehouse-keepers' warrants, and dock warrants

Some writers emphatically condemn documents of title to goods as undesirable banking securities, but the more modern view—borne out by the frequency with which such security is accepted in practice—is that such cover is reasonably sound if adequate precautions are taken to safeguard the position of the lender Moreover, it is not to be forgotten that loans of this type are among those which afford the greatest assistance to the trading community, while at the same time providing bankers with a highly remunerative and in other ways attractive type of business

Nevertheless, successful loaning against the security of goods undoubtedly calls for a fair degree of specialised knowledge, for apart altogether from the necessity of ensuring the validity and completeness of the documents themselves, and of dealing so far as is possible with customers of known integrity, there is the further need of taking into consideration the quality, value, and freedom from deterioration of the goods in respect of which the documents are issued

The question of the *quality* of the goods is clearly of importance if the banker is called upon to realise the commodities which he has accepted as security, while the *risk of deterioration* must be carefully weighed in cases where a long journey to market is necessary, or where the goods have to be stored for a period before realisation Perishable goods or goods which are subject to vagaries of demand or of fashion are certainly not suitable as banking securities, while greater protection can be obtained by accepting as security goods in everyday use, capable of a steady sale, than by accepting luxury articles subject to an uncertain or widely fluctuating demand

In addition, the considerable risk of fraud in connection with the taking of goods as security must not be overlooked, for it is clearly not always easy for a banker to satisfy himself regarding the real value and absolute quality of the great variety of articles which enter into the trade of the country, and which may be offered to him as security.

The banker's position in this respect can, however, be reasonably safeguarded, if produce and goods are accepted as security only from customers of known repute, or if a competent independent valuation of the goods is insisted upon Revaluation at intervals should, of course, be arranged wherever it appears to be desirable in the banker's interests

Apart from satisfying himself as to the actual value of the commodities, the banker must exercise extreme care to ensure that the property in the goods is clearly and properly conveyed to him by the documents deposited by the customer, for it must be remembered that, although the loans are granted against the security of the goods, the security is evidenced essentially by the documents of title which come into the banker's possession

Taking Goods as Security.

Goods represented by the relative documents of title will be taken by a banker as security in one of two chief ways, either (*a*) *directly* as security for an advance on current account, or (*b*) as security for the due payment of bills of exchange discounted or accepted by the banker on behalf of his customer In the first case, the goods will constitute a *direct* security for a due payment of the advance, whereas in the second case they are merely a *collateral* security for due payment of the bills

Apart from the general considerations to which reference has already been made, a banker accepting such security will have regard to three important points (*a*) the validity and completeness of the documents, (*b*) the nature, quality, and value of the goods, and (*c*) the rights of any persons who may have claims against the goods, including the seller, the buyer, and the person having possession of the goods for the time being

In examining the documents the banker will ascertain that they purport to be complete and in order, and that they are properly stamped, where stamping is necessary Care will be taken to distinguish between documents which in themselves *give a title* to the goods specified, *e g*, bills of lading and dock warrants, and documents such as warehouse-keepers' receipts and certificates, which are merely *acknowledgments of the deposit* of goods in a named warehouse.

Bills of Lading.

A bill of lading is a document signed by the master of a ship, acknowledging the receipt on board the ship of certain specified goods for carriage, and embodying an undertaking on behalf of the shipowners to deliver the goods to "order," or to a named person "or his or their assigns", upon payment of the freight stipulated for

A bill of lading is not a negotiable instrument, and, if it is drawn in favour of a named person, it is not even transferable If, however, a bill of lading is drawn "to order," the full property in the goods concerned may be transferred simply by delivery of the bill after indorsement by the shipper But such a transfer is "subject to equities", *i e*, the transferee, even if he takes the instrument for value and in good faith, cannot acquire, or pass, a better title to a bill of lading than that of his immediate transferor

When a bill of lading does not state that the goods are deliverable "to order" but simply names a consignee, it is known as a *Straight Bill of Lading*, and the goods concerned must be delivered to the person named and to him only Delivery to any other person will be made at the shipowner's own risk

Bills of lading, like documentary bills, are drawn in *sets* usually of three or four parts, excluding any unsigned copies The object is to enable the different parts to be sent to the consignee or his agent (frequently a banker) by different mails, and so reduce to a minimum the risk of loss or delay in transit This practice, however, may cause additional trouble and risk to the banker, since delivery of the goods may be made by the shipowner to the holder of *any one of the parts*, and that part may be in wrong hands

As a general rule, an unsigned copy of a bill of lading is retained by the consignor as evidence of shipment, for use in the event of his having to claim on the insurers under the marine insurance policy covering the goods A second copy will be kept by the master of the ship, to assist him in the identification of the goods

"Received for Shipment" Bills of Lading.

The ordinary form of bill of lading states that the goods in question are "*Shipped* on board the ," and such bills are known as "shipped" or "on board" bills of lading For many years, however, some shipping companies have stated in their bills of lading that the goods are "*Received for Shipment* on board the ," and such bills are distinguished as "received for shipment" bills of lading

Bills of this second class are issued because, at certain busy periods, or in the case of *through transit*, a shipping company cannot undertake definitely to carry goods *on a particular ship* Hence, a "received for shipment" bill is issued, but since it does not afford evidence that the goods concerned have been received on board a particular or, indeed, on any ship, there is no guarantee that actual shipment will not be delayed indefinitely It is, therefore, doubtful whether, where delivery of a bill of lading is demanded, a received for shipment bill is a good tender No general rule can be laid down, and each case must be considered on its merits, due consideration being given to the usage of

the particular trade But in the absence of any evidence of usage to the contrary, a "received for shipment" bill is *not* a good tender under a C.I F contract (*Diamond Alkali Export Co* v *Bourgeois*, 1921)

"Through" Bills of Lading.

Bills of lading occasionally purport to cover the goods concerned throughout their journey, from the place of origin to the place of shipment and thence to the port of destination Such documents are commonly issued by American railway companies in respect of produce moved from the interior to the seaboard for shipment abroad, and they then combine a railway receipt and a bill of lading

While these documents are usually perfectly valid and satisfactory, it has been decided by our Courts that they did not, *in certain cases*, constitute a good tender under a C I F contract, as the bills did not purport to cover the goods throughout the whole of their journey Consequently, a banker should not accept documents of this kind unless he is authorised to do so, or unless he is perfectly satisfied that they adequately cover the goods

Wherever possible, bills of lading accepted as security should be drawn "to order or assigns," so that they may be transferred by indorsement to the banker They should be closely examined to ascertain whether they contain clauses which may necessitate the payment of heavy charges to the shipper, or which may otherwise operate to the detriment of the lender Moreover, it must always be remembered that, while a bill of lading is conclusive evidence of the shipment of goods as against the person who has signed it, it affords no evidence either of their quality or value, although the lender may protect himself in this regard by insisting on the deposit of an invoice showing the value and description of the goods Further protection in this respect will be obtained by ensuring that the bill of lading is accompanied by the relative marine insurance policy or certificate of insurance, provided that it is seen that the description of the goods in the policy agrees with that given in the bill of lading It should also be ascertained whether the bill of lading is *clean*, *i e*, whether it acknowledges that the goods are shipped "in good order and condition," or whether the shippers qualify their acknowledgment of the shipment by stating that the goods or the packages were in some way defective at the time of their receipt on board, in which event the bill of lading is said to be *claused*, or *foul* or *dirty*

Wherever possible, a banker advancing against the security of bills of lading issued in sets should arrange for the deposit with him of all parts of the set, so as to ensure that the goods cannot be claimed by any person to whom one of the parts may have been fraudulently transferred Finally, the banker should ensure that the goods are

adequately insured (*in his name* but at the customer's expense) against fire and theft at any place where they are stored

Dock and Warehouse Warrants, and Warehouse Receipts.

DOCK AND WAREHOUSE WARRANTS are documents in a variety of forms issued by dock companies, warehouse-keepers, or wharfingers, in favour of persons depositing goods, and stating that goods described therein are deliverable to the person named in the warrant, or to his assigns by indorsement

Although these warrants are transferable by indorsement and delivery, or by mere delivery if indorsed in blank, they are not negotiable instruments, so that any transferee thereof will be affected by any defects in the title of his transferor And though a warrant passes the title in the goods concerned, it does not operate as a transfer of possession Consequently as a dock company or warehouse-keeper cannot be compelled to hold goods on behalf of any person other than the original depositor with whom the contract was first made, it is essential that a banker who takes such a document as security should at once give notice of his claim to the holders of the goods, so that a new warrant may be issued in his name The banker should also make arrangements to have the goods concerned insured against fire and theft at the borrowing customer's expense

WAREHOUSE-KEEPERS' RECEIPTS AND CERTIFICATES These are documents issued by warehouse-keepers, stating that the goods specified therein were deposited on a particular date by a person named, and that they are held at his disposal Such documents, which are usually stated to be "not transferable," are merely receipts or acknowledgments for the relative goods They are not documents of title, for the owner may obtain possession of the goods, without surrender of the certificate or receipt, by signing and forwarding to the warehouse-keeper what is known as a DELIVERY ORDER This is a document addressed by the owner of goods to the proprietor of a dock or warehouse in which the goods are stored, instructing such proprietor to deliver either all or some of the goods to a specified person or to his assigns Although such a document is not strictly a document of title, it is nevertheless necessary to enable a third party to obtain goods in respect of which a warehouse-keeper's receipt has been issued

A *warehouse-keeper's receipt* or *certificate* taken as security should be accompanied by a delivery order made out in favour of the banker, so that he can obtain possession of the goods and have them stored in his own name In any case where the banker does not take steps to register himself as owner of the goods, he should lodge a "*stop order*" with the dock company or warehouse-keeper holding the goods, in order to prevent unauthorised dealing with the articles by the customer or third parties

The registration in the banker's name of goods specified in a warehouse-keeper's certificate or receipt is of particular importance if the banker is to be protected in the event of the bankruptcy of the borrower Whereas possession by the banker of a bill of lading, or dock warrant, or warehouse *warrant*, is sufficient to take the goods concerned out of the order and disposition of a bankrupt customer so as to defeat the claim of his trustee that the goods form part of the bankrupt's estate, a warehouse-keeper's receipt or certificate has no such effect and the goods may be claimed by the trustee

Letters of Hypothecation.

In practice, customers depositing documents of title to goods with a banker as security, are required to sign a document of charge described as a *Letter of Hypothecation* This conveys to a banker the full right to, and property in, any goods in respect of which he may have given advances, either by way of direct loan, or by acceptance or negotiation of drafts relative thereto

The Letter of Hypothecation pledges the documents with the banker as security, authorises him to deal with the goods in any way which may be necessary, to insure and store them in his own name at the customer's expense, to pay freight thereon to the customer's debit, to sell them if he deems fit, and to apply the proceeds in repayment of any advance or payment made by him on behalf of the pledgor Should the amount so realised be insufficient to satisfy his claims, the banker still has recourse to the signatory to the Letter of Hypothecation for the balance due Thus the object and general effect of such an authority is to ensure that the banker obtains the additional security afforded by *absolute rights* over the actual goods concerned, so that his position may be adequately covered in the event of the dishonour of the bills drawn against them, or in the event of the failure of the customer to repay the sum advanced

Such a memorandum of charge is essential in circumstances where the documents are not made out " to order or assigns," and the banker is not able to obtain a clean title by mere delivery Moreover, a memorandum of this kind is essential to support the banker's claim to the relative goods or the documents of title thereto, in cases where he does not deem it desirable to append his own signature to the actual documents, in view of the risk that he may incur liability to parties of whose interests he is unaware

Trust Receipts.

Customers who have obtained advances from a banker on the security of goods, are frequently unable to repay the amount borrowed until

they realise the goods and obtain payment of the proceeds As the documents of title must be produced before goods can be obtained from a shipping company, dock company or warehouse-keeper, bankers sometimes arrange to release the documents to the customer against his signature to an instrument known as a "*Trust Receipt*"

This embodies an agreement by the customer hypothecating the goods to the banker as security for the advance, and undertaking to hold them and any proceeds received in respect thereof as a trustee for the banker, in whose name the goods are insured and warehoused

BILLS OF SALE

A bill of sale is a document, usually under seal, whereby the property in certain specified personal chattels is transferred or mortgaged by one person to another If the instrument gives the grantee an absolute assignment of the goods and chattels concerned, it is described as an *absolute bill of sale*, in contradistinction to a *mortgage bill of sale, or conditional bill of sale*, which merely passes the property by way of security for a debt or advance, and authorises the creditor to sell the goods named therein if the debt or advance is not repaid by a specified date, and to reimburse himself out of the proceeds

A mortgage bill of sale intended as security for an advance must be substantially in accordance with the form prescribed by the Bills of Sale Act, 1882, and must expressly state the consideration for which it is granted, which must not be less than £30, and also the chattels to which it refers For the purpose of the Act, "personal chattels" are stated to include goods, furniture and other articles capable of complete transfer by delivery, also fixtures and growing crops (in certain circumstances) and trade machinery But the term does not include *choses in action*, such as stocks and shares, or interests in real estate or fixtures other than trade machinery

In order to be valid, a bill of sale taken as security must be registered within seven days of its execution at the central office of the Supreme Court, and the registration must be renewed every five years if the security is to continue Provided a bill of sale is duly registered in the manner prescribed by the Act, registration of any subsequent transfer or assignment is unnecessary If two or more conditional bills of sale are given in respect of the same chattels, their priority is determined according to the date of registration

Bills of sale are not a desirable form of banking security, for whether such an instrument is taken by the banker himself, or is given by his customer to a third party, its execution is usually regarded as an indication that the grantor is financially embarrassed If such a document is accepted, however, the banker must take precautions to ensure that all requirements of the Act are properly complied with, otherwise the

security will be rendered void. He should particularly guard himself against the facts that a bill of sale will be invalid if it is given to him by a person who has been adjudged bankrupt, or by a person who to the banker's knowledge has committed an act of bankruptcy within three months preceding the date of the bill of sale, or if the bill of sale can be regarded as being a fraudulent preference over other creditors of the grantor.

The remedies of the holder of a bill of sale as set forth in Section 7 of the Bills of Sale Act, 1882, are to seize the goods and chattels covered by the charge if the grantor (*a*) fails to make repayment on the prescribed date ; (*b*) becomes bankrupt ; (*c*) fraudulently removes the goods from the place specified by the instrument, in which they are stated to be ; (*d*) without reasonable excuse, fails to produce his last receipts for rent, rates and taxes, or (*e*) has execution under a judgment levied against the goods and chattels comprised in the bill of sale.

CHAPTER 19

SAFE CUSTODY AND OTHER SERVICES FOR CUSTOMERS.

THE safes and strong-rooms with which the banker must be provided for the purposes of his business form a very convenient and safe place of storage for property which customers desire to safeguard from fire and theft

As a general rule, property which is thus left with the banker for safe custody is deposited in a locked box, the key of which is kept by the customer, or, if it consists of deeds or securities, it may be enclosed in an envelope, which should be sealed with the customer's recognisable seal The name of the customer usually appears on the outside of the box or envelope, but in the majority of such cases, the banker is given no precise information regarding the contents Negotiable securities, such as bearer bonds, are usually left with the banker uncovered, particularly where he is required from time to time to detach the coupons and to present them for payment

Receipts for Articles Left for Safe Custody.

The majority of banks in this country issue to customers a special form of receipt in respect of all articles lodged for safe custody, and require that the receipt shall be returned to the banker duly discharged by the customer before the articles deposited can be withdrawn Moreover, it is usually provided that the depositor shall attend *in person* at the bank in order to withdraw the articles, and, if he is unable to do so, he is required to sign an order on the back of the receipt instructing the banker to deliver the articles to the bearer of the document

As a rule the receipt is taken from a *Safe Custody Receipt Book*, and is detached from a counterfoil which the customer is required to sign on depositing the valuables By so doing he not only acknowledges that the articles deposited by him are as stated on the counterfoil, but also provides the receiving banker with a specimen of his signature, which can, of course, be compared with that signed on the receipt when the articles are withdrawn.

In the event of the receipt being lost by the customer, he is requested on withdrawing the articles either to give another receipt, or to sign

his name opposite the relative entry in the bank's Register of Articles for Safe Custody As a rule, a third party who withdraws articles belonging to a customer under a letter of authority or by virtue of the customer's instruction on the back of the receipt, is required to sign the Register, the customer's letter of authority or instruction being carefully filed away with the other receipts for articles withdrawn

If articles are deposited in the names of two or more persons, all of those persons should be required to sign the counterfoil and the Receipt should be made out in the names of all the parties The Council of the Institute of Bankers suggest that, upon proper proof of the death of one of two or more parties in whose joint names valuables are deposited, delivery may be made to the survivor or survivors, provided the bank has no notice that the valuables are held by the parties as trustees

Articles lodged for safe custody on behalf of a partnership, limited company, local authority, or other body should be accepted only if the counterfoil is signed by duly authorised officials, while the return of valuables in such cases should be made only against the signature of persons who are properly authorised to act on behalf of the body concerned, although such persons need not necessarily be those by whom the valuables were originally deposited

In the case of trustees, the banker should take particular care to see that the valuables are deposited in the names of *all* the trustees, and that the signatures of all are obtained to the counterfoil In no circumstances should one or some of several trustees be permitted to withdraw or to handle valuables deposited in the names of all, unless the signed authority of all the trustees is first obtained Moreover, if one of several trustees is given authority by his co-trustees to deal with valuables for safe custody in a certain way (*e g*, to cut off coupons for collection), the banker acting on such authority should see that its terms are rigidly complied with and not exceeded

On the death of the person in whose name articles are left with a banker for safe custody, the banker should not permit dealings with the property except by the personal representatives *after* production of the probate or letters of administration, although the banker should not object to the examination of the articles in his presence by persons properly interested, as, for example, near relatives of the deceased If a will is contained in a box which is so examined, it may be handed over against the signature of all the executors mentioned therein, but no other documents should be transferred until probate is produced, and the authority of all the personal representatives obtained If several executors are named in a will, the signature of all should be required in acknowledgment of articles lodged for safe custody in the name of the deceased

On the bankruptcy of a person who has deposited articles with a banker for safe custody, the banker should obtain the permission of the

Official Receiver or of the trustee before releasing the articles, and will be safe in accepting the signature of the official receiver or the trustee as an authority for the withdrawal

The Banker as Bailee.

In taking charge of a customer's valuables for safe custody, the banker undertakes the obligations of a *bailee*, *i e*, a person to whom goods are delivered in trust under a contract, to be held until reclaimed by the depositor, who is described as the *bailor* No property in the goods thus deposited passes to the bailee, his capacity is merely that of a warehouseman or custodian of the goods for the person depositing them, and his liability for loss or theft of the articles depends upon whether he renders the service gratuitously, *i e*, free from any charge or profit, or whether he is paid for his trouble

A person who undertakes the safe custody of valuables simply to oblige and without receiving any payment for the service is known as a *gratuitous bailee*, whereas a person who makes a special charge for the service, or obtains any profit therefrom, is described as a *bailee for reward* or a *bailee for hire* The distinction is important from a banker's point of view because the liabilities and obligations of a bailee for reward are more onerous than those of a gratuitous bailee Whereas a gratuitous bailee is bound to use only the best means and facilities at his disposal, a paid bailee is in the position of an expert, and is bound to provide himself with the best safeguards known to practical science

If the banker is *specifically* paid for taking care of articles left for safe custody, he is, of course, in the position of a bailee *for reward*, and, as such, his failure to display the requisite degree of care will constitute negligence for the consequence of which he will be responsible to his customer Accordingly, he must take every reasonable expert means to safeguard the property entrusted to him against loss or damage, and, with this object, must provide himself with the most effective appliances possible

It is more difficult to define the banker's position in the ordinary state of affairs, where he receives no special payment for his services, and no definite arrangements are made with the customer when the account is opened Unfortunately, there is no agreement among the authorities as to whether the banker in such circumstances is a gratuitous bailee or a bailee for reward Sir John Paget maintains that the banker is properly regarded as a *gratuitous* bailee, and this opinion would no doubt be endorsed by the Council of the Institute of Bankers

Other eminent authorities, including Dr Heber Hart, maintain that a banker is a bailee *for reward* because he makes a profit by keeping a customer's account, and because one of the considerations by virtue of which customers open or continue their accounts at a bank is that the

banker will at any time accept their valuables for safe custody in accordance with long established practice In support of this view it is argued that, upon opening an account, a new customer knows from the advertisements and literature of the bank that he will have a right to leave his valuables in the hands of the bank for safe keeping, and that he will be able to obtain the benefit of the modern protective devices at the disposal of the bank for the safeguard of his property from fire or theft On his part, the banker knows that customers will expect this service, and he lays himself open to act as a bailee of the customer's property because he expects to derive some benefit from the existence of the account

The matter remains to be settled by the Courts, but, whichever view is accepted, it cannot be denied that the service rendered must be regarded as being more than mere courtesy, for there is little doubt that the refusal of a banker to accept a customer's valuables for safe custody would be followed in the majority of cases by the removal of the account to another bank Moreover, this service is one which bankers do not usually place at the disposal of persons who are not customers, and presumably a charge would ordinarily be made by a banker who was asked to undertake the safe custody of articles belonging to outside parties Nevertheless, it must be remembered that a customer cannot *compel* a banker to take charge of his valuables

Ordinary or Gross Negligence?

It is generally stated that the difference in respect of a banker acting as a gratuitous or a paid bailee is that in the former case he is liable only for *gross* negligence, whereas in the latter case he is liable for *ordinary* negligence But even if the view that a banker is a gratuitous bailee is accepted, "he is bound to take the same care of the property entrusted to him as a reasonably prudent and careful man may fairly be expected to take of his own property of the like description" (*Giblin v M'Mullan*, 1868) Unquestionably, a banker is imputed with high qualities of care and caution in safeguarding the property of others "The banker publicly professes the art of taking care, which may indeed be considered the historical origin of his other functions, and negligence which, in the case of another person might be unrecognisable, would be appalling in the case of a guardian of credit and capital"[1] It follows, therefore, that even if a banker is to be regarded as a gratuitous bailee, he would be liable if he had failed to take all precautions which his experience had shown were usual and necessary

The banker does not *insure* the safety of goods thus entrusted to him, so that if the goods are lost in spite of the fact that he has exercised every necessary care, he will incur no liability to the party depositing

[1] Hart, *Law of Banking*, page 308

This is so even if the goods are lost or fraudulently dealt with by one of the bank's employees, provided that the bank itself can show that it has acted without negligence

As a rule, the banker does not incur any special liability in respect of valuables for safe custody on account of his knowledge or lack of knowledge of the nature of the goods, thus, the fact that goods of a certain character have deteriorated in keeping in spite of the efficiency of the banker's storage accommodation, would not involve him in liability unless it could be shown that he had been unreasonably or imprudently negligent

A banker will be held liable for the loss, destruction or damage of articles entrusted to him for safe keeping which he deposits elsewhere than on his own premises, quite apart from any question of negligence In such circumstances, his liability arises from breach of one of the conditions of the contract of deposit between the banker and his customer

Finally, it should be noted that a bailee of goods has no better title thereto than the bailor, so that if the latter has obtained goods or securities from another person by fraud, the true owner will be able to sue the bailee for their return even though the bailor's authority for withdrawal is not obtained

The Return of Goods Left for Safe Custody.

Whether the banker is regarded as a gratuitous bailee or a bailee for reward, he must return the articles upon demand to the depositing customer *but to no other*, and if through his negligence the articles are stolen or otherwise lost, or if he delivers them to a third person without being authorised to do so by his customer, he will be liable to make good their value

For these reasons a banker should take every care to satisfy himself concerning the genuineness of the signature to an instruction for delivery of articles left for safe custody, for he will certainly be liable to his customer for negligence or conversion if, in returning such property, he acts upon a signature which is forged or unauthorised If there is any doubt as to the authority of a person who presents an order for delivery of articles left for safe custody, the banker is justified in obtaining the customer's confirmation of the request for withdrawal Danger of mis-delivery in such a case may be avoided if the banker insists upon sending the articles by a member of his own staff to the customer's own house or place of business

The articles returned must accord in description with the articles deposited Thus, if uncovered bearer bonds are left with the banker, the instruments returned must be identical in description and value with those which were deposited But a banker is in no degree liable

for the contents of a locked box or a sealed envelope, unless in the case of a box the contents are specifically divulged to him at the time of the deposit and the key is left in his hands

Valuables for Safe Custody and Third Parties.

If a customer gives an authority to a third party to obtain access to a box or parcel deposited at a bank for safe custody, the banker should see that the terms of the authority are strictly complied with Thus, if the customer merely authorises the third party to *inspect* the documents or contents, the banker should ensure that the contents are examined in his presence and should see that nothing is removed and that nothing is altered or damaged Moreover, if the authority permits the third party to remove a particular article from a box or parcel, the banker should see that only the specified article is taken away

Accordingly, a solicitor who has the customer's authority to inspect the contents of a box deposited by him should not be permitted to remove any of the contents, or to alter any documents without the customer's express consent, or to remove the box from the bank, even if, in the latter case, the solicitor offers to give an undertaking not to interfere with, damage or remove the contents

The Banker's Lien Over Articles for Safe Custody.

Since articles deposited for safe custody are left with the banker for a specific purpose only, they cannot be subject to the banker's general lien In other words, a banker cannot retain jewellery or negotiable securities deposited with him merely as a warehouseman for his customer in respect of any loan or overdraft due by that customer to the bank. In such circumstances the banker acts in two distinct capacities, and his legal rights and liabilities arising from the two capacities are in no wise related If, however, a customer's securities deposited for safe custody have to be dealt with by the banker in the ordinary course of his business *as a banker*, then the lien will arise

The foregoing is the guiding principle, but the decisions based thereon are not consistent, and each case is a question of fact to be determined according to the custom of bankers in the circumstances and the general course of dealings between the banker and the customer concerned Thus, if bearer bonds with coupons attached are left in the care of a banker and the *customer* periodically cuts off the coupons and hands them to the banker for collection, no lien will arise in respect of the *bonds*, although the banker can exercise a lien over the *coupons* and their proceeds by virtue of the fact that they come into his hands *as a collecting banker* Moreover, it has been suggested, though on somewhat doubtful grounds, that the lien will extend to the bonds as well as to the

coupons if the securities are lodged with the banker and he is instructed to cut off and present the coupons as they fall due But the banker will have no lien either on the bonds or on the coupons if the latter are cut off *and* presented for payment *by the customer* himself Again, no lien will arise over the bonds in any of the foregoing circumstances, if there is evidence from the terms of a receipt given by the banker that the securities are received by him expressly for safe custody, as, for example, if the receipt specifically acknowledges that the bonds are to be held by the banker "*for safe custody*"

For similar reasons, if certificates of debenture or other stock registered in the name of the customer are deposited with the banker for safe custody, and instructions are given by the customer that dividend and interest warrants are to be forwarded direct to the banker for the credit of his account, the banker's lien will extend to the warrants but not to the certificates, since the former are handled by the banker in the ordinary course of his business, whereas the latter are not Again, if bills are deposited by a customer for safe custody until maturity, with instructions that the banker is to present them for collection and payment on the due dates, the banker can enforce a lien against the proceeds, for although in the first instance the bills come into his hands as a bailee, they are subsequently dealt with by him *as a banker*

The Presentment of Drawn Bonds and Coupons Lodged for Safe Custody.

In the absence of an express or implied agreement with the customer, there is no obligation on the banker's part to present for payment coupons or bonds left with him for safe custody, although in practice bankers almost invariably undertake this service in respect of all bonds of their customers to which they have access Of course, if the banker has once accepted the responsibility to make collections, he will be liable to the customer if any loss ensues by reason of his failure to present coupons for payment at the correct time If the coupons are payable by advertisement, it devolves upon the banker to ascertain the dates upon which payment will be made (*e g*, by searching the *Bondholder's Register*), and to present the coupons for payment at the place specified

The banker's liability to present for collection applies also to bonds, held by him for safe custody and accessible, which are periodically drawn for payment, and he must take any necessary steps to ascertain whether any bonds so held are among those which are from time to time advertised as drawn

Clearly the bank can incur no liability in respect of the collection of coupons and bonds if it has no access to the bonds, as, for example, where they are deposited by the customer in a locked box of which he keeps the key, or in a sealed envelope

In actually collecting the proceeds of coupons and bonds the banker must exercise every possible care as the customer's agent for the purpose, and will be liable for any loss that may arise from his negligence in the discharge of this duty

Stock Exchange Transactions.

A banker must exercise due care and follow the usual course of business in connection with the purchase and sale of stock exchange securities on behalf of his customers In rendering this service the banker becomes the *special* agent of his customer for the matter in hand, and it is imperative that he should act strictly in accordance with the customer's instructions and follow the exact course of business which is usual in connection with these operations This implies that he must exercise every care in buying or selling as the case may be, see that the bank's brokers do not exceed the limits (if any) given by the customer, use due diligence in obtaining the transfer and having it properly completed, ensure that the securities bought or sold (and no others) are actually received by him or sent to the brokers, and, finally, see that the correct amount is paid or received by his customer in respect of the transaction If the banker omits in any way to comply strictly with the instructions given to him by the customer, or if he is negligent in effecting a sale or securing a purchase at the given limit, he may be held liable for any loss which ensues

Advising Upon Investments.

In spite of the fact that advising customers concerning their investments cannot be regarded as part of the ordinary business of bankers, it is nevertheless a common practice for them to give such advice, and Sir John Paget[1] expresses the opinion that, if the Courts were called upon to decide the question, they would probably find that advising upon investments is a part of ordinary banking business, if it were shown that it is usual for banks to participate in the broking commission

It is unlikely that a joint-stock bank or its managers would act otherwise than in good faith and honesty in giving such advice, and, since the bank is adequately protected against a charge of fraudulent misrepresentation by Lord Tenterden's Act, 1828, the only ground on which a customer could bring an action against a bank for wrong advice is that of negligence on the part of its agent, the manager or other person giving the advice (See page 168)

Nevertheless, the practice of giving customers advice of this kind is fraught with considerable danger, for the average bank manager

[1] *Law of Banking*, 3rd edn , page 82

cannot possibly be in a position to advise on any one of the multitude of securities which are quoted on the Stock Exchange. At the same time, the manager always has at his disposal the assistance and knowledge of the experienced brokers who act on behalf of his bank, so that the safest course is merely to forward to the customer an opinion obtained from the bank's brokers. This procedure safeguards both the manager and the bank.

PART III.

BANK INSTRUMENTS.

CHAPTER 20

BILLS OF EXCHANGE.

NOTE.—Section references herein are to the *Bills of Exchange Act*, 1882

THE Bill of Exchange (including the cheque) is the most important type of negotiable instrument known to the modern trading community, and, since transactions therein form the basis of daily banking practice, every banker has to be thoroughly acquainted with the legal principles and provisions applicable to bills of exchange, as laid down by decisions in the Courts and by the Bills of Exchange Act, 1882

The Meaning of Negotiability.

Before approaching the main features of the law relating to bills of exchange, we may usefully consider the meaning of that characteristic of *negotiability* which gives the bill of exchange so much of its importance

A NEGOTIABLE INSTRUMENT is one which is, by legally recognised custom of trade or by law, transferable by delivery or by indorsement and delivery in such circumstances that (*a*) the holder of it for the time being may sue on it in his own name, and (*b*) the property in it passes to a *bona fide* transferee for value free from equities and notwithstanding any defect in the title of the transferor The general rule of law is that no person can derive a good title to any property if he took it from a person who was not the true owner In the case of a negotiable instrument, however, a person taking it in good faith and for value is not affected by any defect in the title of the person from whom he took it, and he can thus obtain a good title even through a thief

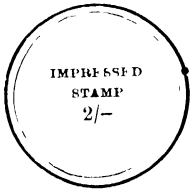
Bills of exchange, promissory notes, cheques, bearer bonds, scrip and share warrants to bearer, Exchequer Bills, East India Bonds and bearer debentures are all negotiable, and although at one

time the Courts refused to recognise as negotiable various documents which were in practice treated as such, nowadays those instruments which are proved to be so regarded by mercantile usage are legally recognised as negotiable Hence, the list here given is capable of extension Other documents, such as share certificates (not expressly bearer scrip), dock warrants, etc , are not negotiable

Specimen Bill of Exchange.

The following is a specimen of an inland bill of exchange, a study of which should help the reader to understand more easily the principles of law discussed in this chapter

Ordinary Form of Bill after Date



£200 LONDON, 1*st April*, 19

Three months after date pay to James Brown or Order the sum of two hundred pounds for value received

To WILLIAM ARNOLD, FRED DAVIES
62, ST JAMES' STREET,
LIVERPOOL

In this example, Fred Davies is described as the *drawer* of the bill, who orders the *drawee*, William Arnold (usually a *debtor* of the drawer) to pay a sum certain in money (£200) to or to the order of the *payee*, James Brown (usually a *creditor* of the drawer) at a determinable future time, *i e* , three months after the date of the bill, *viz* , 1st April, 19

After he has drawn and signed the instrument, the drawer, Fred Davies, will arrange to have the bill presented to the drawee, Arnold, who will express his willingness to comply with the order by writing his signature across the face of the instrument, adding, if he wishes, the word "*Accepted*" and the date By so doing Arnold is said to have "accepted" the bill, and thereafter is liable in respect of his signature as *acceptor* to all persons who may take the bill as holders

After acceptance (or possibly before) the drawer, Davies, may send the bill to the payee, James Brown, and the latter may either hold it until it falls due for payment, or discount it with his banker or hand it to another person in payment of a debt If he decides to transfer the bill and the rights therein to another, he will sign his name on the back, *i e* , he will "*indorse*" the instrument and pass it to the "*indorsee*" By thus transferring the instrument, Brown is said to "negotiate it", and by affixing his signature to the bill and delivering it he thereby incurs the liabilities of an *indorser*

If Arnold does not feel disposed to carry out the instructions of the drawer, he will refuse to accept the instrument, in which case he is said to "dishonour the bill by non-acceptance", and does not then become liable *on the instrument* to any party. Again, even after accepting the bill he may decide not to pay it when it is presented for payment, in which case he is said to "dishonour the bill by non-payment", but in this instance there will be an immediate right of action against him in a Court of law

The Interpretation of Terms used in the Act.

Before the provisions of the various sections of the Bills of Exchange Act can be clearly understood, it is necessary to be acquainted with the precise significance of certain important "terms" which are frequently used therein A number of these are explained as follows in Section 2 of the Act —

> **2.** In this Act, unless the context otherwise requires,—
> "Acceptance" means an acceptance completed by delivery or notification
> "Action" includes counter-claim and set off
> "Banker" includes a body of persons, whether incorporated or not, who carry on the business of banking
> "Bankrupt" includes any person whose estate is vested in a trustee or assignee under the law for the time being in force relating to bankruptcy
> "Bearer" means the person in possession of a bill or note which is payable to bearer
> (*Technically, the possessor of a bill or note payable to order is not the bearer of it*)
> "Bill" means bill of exchange, and "note" means promissory note
> "Delivery" means transfer of possession, actual or constructive, from one person to another
> "Holder" means the payee or indorsee of a bill or note who is in possession of it, or the bearer thereof
> "Indorsement" means an indorsement completed by delivery
> "Issue" means the first delivery of a bill or note, complete in form to a person who takes it as a holder
> "Person" includes a body of persons whether incorporated or not
> "Value" means valuable consideration
> "Written" includes printed, and "writing" includes print

The Requisites as to Form of a Bill of Exchange.

A bill of exchange is thus defined by the Bills of Exchange Act, 1882, Section 3 (1) —

> **3.** (1) A bill of exchange is an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a sum certain in money to or to the order of a specified person, or to bearer

From this definition it will be seen, that there are *eight* essential requirements of an instrument which is to constitute a valid bill within the meaning of the section (*a*) the bill must be an *order to pay*.

(*b*) the order must be *unconditional*, (*c*) the instrument must be *in writing*, (*d*) it must be *addressed by one person to another*, (*e*) it must be *signed by the person giving it, i e*, the drawer, (*f*) the bill must be payable *on demand or at a fixed or determinable future time*, (*g*) it must require payment of a *sum certain in money*, (*h*) the bill must be made *payable to order or to bearer*

The Order must be Unconditional.

The order to the drawee must be free of any conditions subject to which payment is to be made There may be a conditional acceptance or a conditional indorsement of a bill, but the use of any words implying a conditional *order* from the drawer would invalidate the instrument as a bill

In this connection, Section 3 (3) provides

> **3.** (3) An order to pay out of a particular fund is not unconditional within the meaning of this section but an unqualified order to pay, coupled with (*a*) an indication of a particular fund out of which the drawee is to re-imburse himself or a particular account to be debited with the amount, or (*b*) a statement of the transaction which gives rise to the bill, is unconditional

Hence, the employment of words which give a *direction* to the drawee coupled with the order do not necessarily affect the unconditional character of the order Thus, instruments running, " Pay AB or order £100 out of the money in your possession belonging to the A Company ", or " Pay to Thomas Brown £700 out of the proceeds of the sale of cargo shipped per ss *Majestic* ", are invalid as being conditional orders to pay out of a particular fund On the other hand, an order to pay a sum of money followed by the statement, " Which you will please charge to my account and credit according to a registered letter I have addressed to you ", has been held to be an unconditional order, since it consists merely of an unqualified order to pay coupled with an indication of a particular account to be debited with the amount

The test of the conditional character of the order is whether payment to the holder of a bill *depends upon* the fulfilment of any condition other than the mere pecuniary capacity of the drawee to pay the bill when presented, if so, then the order is conditional

" Addressed by one Person to another."

Since the term " person " is defined by Section 2 as including " a body of persons whether incorporated or not ", the drawer or drawee may be one or more individuals, or they may be incorporated bodies or partnerships There may be more than one drawee to a bill, but if there are, they must be addressed *jointly* and not alternatively or in succession

An instrument in which drawer and drawee are the same person does not come within the definition of a bill of exchange, which requires a bill to be addressed *by one person to another* While such an instrument is not a valid bill, it may nevertheless be *treated* as a valid bill *by the holder*, whose rights are not prejudiced by the irregularity in the form of the instrument For example, in the case of bankers' drafts drawn by one branch on another branch, or on Head Office, the *holder* has all the rights of the holder of a cheque, but the *drawee banker* (who is not a holder) cannot avail himself of the protection afforded by Section 60 of the Act to a banker paying *cheques* drawn upon himself, although he is covered by Section 19 of the Stamp Act, 1853, for that section applies to documents which are not strictly cheques (See Chapters 23 and 25)

"A Sum Certain in Money."

All bills must be drawn for payment of money and money only An instrument which by its terms requires some other act to be done in addition to the payment of money is an invalid bill [Section 3 (2)]

For the purposes of the Act, the term "money" means legal tender currency of the realm, so a promise to pay in "East India Bonds" does not comply with the provisions of the Act

A bill is invalidated by the addition of any words to the amount which would cause the sum payable to be other than *a sum certain, i e*, such as would make the amount payable an indefinite or contingent sum Thus a bill ordering payment of "£100 and all fines according to rule" was held to be an invalid bill But the amount of a bill may be stated to be payable with interest, *or* by *stated* instalments, *or* according to an indicated or determinable rate of exchange The essential point is that the liability in terms of money must *at any time* be ascertainable *from the terms of the bill*

Where interest is stipulated for it is computed (unless the bill otherwise provides) from the date of the bill, or, if no date appears, then from the "issue"—that is, from the first delivery of the bill

A discrepancy between the amount payable in words and figures on a bill will not invalidate the instrument, for in such a case the sum denoted by the words is the amount payable [Section 9 (2)]

"On Demand or at a Fixed or Determinable Future Time."

The period of time for which a bill has to run before maturity does not affect the validity of the bill, so long as the day upon which payment is to be made is definite and certain to occur Thus if payment is dependent on the occurrence of an event which is *certain* to happen even though the actual date of its happening is unknown,

then the bill is valid Accordingly, an order to pay "Seven days after the death of A" is a good bill, but orders to pay "On the marriage of A" or "On the birth of a son to X" or "On the arrival of H M S *Connaught* at Calcutta" are not valid, for there is no certainty that any of these events will occur

Payment must be to Order or to Bearer.

If a bill is not payable to bearer, the payee must be named or otherwise indicated therein with reasonable certainty [Section 7 (1)]

This certainty as to the payee must be obvious from the face of the bill itself, but in cases of "latent ambiguity"—as, for instance, when the payee is misnamed or designated merely by description—evidence will be allowed to identify the payee Thus if a bill is made payable "to the order of Jim Broune", evidence will be admissible to prove that "James Brown" is the person intended to receive the money, or the payee may write the *wrong* name and sign his proper signature underneath The certainty of persons in this respect is not affected by the fact that there may be one or more payees, for Section 7 (2) allows payment to be made to joint, alternative or one of several payees

As a general rule, a bill payable to order or to bearer is a fully negotiable instrument, but by its terms transfer may be definitely prohibited. In this regard, Section 8 (1) of the Act provides that —

> 8 (1) When a bill contains words prohibiting transfer, or indicating an intention that it should not be transferable, it is valid as between the parties thereto, but is not negotiable

An example would be a cheque drawn "Pay Wm Brown *only*", without the words "or order" or "or bearer", or with such words deleted and initialled by the drawer

Date of Bill.

The date of the bill is generally affixed by the drawer in the right-hand top corner, though the omission of the date does not invalidate the bill Moreover, a bill is not invalid merely because it is antedated or postdated, or because the date borne is a Sunday

If the bill is undated, it will be considered to be dated as at the time it was issued The date appearing on a bill is *prima facie* the true date of the instrument, and, likewise, a date against an acceptance or indorsement is *prima facie* the true date of such acceptance or indorsement

Since the date of a bill is *material*, any alteration therein will render the bill void as against any parties who have not consented to the

alteration Nevertheless, the holder of an undated bill or acceptance may insert the true date of the issue or acceptance, and the bill will be payable accordingly

Inland and Foreign Bills of Exchange.

An *inland* bill of exchange is defined by the Act as "A bill which is, or on the face of it purports to be (*a*) both drawn and payable within the British Islands, or (*b*) drawn within the British Islands upon some person resident therein Any other bill is a foreign bill" For example, a bill is a foreign bill if it appears on the face of it to be (*a*) drawn outside the British Isles, or (*b*) drawn within the British Isles upon a person resident abroad, provided it is also payable abroad

Unless the place of payment is clearly indicated on a bill, the reasonable presumption is that it is payable at the residence of the drawee

Days of Grace and the Due Date.

A bill payable *on demand* is payable by the drawee at any time on or after the date of the instrument A bill payable *after sight* is payable at the expiration of the determinable period from the time when the bill is first sighted by the drawee, while a bill payable *after date* falls due at the expiration of the determinable time calculated from the date given on the instrument But in the last two cases Section 14 provides for the allowance of three extra days, known as "Days of grace", before the bill need be paid by the acceptor, and specifies how the day of payment is to be determined in cases where bills fall due on *non-business* days, *i e*, bank holidays, common law holidays and holidays appointed as such by Royal proclamation.

COMMON LAW HOLIDAYS are those which have resulted from very ancient custom, and which are now legally recognised They include Sunday throughout the British Isles, and Christmas Day and Good Friday in England, Wales and Ireland Bills whose last day of grace falls on such days are payable on the *preceding* business day, unless the latter is a bank holiday (see below), in which cases the date of payment is the *succeeding* business day

BANK HOLIDAYS are those appointed by the Bank Holidays Acts, 1871 and 1903 *In England*, the bank holidays are Easter Monday, Whit Monday, the first Monday in August and Boxing Day, *i e*, the 26th December if that date is a week-day, otherwise the 27th December if 26th December falls on a Sunday The bank holidays *in Ireland* are similar, with the addition of St Patrick's Day, 17th March, if this day is a week-day, or 18th March if the 17th falls on a Sunday *In Scotland*, the bank holidays are New Year's Day (or if this day falls

on a Sunday, the following day), the first Monday in May, the first Monday in August, Christmas Day and Good Friday Bills falling due on a bank holiday are payable on the *succeeding* business day

The Act made an attempt to assimilate the law in England and Scotland by providing that, in either country, all bills whose last day of grace falls on a Sunday, or on Christmas Day, or on Good Friday, are to be payable on the *preceding* day, although these days (which are *common law* holidays in England and Wales) are *bank* holidays in Scotland

But the Act did not cover one case, and a difference arises where Christmas Day is a Saturday and the last day of grace of a bill falls on the following day, Sunday, 26th December Since Christmas Day is a bank holiday in Scotland such a bill in Scotland would be payable on the succeeding business day, *i e*, Monday, 27th December, for by virtue of Sub-section 14 (1*b*) "when the last day of grace is a Sunday and the second day of grace is a Bank Holiday, the bill is due and payable on the *succeeding* business day" But as Christmas Day is merely a common law holiday in England and Ireland, such a bill in those countries would be payable on the preceding business day, *i e*, Friday, 24th December

Forged and Unauthorised Signatures.

Where a signature on a bill, note or cheque is forged or placed thereon without the authority of the person whose signature it purports to be, the forged or unauthorised signature is wholly inoperative, and no right to retain the bill or give a discharge therefor, or enforce payment against any party thereto, can be acquired through or under that signature (Section 24)

If, however, the party against whom it is sought to retain or enforce payment of the bill acts in such a manner as to induce a person to act upon the bill which bears what purports to be his signature but which is in fact a forgery, he is estopped or precluded from denying to that party the validity of the signature

The fact that a person can have no title to a bill or cheque if he claims through a forgery does not mean that such a person never has any *recourse* in respect of the bill On the contrary, he will have a right of action against (*a*) all parties to the bill who incurred liability thereon *subsequent to the forgery*, (*b*) the immediate transferor for value, if the latter has not indorsed, (*c*) the forger, also in some circumstances, against (*d*) the person whose signature has been forged, if the latter is estopped from denying its validity Moreover, if the holder can show that the payee is a *fictitious* or *non-existing person*, his title to the bill is not affected by the forgery, since the instrument may then be regarded as payable to bearer (See page 268)

It must be observed, too, that where a signature is *unnecessary to the passing of title* to the bill (*i e*, where it is not the signature of the payee or of an indorsee), the fact that it is forged will not affect the title of a transferee, though the latter will, of course, be unable to sue the person whose signature has been forged For example, a transferee's title to a bill originally made *payable to bearer* is not prejudiced by a forgery of the *payee's* indorsement, since the person in possession of such a bill is the bearer and therefore the holder of it, nor will a forged indorsement placed on a bill merely by way of security prevent the passing of a good title

For similar reasons, forgery of the *acceptor's* signature does not prevent the passing of a good title, since this signature is not essential to the negotiation of the bill Forgery of the *drawer's* signature, on the other hand, has the effect of rendering the bill invalid, since the instrument cannot then be regarded as "drawn by one person on another", nevertheless Sections 54 and 55 of the Act enable the holder, in such a case, to enforce payment against all parties *subsequent* to the forgery

Not only does a person taking a cheque under a forgery derive no title to the instrument, but he is also liable to the true owner for conversion (see page 328) The only exception to this rule is where a bill or cheque is negotiated abroad in a country under whose laws forgery does not prevent the passing of a good title, in which case subsequent holders of the instrument are not liable Indeed, it would appear from the decision in *Embiricos* v *Anglo-Austrian Bank*, 1905, that such persons acquire a *perfect* title to the instrument and its proceeds

The question as to what is or is not an *authorised* signature of a bill of exchange has been the subject of much controversy and of apparently conflicting decisions in the Courts Prior to 1926, the position as deduced from various decided cases appeared to be that a signature which was, in fact, authorised by a principal did not become unauthorised merely because it was misused by the agent, as where funds were wrongly appropriated by an agent in consequence of misuse of a signature which he had authority to sign on the principal's behalf The case of *Stewart* v *Westminster Bank*, 1926, however, appears to establish the rule that a signature is unauthorised, within the meaning of Section 24, unless both the placing of the agent's signature on the instrument, *together with the agent's subsequent dealings with the instrument and its proceeds*, are in accordance with the principal's authority, express or implied

Signature by an Agent.

Section 25 of the Act provides that a signature "by procuration" operates as notice of limited authority, and the signature is binding upon

the principal only if the agent did not exceed his authority Consequently, a person taking a bill or cheque bearing a " per pro " signature is deemed to have notice that he may not receive payment of the instrument, and he may be unable to enforce payment as a holder in due course unless he can prove that the agent was acting within the scope of his authority *for the principal's benefit and not for his own* Once the bill has been paid, however, Section 25 does not confer upon the principal any right to recover the money if the agent has exceeded his authority, though such a right may arise on other grounds, as, for example, the fact that the person who received payment of cheques drawn by an agent on his principal's account had express or constructive notice that the cheques had been issued for the agent's own purposes, or in payment of his own debts (*Reckitt v Barnett, Pembroke and Slater*, 1928, *Reckitt v Nunburnholme*, 1928)

A number of recent legal decisions regarding the implied powers of company officials are considered on page 332 There has been much discussion as to whether a signature on behalf of a company, whatever the form of words used, is a signature " by procuration " within the meaning of Section 25 The better view appears to be that it is not

" Holder " and " Bearer ".

THE BEARER of a bill is the person in possession of a bearer bill, *i e*, a bill drawn payable to bearer, or a bill on which the last indorsement is an indorsement in blank The person in possession of a bill payable to " order " and requiring indorsement is not the " bearer " thereof

THE HOLDER of a bill is the payee or indorsee of a bill or note who is in possession of it, or the bearer thereof Thus the bearer is always a holder, but the converse is not necessarily true

A person who takes a bill under a forgery is not the " holder " of the bill, since he is neither the payee, the indorsee nor the bearer Thus, if a bill is payable to A *or order*, and A's indorsement as payee is forged by B, who transfers the bill for value to C, C is not the holder of the bill, but is merely the person in possession of an unindorsed " order " bill

The holder of a bill may sue upon it in his own name, and although his own title be defective, he can give to one who innocently takes the bill for value without notice of such defect a better title than he himself possesses Payment to such a holder is payment in due course, and constitutes an absolute discharge

Holder in Due Course.

Section 29 of the Act defines a " holder in due course " in the following terms :—

29. A holder in due course is a holder who has taken a bill, complete and regular on the face of it, under the following conditions, namely,

(*a*) That he became the holder of it before it was overdue, and without notice that it had been previously dishonoured, if such was the fact;

(*b*) That he took the bill in good faith and for value, and that at the time the bill was negotiated to him he had no notice of any defect in the title of the person who negotiated it

It is clear from these provisions that the first requisite of the title of a holder in due course is that he must be the *holder* of the bill, and a person cannot be a holder if there is a prior forgery, since a forged signature is "wholly inoperative" If, however, there is no prior forgery, the title of a holder in due course is not affected by any *defects in the title* (*i e*, as distinct from *complete absence of title*) of the person who negotiated to him He holds the bill free from any such defects in title, as well as from mere personal defences (such as set-off or counterclaim) available to prior parties amongst themselves, and he can enforce payment against all parties liable on the bill Thus, in the example given in the preceding paragraph, C, owing to the forgery of A's indorsement, cannot be a holder in due course because he is not even a holder If, however, the bill had been payable to A *or bearer*, and had been stolen by B before he transferred it to C, the latter, provided that the bill was not overdue and that the other requirements of Section 29 had been satisfied, would be a holder in due course, with every right to enforce payment of the bill against all prior parties

Furthermore, a holder in due course can transfer his rights to a subsequent holder if the latter is not a party to any fraud or illegality affecting the bill and so enable his transferee (whether he has given value or not) to sue as a holder in due course On the other hand, a holder can transfer a title to a holder in due course so as to give the latter an unassailable title, whereas he, the transferor, may not have been able successfully to claim on the bill.

The original payee of a cheque cannot be a holder in due course, for, by Section 29 (1), a bill must be *negotiated* to a holder in due course, whereas a bill is *issued*, not negotiated, to an original payee (*R E Jones, Ltd*, v *Waring and Gillow, Ltd*, 1926)

The terms "holder for value" and "holder in due course" are frequently confused, but should be clearly distinguished A holder for value is the holder of a bill *for which value has at any time been given*, while a holder in due course must *himself have given value* for the bill Moreover, a holder for value who is not a holder in due course obtains no better title than that of his transferor

Consideration for a Bill.

In the case of cheques, bills and notes "consideration may be constituted by any consideration sufficient to support a simple contract". [Section 27 (1)]

Consideration to support a simple contract must be what is known in law as "*valuable* consideration", which has been defined as "Some right, interest, profit or benefit accruing to one party or some forbearance, detriment, loss or responsibility given, suffered or undertaken by the other" Hence, family affection is not effective as consideration for a bill On the other hand, the Act overrides the common law in that it permits a *past* (*antecedent*) debt or liability to suffice as valuable consideration for a bill of exchange or promisory note

Until the contrary is proved, a bill is always deemed to have been given for valuable consideration, and every holder is deemed to be a holder for value, and it is immaterial whether the words "value received" are or are not inserted in the body of a bill

If value has at any time been given for a bill, the holder is deemed to be a "holder for value" as regards the acceptor, and all parties who became liable prior to such time, that is to say, an action will lie against any party whose liability existed prior to the last transaction for value, even though he gave no consideration for the bill As between *immediate* parties, there is no right of action unless value has actually passed between them for the bill

If anyone has a lien on a bill, he is deemed to be a holder for value to the extent of that lien

Accommodation Party and Accommodation Bill.

Section 28 defines an *accommodation party* as "a person who has signed a bill as drawer, acceptor, or indorser, without receiving value therefor, and for the purpose of lending his name to some other person" Any bill which bears such a signature is often loosely referred to as an "accommodation bill", and this use of the term is defensible Legally, however, the term *accommodation bill* has special significance, as it is provided by Section 59 (3) that, in the case of an accommodation bill, payment in due course by the *party accommodated* is a valid discharge In this strict sense, an accommodation bill is one of which the *acceptor* (*i e*, the principal debtor on the bill *as drawn*) is in fact a mere surety for some other person (the principal debtor, *in fact*), who need not necessarily be a party to the bill A holder in due course has a right to proceed against any of the signatories to an accommodation bill, even though he took the bill knowing it to be an accommodation bill.

Fictitious or Non-Existent Payee.

Where the payee is a "fictitious or non-existent person" the bill may be treated as payable to bearer [Section 7 (3)] It was at one time considered that this phrase applied only to some purely imaginary payee

such as "The Man in the Moon", "Old King Cole", etc, but now no bank would pay cheques so payable without indorsement or confirmation

The importance of this section is illustrated in cases where the payee's indorsement has been forged If the payee is fictitious, the bill is payable to bearer, and a person who has given value for it can enforce payment as a holder in due course, otherwise, he is not even *a holder* since he has no title whatever to the bill

Moreover, the Courts have decided that a payee of a bill is fictitious when he is *not intended by the drawer* to receive payment (*Vagliano* v *Bank of England*, 1891, *Vinden and Rogers* v *Hughes*, 1905) In the former case, a clerk in the employ of the plaintiffs forged the signatures of a number of their creditors as drawers of bills drawn on the plaintiffs and payable to persons whom the clerk (and naturally the drawers whose signatures were forged) did not intend actually to receive payment It was held that, in the circumstances, the payees were fictitious and that the bills were payable to bearer

In the latter case, a clerk got his employer to draw cheques payable to actual creditors of the firm but for fictitious amounts, which he appropriated by forging the indorsements and fraudulently cashing the cheques with the defendant The defendant maintained that the payees were fictitious and that the bills were therefore payable to bearer, but this defence failed, as it was held that the payees were not fictitious persons, since *the drawer* actually *intended* them to receive payment

The provisions of Section 7 (3) cannot be extended to cover cases where cheques are drawn in favour of *impersonal* payees (See page 306)

Material Alterations.

Where a bill or acceptance is materially altered without the assent of all parties liable on the bill, the bill is avoided except as against a party who has himself made, authorised, or assented to the alteration, and subsequent indorsers, provided that where a bill has been materially altered, but the alteration is *not apparent*, and the bill is in the hands of a holder in due course, such holder may avail himself of the bill as if it had not been altered, and may enforce payment of it according to its *original* tenor (Section 64)

Inchoate Instruments.

The delivery to a person of a blank paper signed and stamped is a *prima facie* authority to that person to fill it up for any amount the stamp will cover, and the signatory will be liable to a holder in due course on the completed instrument as if it had been originally filled up by him But if the bill is not completed in a reasonable time and

in accordance with the authority given, it cannot be enforced except by a holder in due course, who can enforce payment even if any limitation as to the authority to complete the bill has been exceeded, or if the bill has been fraudulently completed. In no case, however, can even a holder in due course enforce payment unless there has been *delivery*, actual or constructive of a signed instrument for the purpose of completion

Bills in a Set.

Bills on places abroad are often drawn in sets of three, identical in all respects, except that each refers to the other two, and only one is stamped. Loss is prevented by sending two parts for acceptance by different mails, whilst the other is negotiated at home One part only should be accepted, or indorsed, otherwise the signer may be liable on two signatures All parts form one bill, and should be fastened together when they reach their destination Discharge of one is a discharge of the set, but the acceptor remains liable if he pays a part other than the one which bears his acceptance If two or more parts are negotiated to different holders in due course, the one whose title first accrues is deemed the true owner as between such holders.

The Negotiation of Bills of Exchange.

This important matter is dealt with by Section 31 of the Act in the following terms —

> **31.—(1) A bill is negotiated when it is transferred from one person to another in such a manner as to constitute the transferee the holder of the bill**
>
> (2) A bill payable to bearer is negotiated by delivery.
>
> (3) A bill payable to order is negotiated by the indorsement of the holder completed by delivery.
>
> (4) Where the holder of a bill payable to his order transfers it for value without indorsing it, the transfer gives the transferee such title as the transferor had in the bill, and the transferee in addition acquires the right to have the indorsement of the transferor
>
> (5) Where any person is under obligation to indorse a bill in a representative capacity, he may indorse the bill in such terms as to negative personal liability

The Act does not specifically define the term "indorsement", but it may be taken to mean the writing, on a bill or cheque *payable to order*, of the signature of the payee or indorsee which, when accompanied by delivery of the instrument, enables the instrument and the value it represents to be transferred or negotiated from one person (called the *indorser*) to another (called the *indorsee*) The indorsement of a cheque or bill is thus evidence of its transfer or "negotiation," the transferor indicating by his signature his desire to pass the instrument and any rights connected with it to another person, who is known as the transferee.

Delivery Essential to Negotiation.

Except as concerns a holder in due course, in whose favour delivery is always conclusively presumed, a transfer of a bill is ineffectual as a negotiation thereof unless it is completed by *delivery*, *i e*, a transfer of possession, actual or constructive *Actual* delivery exists, of course, when the instrument is handed by the transferor to the transferee or his agent, but it is not always so easy to show that a *constructive* delivery has taken place Constructive delivery is some act which shows a present intention to deliver, such as giving notice that the bill is ready to be delivered It is the *intention* that is of importance, so that if a person who has signed can satisfy the Court that he had no intention of becoming liable, and is not responsible for delivery of the instrument, the Court will exonerate him from liability thereon On the other hand, if by his conduct—or by communication—he induces another person to infer that the bill has been delivered, and such person acts on that presumption to his detriment, the former would be barred by "estoppel" from denying delivery, and would have to abide by the consequences of his action

It follows that no property in a bill or cheque will pass if the transferor (*a*) does not actually hand it to the transferee or inform him that the bill or cheque is at his disposal, *or* (*b*) hands it to another person *for a special purpose only*, as, for example, to be held in safe keeping, or for any other specific purpose, such as to meet a bill of exchange

If delivery is made subject to a condition, then it does not become effective so far as the transferor is concerned until that condition is fulfilled Nevertheless a valid and unconditional delivery is presumed until the party seeking to evade liability proves that a complete delivery has not been made by him, but such a party cannot evade liability to a holder in due course *unless the instrument was incomplete in form at the time it left his possession*

But if an instrument *which is a valid bill, complete and regular on the face of it*, leaves the possession of the holder and subsequently comes into the hands of a holder in due course, delivery of the bill will be *conclusively* presumed as against the party to be charged.

Negotiation of a Bearer Bill.

In accordance with Section 31 (2), a bill payable to bearer is negotiated merely by delivery, *i e*, the actual or constructive transfer of the instrument from one person to another, and if the transferor does not indorse the instrument negotiated, it follows that he cannot be held liable *in respect of his signature* by any subsequent transferees A holder who thus negotiates a bearer bill or cheque without indorsing it is called a "transferor by delivery" But it is advisable for anyone taking a cheque, whether it is payable to bearer or not, to demand the

signature of the transferor in order to secure his liability as an indorser. Nevertheless a transferor by delivery is liable as such to his immediate transferee if the instrument turns out to be a forgery

Negotiation of an Order Bill.

To constitute a valid negotiation of an order bill, the indorsement thereof must be accompanied by actual or constructive delivery, as above defined. Hence the signature of a payee on the back of a cheque will not operate as an indorsement of the instrument and as a transfer of the value therein if the payee can show that, although he had indorsed the cheque, he had not actually handed it to the transferee or given the latter to understand that the cheque was at his disposal

Again, except as concerns a holder in due course, an indorsement would not be effective against an indorser if the latter could show that, after signing the instrument, he had transferred it to another person for a special purpose only

Where Indorsement may be Demanded.

If a cheque or bill *payable to the transferor's order* is transferred without indorsement, the transferee has the right to demand the transferor's indorsement The object of this is twofold first, to convey the title in the instrument to the transferee, and, secondly, to make the transferor definitely liable as an indorser by his signature on the instrument If the signature is not obtained, the transferee does not become a *holder*, he is merely an *equitable assignee* of a chose in action, and he cannot sue on the instrument in his own name or transfer the property therein to any other person The transferee can, however, bring an action against the transferor to compel him to give his indorsement to the bill, and when this is obtained, the transferee then becomes a holder and can sue any party in his own name

When the transferor's indorsement is obtained, the transfer of the instrument takes effect from the date of the indorsement and not from the date of negotiation

THE LIABILITY OF PARTIES TO A BILL.

Capacity to Incur Liability on a Bill.

Since it is provided by the Act that capacity to incur liability on a bill, note, or cheque is co-extensive with capacity to contract, the limits to the contractual capacity of certain persons may be briefly observed·

INFANTS At law, a person under the age of 21 is an infant and, as such, is incapable of incurring personal liability on bills, even to make

payments for necessaries An infant, however, may act as agent and bind others, while his signature as an indorser to a bill would serve to pass rights and liabilities in the chain of indorsements, but no remedies on the bill are available against him personally

REGISTERED TRADING COMPANIES have *implied* powers to incur liability on bills in the transaction of their business, but, in the absence of *express* authority in its Memorandum of Association, a *non-trading* company has no such powers, although such a company may have implied powers to issue cheques for the purposes of its business

PARTNERSHIPS Articles of partnership authorising the drawing, etc , of bills are not necessary for a partnership In the case of a *trading* firm, a partner has full implied power to bind the firm by acts done in the ordinary course of business, including the drawing and accepting of bills But though there is nothing to prevent a partner in a *non-trading* firm from drawing and indorsing cheques for the purpose of the firm's business, a partner in such a firm has no *implied* power to bind it by a bill of exchange, and cannot safely do so unless he is expressly empowered either by the Articles or by special authority from all the other partners And if *all* the partners in a non-trading firm join in a bill, it will bind the firm, whether or not the use of bills is authorised by the Articles or by any other means

Liabilities of Parties to a Bill of Exchange.

No party is liable as drawer, acceptor, or indorser of a bill who has not *signed* it as such and *delivered* it A person who signs in a trade name or assumed name is liable as though he signed in his own name

Before acceptance, the drawer is the principal debtor, and any indorsers are sureties for him On acceptance, the drawee or acceptor undertakes the principal liability, and then the drawer and indorsers are sureties for *him* They are not, however, in the same position as ordinary sureties who, on default by the principal debtor, are liable to contribute *pro rata* *Each* party to a bill is liable for the *full amount* of the bill and there is no right of contribution as between the parties

Since the drawer and each indorser of a bill is a surety for the acceptor, the holder is at liberty to proceed against any or all of the parties for the whole amount of the bill on default in payment by the acceptor, provided the requisite notice of dishonour has been given and application for payment has been made in proper form And when any party other than the acceptor pays the bill, he is entitled to enforce payment from any party prior to him in order of liability

Estoppel of Parties to a Bill (Sections 54 and 55).

ESTOPPEL OF THE ACCEPTOR By accepting a bill the acceptor is precluded from denying to a holder in due course (*a*) the existence of

the drawer, the genuineness of his signature, and his capacity and authority to draw the bill; (*b*) in the case of a bill payable to the drawer's order, the then capacity of the drawer to indorse, but not the genuineness or validity of his indorsement, (*c*) in the case of a bill payable to the order of a third person, the existence of the payee and his then capacity to indorse, but not the genuineness or validity of his indorsement

ESTOPPEL OF THE DRAWER By drawing a bill, the drawer is precluded from denying to a holder in due course the existence of the payee and his then capacity to indorse

ESTOPPEL OF THE INDORSER By indorsing a bill, the indorser is precluded from denying (*a*) to a holder in due course, the genuineness and regularity in all respects of the drawer's signature and all previous indorsements, (*b*) to a subsequent indorsee, the validity of the bill at the time of indorsement, and that he had then a good title thereto

Transferor by Delivery.

A bill payable to bearer is capable of immediate transfer without indorsement By Section 58, a transferor by delivery (*i e*, a holder who negotiates a bearer bill without indorsing it) "is not liable *on the instrument*", and no action would therefore lie against such a person if a bill or a cheque transferred by delivery were returned unpaid Nevertheless, since by the same section he warrants to his immediate transferee, being a holder for value, "that the bill is what it purports to be", he will be liable if the instrument subsequently proves to be a forgery

Overdue and Dishonoured Bills.

When a bill is overdue, it is taken by a transferee subject to any defects affecting it at maturity (a holder in due course must take a bill "before it is overdue") A demand bill is deemed to be overdue when it has been in circulation for an "unreasonable time", which is a question of fact to be determined by the circumstances of each particular case Where an indorsement is not dated, it is deemed to have been made *before* the *due* date of a bill A current bill, which has been dishonoured, is in subsequent negotiations subject to any defects of title attaching to it at the time of dishonour, and any person who takes it with notice of the dishonour cannot claim to be a holder in due course.

THE DUTIES OF THE HOLDER

The Bills of Exchange Act imposes upon the holder of a bill certain important *duties*, the neglect or omission of which may have serious

consequences for both the holder himself and other parties to the bill These duties are chiefly (*a*) to present the bill for acceptance and payment in accordance with the rules laid down in the Act, (*b*) to note or protest the bill on dishonour, where such noting or protest is necessary, and (*c*) to give due notice of dishonour to all prior parties

Presentment for Acceptance.

Presentment for acceptance is not necessary unless specially stipulated for, or unless the bill is drawn payable elsewhere than at the residence or place of business of the drawee, or is payable after sight, in which case acceptance is necessary to fix the date of maturity But if presentment is made, it should be made by the holder of the bill at a reasonable hour on a business day and before the bill is *overdue*, to the drawee or his agent If after twenty-four hours acceptance is not given, or if presentment is excused in the circumstances prescribed by the Act, the bill stands dishonoured, in which event it should be noted and if necessary protested, notice being given to all parties.

Kinds of Acceptance.

An acceptance may be either —

(*a*) GENERAL, *i e*, assenting without qualification to the order of the drawer, or

(*b*) QUALIFIED, in one of the following ways —

(1) *Conditional*, *i e*, where payment is made dependent upon the fulfilment of a stated condition, *e g*, "Accepted subject to a three months' renewal"

(2) *Partial*, *e g*, a bill for £500 accepted for £250 only

(3) *Local*, *i e*, payable at some particular place and there only (If the acceptance made the bill payable at, say, "Lloyds Bank, Chester', it would be "general", but if it read "Accepted payable at Lloyds Bank, Chester, and there only", it would be "local", and would have the effect of making presentment at the specified place essential)

(4) *As to Time*, *e g*, a bill drawn for three months accepted payable in six months

(5) *As to Drawees*, *i e*, a bill accepted by one or some, but not all, of the drawees where there are more than one (Section 19)

A qualification in acceptance should appear on the face of the bill in clear and unequivocal terms.

A holder may refuse a qualified acceptance and, if he cannot get a general one, he may treat the bill as dishonoured If a holder takes a *qualified* acceptance, other than a partial acceptance, without the consent of the drawer and previous indorsers, such parties are discharged from all liability But a holder may take a *partial* acceptance without losing his rights so long as he at once notifies the parties that he has taken the partial acceptance without prejudice, in which case he can claim on all the parties, other than the acceptor, for the unaccepted balance of the bill

Effect of Qualified Acceptance.

Failure of the holder to present for payment a bill bearing a general acceptance will release the drawer and indorsers, but not the acceptor On the other hand, negligence or want of diligence on the part of a holder in presenting for payment a bill bearing an acceptance, qualified as to *place of payment*, at the specified place in due course, will release all parties to the bill from liability thereon, although, to effect the discharge of the *acceptor*, the acceptance must distinctly state that presentment for payment as specified is required

Due Date of Bill Refused Acceptance.

Subject to the fact that a bill is dishonoured if presentment is excused, a bill cannot be dishonoured until it has been duly presented, and due presentation of a bill for acceptance means presentation of the bill complete and in order to the drawee or other person authorised to make or to refuse payment In the case of documentary bills, the proper documents must be attached, otherwise the drawee is under no obligation to accept If, therefore, such a bill is payable *after sight*, the due date will be calculated from the date of due presentation, *i e*, when the bill, in order, and with documents attached, is presented for acceptance

Presentment of Bills for Payment.

Presentment of a bill for payment must be made when the bill is due, at the proper place, to the original acceptor or his agent, at a reasonable hour on a business day, or the drawer and indorsers will be discharged The bill is dishonoured by non-payment if it is not paid, or if presentment for payment is impossible or is excused and the bill is overdue and unpaid, in which case notice should be given to all parties liable thereon in order to preserve recourse against them Notice of dishonour is excused if it is waived, or if after the exercise of reasonable diligence it cannot be given, and delay in giving such notice is also excused under similar circumstances The times specified in the Act must be observed, if recourse is to be ensured

THE DISHONOUR AND DISCHARGE OF BILLS.

Consequences of Dishonour.

When a bill is dishonoured by non-acceptance or non-payment, an immediate right of action accrues to the holder against all parties thereto, provided that the requisite proceedings are taken and that notice of dishonour is duly given

In giving notice of dishonour, no stereotyped form of words is necessary, but the bill should be sufficiently identified and the object

of the notice made clearly comprehensible to the recipient Failure to give notice of dishonour, when such notice is necessary, will discharge the drawer and indorsers, but such notice is excused in certain circumstances prescribed by Section 50 of the Act

Noting and Protest.

NOTING a bill is the making of a note thereon by a Notary Public, who presents the bill on behalf of the holder so as to obtain a legal proof of dishonour The answer given, the date, and the notary's charges and initials are written on a slip attached to the bill Noting is the preliminary to the more formal legal procedure called "protesting" a bill It is advisable to note a bill if there is any likelihood whatever of a protest being subsequently required, otherwise, if the bill has not been noted within the prescribed time, the right to protest is lost

PROTEST is a formal legal document, drawn up by a notary, attesting dishonour of a bill and specifying the reason therefor It must bear a stamp, specify at whose request protest is made, be signed, and include a copy of the bill

It is not necessary to protest an *inland* bill on dishonour, except as a preliminary to acceptance or payment for honour *Foreign* bills, however, must always be protested in case of dishonour, and the document embodying the protest is accepted as evidence in all civilised countries

It is not absolutely necessary to protest a bill *on the day of dishonour*, it will suffice to note the bill on that day, or not later than the next following day, and the protest can then be extended as of that date - *Bills of Exchange (Time of Noting) Act*, 1917

The protest must be made at the place where the bill is dishonoured, but when a bill is presented through the Post Office and returned by post dishonoured, it may be protested at the place to which it is returned, on the day it is returned, if received during business hours, and, if not received during business hours, then not later than the next business day

If the acceptor has become bankrupt or insolvent, or has suspended payment, the holder may cause the bill to be *protested for better security* before it has matured

HOUSEHOLDER'S PROTEST If a notary is not available, Section 94 authorises any householder in the presence of two witnesses to make the necessary protest The bill itself, or a copy thereof, should be annexed to the protest, and the householder's signature should be attested by two witnesses who need not be present at the time of the presentation of the bill

Rights of Action and Measure of Damages on Dishonour.

A right of action on a dishonoured bill arises when no response is made to the notice of dishonour "Right of action" means the right to sue the parties for recovery of the amount of the bill *plus* any expenses incidental to the dishonour.

If a bill is dishonoured, the holder may recover from *any* party liable on the bill, the drawer, if he has paid the bill on default of the acceptor, may recover from the acceptor, and an indorser who has been compelled to pay the bill may recover from the acceptor, the drawer, or a prior indorser (*a*) the amount of the bill, (*b*) interest from the time of presentment, if the instrument is payable on demand, otherwise interest from maturity, (*c*) any expenses of noting or protest, if incurred In the case of a foreign bill the damages may be the amount of the re-exchange plus the interest to the date of payment

The Court may at its discretion refuse interest wholly or in part, even though the rate is indicated in the bill itself

Acceptance for Honour.

The drawer of a bill or any indorser may by Section 15 insert in a bill of exchange the name of a person to whom the holder may resort *in case of need*, that is to say, in case the bill is dishonoured by non-acceptance or non-payment This person is known as a *Referee in case of need* If the drawee refuses to accept, the holder *may*, after the bill is protested for non-acceptance, present it to the referee in case of need, but the holder is not *bound* to do so If the referee accepts he is known as an *Acceptor for Honour*

After protest for non-acceptance, any person *not already liable on the bill* may, with the consent of the holder, accept a bill supra protest for the honour of *any party* liable thereon Such an acceptance may be for part or whole of the amount of the bill, it should specify for whose honour it is made, and be signed by the acceptor, to whose signature are added the words "Accepted S P" In the absence of an indication of the party for whose honour a bill has been so accepted, the presumption is that the acceptance is given for the honour of the drawer.

The acceptor for honour is liable to the holder and to all parties to the bill subsequent to the party for whose honour he has accepted

A bill which has been accepted for honour is first presented for payment to the drawee, and, if it is not paid by him, it is noted or protested for non-payment, and is then presented for payment to the acceptor for honour, being again noted if still unpaid

Payment for Honour.

When an acceptor fails to pay a bill at maturity any person may, after the bill has been protested, pay it supra protest for the honour of the acceptor A person who pays a bill for honour succeeds to the rights of the holder as regards the party for whose honour he pays and all parties liable to that party It is important to observe that, while the holder has every right to refuse an *acceptance* for honour, a refusal of *payment* for honour discharges all parties who would have been discharged by such payment

Discharge of a Bill.

This is effected in one of five ways —

By Payment in due course by or on behalf of the drawee, or acceptor, to the holder, at or after maturity Subject to the fact that payment of an accommodation bill by the accommodated party is a valid discharge (page 268), payment of a bill by any party other than the acceptor is not a discharge, since any such party who pays may still claim on the acceptor

By Negotiation to the acceptor, when he becomes the holder of it in his own right at or after maturity

By Waiver, *i e*, when the holder renounces his rights against the acceptor by writing or by delivery of the bill, at or after maturity The liability of any party may in like manner be renounced before, at, or after the maturity of the bill The bill should be given up to the person discharged, for, if the instrument is left in circulation, waiver is not a defence against a holder in due course who has no notice of the waiver

By Cancellation intentionally, by the holder or his agent The intentional cancellation of the signature of a party by the holder will discharge that party and any indorser who had a right of recourse against him

By Alteration A material alteration avoids the bill except as against a party who has authorised or consented to it, or any subsequent indorser But if the alteration is not apparent, the bill may be enforced by a holder in due course against the acceptor and any other party according to its original terms.

CHAPTER 21

CHEQUES.

A CHEQUE is defined by Section 73 of the *Bills of Exchange Act* as "a bill of exchange drawn on a banker, payable on demand", and the same section decrees that, except as otherwise provided, the provisions of the Act applicable to a bill of exchange payable on demand apply to a cheque

In view of these provisions, a complete legal definition of a cheque can be obtained by combining the definition given in the foregoing paragraph with the definition of a bill, given in the Act, and, on doing this, we obtain the following

1 A cheque is an unconditional order in writing addressed by one person to another, who must be a banker, signed by the person giving it, requiring the banker to whom it is addressed to pay on demand a sum certain in money to, or to the order of, a specified person or to bearer

2 An instrument which does not comply with these conditions, or which orders any act to be done in addition to the payment of the money, is not a cheque

3 An order to pay out of a particular fund is not unconditional within the meaning of this section, but an unqualified order to pay, coupled with (*a*) an indication of a particular fund out of which the banker is to reimburse himself, or a particular account to be debited with the amount, or (*b*) a statement of the transaction which gives rise to the cheque, is unconditional

4 A cheque is not invalid by reason —

(*a*) That it is not dated, (*b*) That it does not specify the value given, or that any value has been given therefor, (*c*) That it does not specify the place where it is drawn or the place where it is payable

The Requisites as to Form of a Cheque.

Every word in this definition is important to a banker, since most of his business consists in dealing with cheques drawn by his customers Moreover, a cheque must conform strictly with the provisions of the definition if it is to be enforceable at law as a cheque, and if the banker and other parties thereto are to obtain that protection which they are afforded by the Bills of Exchange Act

Upon analysing the definition, we find that there are seven essential requisites which must be fulfilled (*a*) The order to pay must be *unconditional*, (*b*) the cheque must be *in writing*, (*c*) the order must be addressed *by one person to another*, who must be a banker, (*d*) it must be *signed* by the person giving it, (*e*) it must require payment *on demand*, (*f*) payment must be of a *sum certain* in money, (*g*) payment must be *to order* or *to bearer.*

As the provisions of the Act relative to bills apply generally to cheques, the rights and liabilities of the drawer, drawee, and indorser of a cheque are technically comparable with those of the drawer, drawee, and indorser of a bill payable upon demand, but there are certain important differences

In the first place, the drawer of a cheque is the party who is *ultimately* liable, since the drawee, *i e*, the banker, does not sign the instrument and does not, therefore, become liable as a *party* thereto The drawer of a cheque has no other party to look to if the instrument is unpaid, whereas the drawer of a bill upon demand usually has a right of action against the drawee upon the consideration, or, if he has accepted, upon his acceptance Furthermore, the holder of a bill upon demand which has been accepted by the drawee has an immediate right of action against the acceptor in the event of dishonour, but there is no privity of contract or liability existing between the holder of a cheque and the banker on whom it is drawn The drawee-banker is liable only to his customer, and then only if the customer has funds at his disposal and the cheque has been wrongly dishonoured

Again the drawer and indorsers of a bill payable on demand are discharged if it is not presented for payment within a reasonable time of its issue, but the drawer of a cheque is not so discharged unless he has suffered loss by the delay in making the presentment, in which case he is discharged to the extent of that loss

The Order to Pay must be Unconditional.

The cheque must be an *unconditional* order to pay, *i e*, the drawer cannot impose any conditions upon the drawee-banker, as, for example, by stating on the face of the instrument that it is to be paid only on condition that a receipt either on the front or on the back is duly dated, signed and stamped by the person receiving the money But the drawer may if he so desires impose a condition on the *payee*, as for example, by insisting on the face of the cheque that an attached receipt is to be duly signed and stamped before *presentment* for payment It is only the *order* to pay which must be unconditional within the meaning of the definition

A cheque is not invalid merely because it bears on its face an indication of the account to be debited, *e g*, "No 1 Account", or "White Lion Account", or because it bears some indication of the transaction it is intended to settle, *e g*, "Pay John Brown (Rent of 17 Northend Road) or order"

"Signed by the Person giving it."

A cheque must be signed by the person giving it, *i e*, by the drawer, who, although the definition does not so stipulate, must for obvious reasons be a customer of the bank on which the cheque is drawn This

requisite implies also that the signature may be written by the drawer himself or by any person acting under his authority But it is imperative that an agent so signing should clearly indicate that he signs for a named principal in a representative capacity, otherwise he may himself be bound on the instrument

The signature on a cheque need not be the actual name of the drawer, for a person who signs a bill in a trade or assumed name is liable thereon as if he had signed it in his own name, and the signature of the name of a firm is equivalent to the signature by the person so signing of the names of all persons liable as partners in that firm (Section 23)

Thus a customer trading as " The Acme Cycle Company " will be bound on any cheques signed by him in that name, if he has arranged with his banker to draw cheques in that form Furthermore, if three distinct persons are partners in a firm known as " The Acme Cycle Company ", and the name is signed by one of them by arrangement with the banker, all three will be bound as if each had signed individually

On the other hand, the customer cannot as a rule be debited with or held liable on a cheque whereon his signature has been forged or written without his authority (Section 24—see page 264) And a limited company or partnership cannot be debited with a cheque which is not signed in accordance with the authority or mandate given to the banker in respect of its account

The Order must require " Payment on Demand "

The order in a cheque must require payment to be made *on demand* In this connection Section 10 (1) of the Act provides that

> **10.**—(1) A bill is payable on demand—
> (*a*) Which is expressed to be payable on demand or at sight or on presentation , or
> (*b*) In which no time for payment is expressed

In practice, cheques are usually drawn, " Pay Thomas Brown or order ", no time for payment being expressed It is doubtful whether an instrument which provides that presentment shall be made within a prescribed period or before a specified date, or which makes payment conditional upon the signing, etc , of a receipt, is payable on demand within the meaning of this section

The Stamp on a Cheque.

The legal definition of a cheque contains no reference to the fact that the instrument must bear a stamp, but by the *Stamp Act*, 1891, as amended by the *Finance Act*, 1918, all bills of exchange on demand, including cheques (other than those which are specifically exempted), must bear either an impressed or adhesive twopenny stamp

In the case of a cheque drawn *in this country*, the only persons who can effectively stamp the instrument are the drawer or the banker to whom it is presented for payment No intermediate holder can effectually stamp an inland cheque when once it has been issued, and it is provided by Section 38 (1) of the *Stamp Act*, 1891, that every person who issues, indorses, transfers, negotiates, presents for payment, or pays any bill of exchange or promissory note liable to duty and not being duly stamped, shall be liable to a fine of £10 and shall not be entitled to recover upon the instrument

The stamp on a cheque *drawn abroad* should be affixed by the first holder in this country But the validity of such a cheque is not affected if it is stamped by any other person

Cheques which are "Stale" or "Out of Date".

Although a date is not essential to the validity of a cheque, the date is nevertheless of considerable importance to a holder in certain circumstances, for, by virtue of Section 36 (3) of the Act, a cheque becomes overdue for purposes of negotiation when it appears on the face of it to have been in circulation *an unreasonable length of time* As to what is an unreasonable length of time is a question of fact to be determined by the circumstances of each case, but, from certain legal decisions, it would appear that, in the absence of special circumstances, a cheque is to be regarded as having been in circulation an unreasonable length of time from the point of view of its *negotiability* after the lapse of about ten days or so from its date of issue

If a cheque is negotiated after the lapse of a reasonable length of time, the effect is that the holder takes it *subject to any equities*, *i e*, subject to any defects in the title of the person from whom he received the instrument Moreover, an indorser of a cheque which is thus allowed to become "stale" before being presented for payment is freed from liability on his signature to the holder.

The Liability of Drawer and Indorsers on Stale Cheques.

A cheque which is stale for purposes of *negotiation* is not necessarily stale from the point of view of *payment* by the banker The custom of bankers in this respect varies considerably. Some bankers will return for the drawer's confirmation, and marked "stale" or "out of date", cheques which have been outstanding for more than six months, while others will pay cheques bearing a date twelve months prior to the date of presentation for payment

But it must be understood that the fact that a cheque is stale for either of these purposes does not necessarily imply that the *drawer* is freed from his liability to make the payment, or that an *indorser* of

the cheque is discharged from liability in respect of his signature The general rule of law in regard to a bill on demand is that presentment must be made within a reasonable time after its issue in order to render the drawer liable, and within a reasonable time after its indorsement, in order to render the indorser liable In determining what is a reasonable time, regard shall be had to the nature of the bill, the usage of trade with regard to similar bills, and the facts of the particular case (Section 45) An indorser would presumably be discharged under this section if the cheque was stale for purposes of negotiation

So far as the *drawer* of a cheque is concerned, Section 74 further provides that where a cheque is not presented for payment within a reasonable time of its issue, the drawer is discharged to the extent of the damage which he suffers by the delay

In regard to this section, it must be remembered that the right of action on a simple contract debt, including a cheque or bill, is not barred for six years, which period begins to run in the case of a cheque from its date, or if no date is specified, from its date of issue, if that can be proved It follows, therefore, that in spite of the fact that a banker will not pay a cheque which is over six or twelve months old, the holder may enforce payment thereof against the drawer at any time within six years of the date of the instrument, and will succeed except to the extent to which the *drawer has suffered damage by the delay* in demanding payment

Crossed Cheques.

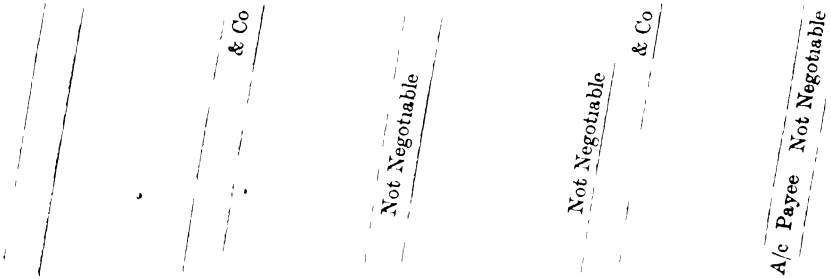
A crossed cheque is defined by Section 76 of the *Bills of Exchange Act*, 1882, in the following terms —

> **76.**—(1) Where a cheque bears across its face an addition of—
>
> (*a*) The words "and company" or any abbreviation thereof between two parallel transverse lines, either with or without the words "not negotiable", or
>
> (*b*) Two parallel transverse lines simply, either with or without the words "not negotiable",
>
> that addition constitutes a crossing, and the cheque is crossed generally
>
> (2) Where a cheque bears across its face an addition of the name of a banker, either with or without the words "not negotiable", that addition constitutes a crossing, and the cheque is crossed specially and to that banker

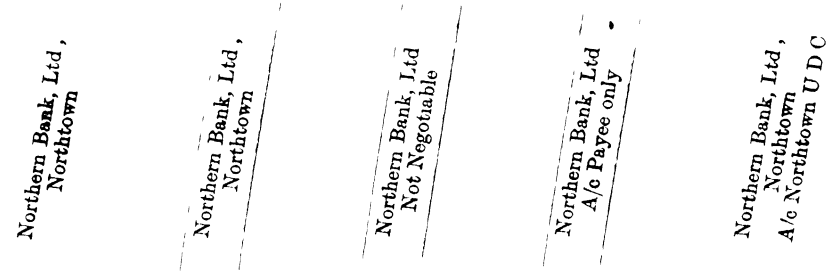
From this definition it will be seen that there are two distinct types of crossing (*a*) *general*, and (*b*) *special* A general crossing must include two parallel transverse lines written, printed, or perforated across the face of the cheque, and these may be accompanied by any such additions as the words "& Co", "and company", "Not negotiable", "Not negotiable & Co", "Account Payee", "Account Thomas Robinson" or "Under pounds" Although the additional words may have a certain definite effect—discussed below—they are not an essential part of the crossing, nor do they constitute a crossing if the transverse lines are absent

The name of a banker written, stamped, or perforated across the face of a cheque forms a *special* crossing, whether it appears alone or with transverse lines, or with any of the additional words which have been mentioned

SPECIMENS OF GENERAL CROSSINGS



SPECIMENS OF SPECIAL CROSSINGS



The Words "Not Negotiable".

Of the additional words which are frequently added to a crossing only the words "Not negotiable" are recognised by the Act as having any special effect, as follows

81. Where a person takes a crossed cheque which bears on it the words "not negotiable", he shall not have and shall not be capable of giving a better title to the cheque than that which the person from whom he took it had

The effect of this section is in no way to restrict the *transfer* of a cheque from one person to another, but it has the effect of removing from a cheque that characteristic of negotiability to which reference has already been made (Chapter 20) If, therefore, a person takes a cheque crossed "Not negotiable" which has been stolen or lost, he cannot enforce payment of the instrument nor can he retain any moneys paid to him in respect of the instrument as against the *true owner*, however honestly he may have acted, and even though he had no knowledge of the fact that the cheque had been stolen or lost On the other hand

if there is no question of defective title, the instrument is good for all purposes, and may circulate in exactly the same way as a cheque which does not bear the restrictive words

Although the words "not negotiable" have no legal significance unless they appear with a crossing, a banker who is called upon to pay an *uncrossed* cheque bearing these words would be well advised to safeguard the interests of himself and of his customer by returning the instrument as an embarrassing document requiring the drawer's confirmation

"Not Transferable" Cheques.

A very clear distinction must be made between a cheque which is crossed "Not negotiable" and one which is not transferable in its origin by reason of its containing words prohibiting transfer or indicating an intention that it should not be transferable, *e g*, words in the body of the cheque such as "Pay X Y *only*"

The former *can* be paid even though it bears evidence of having been transferred, subject to the fact that, if there is any defect in the title of one of the holders, then that holder and subsequent holders will be liable to recoup the true owner A "not transferable" cheque, however, must be paid to the payee specified and to him *only* In no circumstances should such a cheque be collected or paid by a banker if it bears evidence of having been transferred, otherwise the collecting banker will render himself liable for negligence, and the paying banker for disobeying the mandate of his customer

The Object and Effect of Crossing a Cheque.

Unless the words "Not negotiable" appear, a general or special crossing in itself has no effect whatsoever upon the full negotiability of a cheque as between different holders

The general effect of a crossing, so far as it concerns the banker on whom the cheque is drawn, is that he is safe only if he pays the cheque *to another banker*, and if he pays a crossed cheque which has been lost or stolen to anyone other than a banker, he runs the risk of having to pay the amount over again to the true owner of the instrument. The addition of the words "Not negotiable" is an added safeguard, warning anyone who takes a cheque so marked that he does so at his own risk.

It is not always appreciated that the effect of a crossing applies equally to a *bearer* as to an order cheque. The fact that a crossed cheque is payable to bearer merely dispenses with the necessity for indorsement, and, if such a cheque is crossed "Not negotiable", it cannot be safely cashed over the counter and it does not retain the characteristics of full negotiability

Who may Cross a Cheque.

Sections 77 and 78 of the Act provide that —

77.—(1) A cheque may be crossed generally or specially by the drawer

(2) Where a cheque is uncrossed, the holder may cross it generally or specially

(3) Where a cheque is crossed generally, the holder may cross it specially

(4) Where a cheque is crossed generally or specially, the holder may add the words "not negotiable"

(5) Where a cheque is crossed specially, the banker to whom it is crossed may again cross it specially to another banker for collection

(6) Where an uncrossed cheque, or a cheque crossed generally, is sent to a banker for collection, he may cross it specially to himself

78. A crossing authorised by this Act is a material part of the cheque; it shall not be lawful for any person to obliterate or, except as authorised by this Act, to add to or alter the crossing

In accordance with the provisions of Section 77 (3 and 5), every banker in practice makes a point of crossing specially to himself all cheques received over the counter either for collection or payment, with the object of ensuring in the case of cheques drawn on other bankers that the proceeds of the cheques will be paid to the banker named in the crossing and to no other

Since a crossing is a material part of a cheque, it cannot be altered otherwise than is sanctioned by Section 77, and a banker should not therefore pay cheques presented to him which bear evidence that the crossing has been materially altered, obliterated, or erased, or that the name of a banker or the words "not negotiable" have been crossed out

"Opening" a Crossing.

The crossing on a cheque is sometimes cancelled or neutralised, or, as it is technically termed, "opened", by the drawer's writing the words "Pay cash" or "Please pay cash" either across the top of a crossed cheque or alongside the crossing, the words being accompanied either by his signature or by his initials Cancellation is often necessary when a crossing is *printed* on cheques on their first issue by the bank, and its object is to relieve the paying banker of his obligation to pay the amount of the cheque only to another banker, and to free him from liability if he cashes the cheque over the counter

The practice is not sanctioned by the Bills of Exchange Act, and, although it has received a certain degree of recognition in the Courts, it should be strongly discouraged because of the risk to the paying banker that the initials or the signature of the drawer may have been forged by someone who has found or stolen the instrument If a cheque of this description is presented for encashment by the drawer himself, or by the payee who is well known to the banker, the risk is slight, but a banker would undoubtedly be liable to the true owner of the instrument, and unable to debit its amount to his customer, if he paid out the money

and it subsequently turned out that the signature or initials of the drawer had been forged

It must be remembered, too, that once a crossed cheque is issued the drawer himself has no right to alter or add to the original form of his mandate, if by so doing he is likely to prejudice a lawful holder, and he may render himself liable to the true owner if the cheque is paid in a condition different from that in which it was when obtained or stolen from the true owner

Fortunately, little difficulty is likely to arise in practice now that the London clearing bankers have let it be known that no opening of a crossing will be recognised by them unless the alteration is accompanied by the full signature of the drawer, and then only if the cheque is presented for encashment by the drawer himself or by his authorised and known agent.

Inchoate Cheques.

The person to whom an inchoate cheque is handed by the drawer for completion has *prima facie* authority to complete it in respect of the date, name of the payee and amount, and the drawer will not thereafter be in a position to object if the completion is effected in a reasonable time and strictly in accordance with the authority given at the time of issue But the drawer of a cheque runs considerable risk if he issues a signed cheque without filling in the particulars as to amount or name of the payee, for if a wrong amount is filled in and the cheque is subsequently presented for payment by a *holder in due course*, the latter will be in a position to enforce payment even though the amount of the instrument is much in excess of the drawer's original instructions for its completion But payment cannot be enforced by anyone other than a holder in due course, as, for example, a holder who has *not* given value for the cheque

To avoid difficulties of this kind, and also in order to provide against material alterations of the amount, it is usual for the drawer of cheques handed to an agent or employee for completion to stamp them across the face with some such words as "Under ten pounds", or "Not over twenty pounds", in which cases no more than the maximum amount specified will be paid upon presentment Although words such as those given have no statutory authority, a banker who paid more than the sum specified would undoubtedly be unable to charge his customer with the excess payment

Material Alteration.

By virtue of Sections 64 and 78 of the Act, any alteration of the date, sum payable, place of payment or crossing on the face of a cheque is *material*, and, unless it is made with the drawer's consent, (*e g.*, is

confirmed by his signature or initials), the alteration will render the cheque void except as against the party who has himself made, authorised or assented to the alteration, and subsequent indorsers

This general rule is, however, subject to the exception that a holder in due course can enforce payment according to its original tenor of a cheque which bears a *non-apparent* alteration, and also to the exception that the crossing on a cheque can be altered by a holder and by the collecting banker in accordance with the provisions of Section 77, already quoted Moreover, the drawer of a cheque the amount of which has been fraudulently altered cannot refuse to be debited therewith if he has carelessly facilitated the alteration

Subject to these exceptions, the drawer cannot be debited with a cheque which has been materially altered without his consent since its first issue by him, and it is therefore imperative that a banker paying cheques should see that any alterations thereon are duly confirmed by the initials of the drawer or preferably by his signature

In the case of cheques signed by more than one person, or signed on behalf of a limited company, corporation or other body, material alterations should be confirmed by the initials or signatures of *all* the persons who are required to sign the cheques Thus, alterations on cheques signed by *two* parties to a joint account should be duly initialled or signed by *both* parties, but if either party alone has authority to sign cheques, the initials or signature of one will suffice, and that one person need not necessarily be the one who originally signed the instrument Similarly, if any two of several directors have power to sign cheques on behalf of a company, any alteration should be confirmed by the initials or signatures of two directors In no circumstances should a banker accept the initials or signature of a secretary alone in confirmation of alterations on a company's cheques, unless the secretary alone has power to issue and sign such instruments, which is unlikely

An alteration frequently seen in practice is that of the words " or order " on the face of a cheque to " or bearer ", in consequence of which the instrument becomes transferable by mere delivery without indorsement An alteration of this kind can be made by the drawer and by him only, and if made should be clearly confirmed by his initials or signature, or by the initials and signatures of all the drawers, if there are more than one On the other hand, the payee or indorsee of a cheque can alter the words " or bearer " into " or order ", or cross out the words " or bearer " if they appear, thereby making the instrument payable to order Such alterations are not covered by the Act, but presumably the alteration of a bearer cheque to order is sanctioned because it is not in favour of the holder, but on the contrary is an added protection to the drawer

Unusual material alterations sufficient to affect the validity of a cheque if made without the drawer's consent are the deletion of the words

"Not negotiable" if they appear with a crossing, and the alteration of the name of the branch at which the cheque is payable The former is, of course, a material alteration of a crossing such as is prohibited by Section 78, while the latter is material in that it is an alteration of the place of payment of the cheque [Section 64 (2)] which renders the instrument void as against any parties who have not consented to the alteration and all prior parties, and, if it is subsequently dishonoured, such parties cannot be sued by the holder

Cancellation of a Cheque.

A cheque is discharged when it is intentionally cancelled by the holder or his agent, and in such a case any party liable on the instrument is entirely freed from his liability (Section 63) Cancellation may be effected either by cancelling the drawer's signature, or by totally destroying the cheque, by tearing it up, or by marking it clearly in some way across the face with the obvious intention that it shall thereafter be regarded as cancelled

If the cancellation is made intentionally by the holder, the drawer and any indorsers prior to the holder are discharged, but, by Section 63, a cancellation is inoperative if it is made unintentionally, or by mistake, or without the authority of the holder, as, for example, where a bank cashier by mistake cancels the signature of the drawer on a cheque which is not drawn on his branch

Lost Cheques.

If a cheque is lost before it is overdue, the holder may compel the drawer to give him another cheque in identical terms, provided the drawer is indemnified against any claims which may be made if the lost instrument is found again (Section 69) Moreover, the loss of a cheque is no defence to any action or proceeding on it, provided the holder is willing to give a satisfactory indemnity to the drawer (Section 70)

In the event of the loss of a cheque being reported, the drawer should give immediate instructions to his banker to stop payment, while the holder should protect himself by at once giving notice of the loss to any parties to the instrument prior to himself

In the event of a lost and stopped cheque being presented for payment, the banker on whom it is drawn should return it with the answer "Instructions not to pay", and he should at once notify the drawer of the fact, giving the name and address of the holder It may happen that a lost cheque is presented for payment to the drawee-banker before payment has been stopped, and in such a case he will be compelled to pay it if he has no grounds for suspecting the title of the presenter. Provided the banker acts in good faith in so paying the cheque, he can

charge the amount to the account of the drawer And if the cheque has reached the *payee*, the drawer, by virtue of Sections 59, 60 and 80 of the Act (*see* Chapter 23), is thereafter relieved of his liability on the instrument because payment is regarded as having been made in due course

In no circumstances should the drawer issue a duplicate of a lost cheque in favour of the holder unless he is properly protected by an indemnity from the holder against claims of third parties

Payment of Debts by Cheque.

Unless there is an arrangement between debtor and creditor that payment shall be made by cheque, there is no obligation on the part of the creditor to accept payment in this way, and if he so chooses he is free to refuse to accept such an instrument and to demand payment of his debt in legal tender On the other hand, if it is customary as between a debtor and creditor that payment shall be made by cheque, or if a cheque is accepted by the creditor without demur, then he will be presumed to have accepted the instrument in payment of the debt due to him, *subject*, however, to the cheque being duly honoured when it is presented for payment

Payment by cheque or bill of exchange is, in fact, generally regarded as a *conditional* payment, unless there are circumstances which indicate that the instrument was accepted in final discharge of the debt The condition is, of course, that the debt will be revived if the cheque is not duly honoured when it is presented to the drawee, but until such a presentment has been made and payment refused, the creditor has no right to sue the debtor in respect of his obligation

As we have already noticed, the holder of a cheque retains his right of action on the written instrument until six years from its original date, but the neglect of the creditor to obtain payment within a reasonable time will discharge the drawer to the extent of the damage suffered by the delay in respect of his liability both on the instrument itself and on the debt for which it was given Moreover, any indorsers of the cheque will be entirely discharged, by virtue of Section 45.

It may be finally noted that the obligation of a debtor from whom a cheque has been taken in payment may, in some cases, be regarded as having been discharged even though the money has not been received by the creditor This may arise if the cheque is lost or misappropriated after it has reached the creditor's hands, and is paid in due course by the drawee-banker As we have seen in considering lost cheques, a banker is compelled to pay a bearer cheque if it is in order and he is satisfied regarding the *bona fides* of the presenter, while he may in good faith pay an order cheque on which the indorsement of the payee or indorsee has been forged, with the right, in both cases, to debit the amount to the drawer's account Clearly, the drawer having thus paid

once cannot be called upon by his creditor to pay a second time, and in such circumstances the remedy of the creditor is against the finder or thief who has wrongly obtained payment of the instrument

Payment by Cheque Through the Post.

The general rule of law is that, as between the sender and the addressee, any loss which arises from the sending of a cheque by post will fall upon the person *who first makes the Post Office his agent* for the purposes of the payment In the majority of cases the Post Office is the agent of the *sender*, for it is he who usually decides to make the payment by this means, and, if such is the case, the sender must bear any loss which may ensue by reason of the cheque having been lost or stolen before it reached the addressee

On the other hand, there may be circumstances which, in the opinion of a judge or of the Court, make the Post Office the agent of the *creditor*, *i e*, the person receiving the money, as, for example, where he definitely requests that payment shall be made by cheque forwarded to him by post, or where an invoice clearly prescribes that payment shall be made by cheque drawn and crossed in a given manner In such a case, delivery of the cheque to the Post Office is regarded as delivery to the agent of the creditor, and the latter must bear any loss which may arise during the time when the cheque is in the hands of that agent

Furthermore, the Courts tend to free the creditor from liability in this respect if it can be shown that the method of payment adopted by the sender differed in the slightest degree from that which was prescribed by the creditor, or if it differed in any way from the usual course of business between the parties Thus, if over a period of years payments by the sender were made by *crossed* cheques, the presumption would be that any loss should fall on the creditor, by reason of the fact that he would be regarded as having acquiesced in the method of payment and adopted the Post Office as his agent for obtaining payment But if the sender departed from the usual practice and sent an *uncrossed* cheque, or if he sent the cheque by hand instead of by post, and it was stolen, then he would be liable to stand the loss if the cheque were cashed

It must be remembered that, even when a cheque has reached the creditor, it is merely a *conditional* payment, whether the Post Office is the agent of the sender or of the creditor, for, as has been already pointed out, the debt against which the cheque is drawn is at once revived when the cheque is dishonoured, unless there is an express agreement by the creditor that the cheque itself shall be regarded as a final and conclusive settlement, in which case there is a right of action on the cheque only

CHAPTER 22

INDORSEMENTS.

ALTHOUGH the Bills of Exchange Act does not explicitly define an indorsement, Section 32 thereof sets forth the requisites of a valid indorsement in the following terms —

> 32 An indorsement in order to operate as a negotiation must comply with the following conditions, namely —
>
> (1) It must be written on the bill itself and be signed by the indorser The simple signature of the indorser on the bill, without additional words, is sufficient
>
> An indorsement written on an allonge, or on a "copy" of a bill issued or negotiated in a country where "copies" are recognised, is deemed to be written on the bill itself
>
> (2) It must be an indorsement of the entire bill A partial indorsement, that is to say, an indorsement which purports to transfer to the indorsee a part only of the amount payable, or which purports to transfer the bill to two or more indorsees severally, does not operate as a negotiation of the bill
>
> (3) Where a bill is payable to the order of two or more payees or indorsees who are not partners all must indorse, unless the one indorsing has authority to indorse for the others
>
> (4) Where, in a bill payable to order, the payee or indorsee is wrongly designated, or his name is misspelt, he may indorse the bill as therein described adding, if he think fit, his proper signature
>
> (5) Where there are two or more indorsements on a bill, each indorsement is deemed to have been made in the order in which it appears on the bill, until the contrary is proved
>
> (6) An indorsement may be made in blank or special It may also contain terms making it restrictive

As an indorsement must be written *on the bill itself*, a separate promise in writing to indorse, or an assignment of a bill or note by a separate instrument, is not an indorsement

An "*allonge*" [Sub-section 32 (1)], is a piece of paper which is gummed or pasted to one end of a bill or cheque with the object of providing additional space for further indorsements when the back of the cheque or bill is already covered To prevent fraud, the first indorsement on an allonge is written partly on the bill and partly on the allonge

It is, of course, not often that a bill or cheque is negotiated in this country so many times that an allonge becomes necessary, but the device is sometimes met with in connection with foreign bills of exchange *Copies* of a bill are not recognised in this country unless they form part

of a bill in a set, but in those countries where copies are recognised, room for additional indorsements is sometimes found on a copy or copies of the original bill

Although it is usually advisable for indorsements to be made on the *back* of bills and cheques, Sub-section 32 (1) merely provides that an indorsement shall be ' written on the bill itself ", hence an indorsement written on the *face* of a bill of exchange or cheque is quite in order in spite of its inconvenience

Classes of Indorsement.

The Bills of Exchange Act refers to seven classes of indorsement (*a*) *Partial* indorsements , (*b*) Indorsements *in blank* , (*c*) *Special* indorsements , (*d*) *Conditional* indorsements , (*e*) *Restrictive* indorsements , (*f*) Indorsements *negativing* or *limiting* the liability of the indorsers , (*g*) *Facultative* indorsements, *i e* , waiving some or all of the holder's duties

Each of these classes is governed by special sections or sub-sections of the Act, which are discussed in the following paragraphs

In connection with Sub-section 32 (3), the custom whereby dividend warrants payable to two or more persons may be indorsed by any one of the parties is expressly saved by Section 97 (3) (See page 351)

Partial Indorsements.

Partial indorsements [Sub-section 32 (2)], are rarely seen in practice, but typical examples would be special indorsements in the following terms on a cheque for £100 " Pay Thomas Robinson or order sixty pounds ", or " Pay Thomas Robinson sixty pounds and James Brown forty pounds " Both indorsements may operate as an authority to receive payment of the amount specified, but are invalid as a negotiation of the bill, so that the indorsees can neither sue on the instrument nor further indorse in order to transfer the property therein

Indorsements in Blank and Special Indorsements.

Section 34 of the Act distinguishes between indorsements in blank and special indorsements in the following terms —

> **34.** (1) An indorsement in blank specifies no indorsee, and a bill so indorsed becomes payable to bearer
>
> (2) A special indorsement specifies the person to whom, or to whose order, the bill is to be payable
>
> (3) The provisions of this Act relating to a payee apply with the necessary modifications to an indorsee under a special indorsement
>
> (4) When a bill has been indorsed in blank, any holder may convert the blank indorsement into a special indorsement by writing above the indorser's signature a direction to pay the bill to or to the order of himself or some other person

An example of an indorsement *in blank* would be the signature "Thomas Robinson" on the back of a cheque or bill payable to "Mr Thomas Robinson or order", the signature indicating that Thomas Robinson discharges the instrument in return for payment, or that he transfers his rights therein to some person unnamed A bill or cheque on which the *only* or *last* indorsement is an indorsement in blank, is payable to bearer, and thereafter no indorsement of the instrument is necessary to transfer the property therein, unless the instrument is subsequently reconverted "to order" by a later special indorsement

An example of a *special* indorsement on a cheque payable to Thomas Robinson would be

"Pay James Brown or Order,
"Thomas Robinson"

In this case, James Brown is the *indorsee*, and his indorsement is necessary before the instrument can be transferred to another holder A special indorsement of this kind may be made by any indorser, and not necessarily by the payee, while by Sub-section 34 (4), any holder of a bill or cheque originally payable *to order* may convert the last blank indorsement thereon into a special indorsement, and thereby make the instrument payable to order, although by reason of the blank indorsement it had become payable to bearer

For this reason a special indorsement is said to *control* or override a previous indorsement in blank, but it must be clearly understood that a special indorsement on a bill originally made payable *to bearer* has no effect and does not make the instrument payable to order.

Sometimes the holder of a bill or cheque which is not payable to himself takes advantage of the provisions of this sub-section to make the instrument payable to a transferee without himself incurring the liabilities of an indorser This he does by writing above the signature of the last indorser the words "Pay or order", and including the name of the transferee, thus making the instrument payable to order, and making necessary the signature of the transferee before the cheque or bill can be negotiated But although the holder may in this way escape liability as an indorser, he remains liable as a transferor

Conditional Indorsements.

A conditional indorsement is not defined in express terms by the Act, but is one which makes the transfer of the property in a cheque or bill by the indorser to the indorsee dependent upon the fulfilment of a stated condition Examples of such an indorsement would be

"Pay Thomas Robinson or order on the arrival of s s Majestic at Montreal,
James Brown"
"Pay Thomas Robinson if he marries Anne Taylor,
James Brown"
"Pay Thomas Robinson ten days after the death of William Brown,
James Brown."

As between indorser and indorsee, the condition would presumably be operative, so that, if payment of the instrument were received by the indorsee without fulfilment of the condition, he would merely receive the money in trust for the indorser Nevertheless, Section 33 provides that, in such circumstances, the condition may be disregarded by the payer, and payment to the indorsee is valid whether the condition has been fulfilled or not

This provision is clearly of great advantage to bankers, who will usually have no means of satisfying themselves whether a condition has been fulfilled or not Moreover, it would certainly be illogical to affect the payer of a bill or cheque with a condition in an indorsement when the order addressed to that payer by the drawer cannot be made conditional On the other hand, the power to disregard a condition in an indorsement is *optional*, so that the payer may *if he chooses* refuse payment until he has proof that the condition has been fulfilled

Restrictive Indorsements.

A restrictive indorsement is somewhat similar in its effect to an indorsement which is conditional, and is thus defined by Section 35 of the Act

> **35.** (1) An indorsement is restrictive which prohibits the further negotiation of the bill or which expresses that it is a mere authority to deal with the bill as thereby directed and not a transfer of the ownership thereof, as, for example, if a bill be indorsed "Pay D only", or "Pay D for the account of X", or "Pay D or order for collection"
>
> (2) A restrictive indorsement gives the indorsee the right to receive payment of the bill and to sue any party thereto that his indorser could have sued, but gives him no power to transfer his rights as indorsee unless it expressly authorises him to do so
>
> (3) Where a restrictive indorsement authorises further transfer, all subsequent indorsees take the bill with the same rights and subject to the same liabilities as the first indorsee under the restrictive indorsement

Both restrictive and conditional indorsements are types of special indorsement in which the name of the indorsee is specified for the protection of the indorser A restrictive indorsement prohibiting transfer has, in fact, exactly the same effect as words in the body of the instrument inserted for that purpose, *e g*, "Pay James Brown *only*"

While Section 35 gives most of the rights of an ordinary holder to the indorsee under a restrictive indorsement, it limits his full capacity to deal with the instrument in the respect that he cannot transfer his rights unless, *from the words employed*, it can be assumed that he has power to do so

Thus, if a bill is indorsed "Pay D for the account of X", or "Pay D for Collection," D cannot indorse the bill to E so as to give E the right to receive payment on account of X But if the bill is indorsed "Pay D *or order* for the account of X," or "Pay D *or order* for

Collection," then D has a right to indorse to E, since the addition of the words "or order" imply that D has authority to indorse to another party

Restrictive indorsements frequently met with in practice are those which specify that the proceeds of a cheque are to be paid only to a specified account, as in the following examples

1 "To be placed to the account of Jones Bros with the Blankshire Bank,
Jones Bros".
2 "To the credit of Brown and Brown with the Alliance Bank, Manchester,
Brown and Brown"
3 "Pay to A L Turner's A/c,
B Backer"
4 "Please place to the credit of my account,
James Brown"

In none of these cases is a further indorsement required, and though it would be very difficult for a *paying* banker to justify payment of a cheque bearing one of these indorsements *and* a subsequent indorsement or subsequent indorsements he *is under no liability* to see that the instructions given in such an indorsement are complied with On the other hand, a *collecting* banker would doubtless be liable for negligence if he did not ensure that the proceeds of such a cheque were placed to the account specified

Sometimes additions to an indorsement which are intended to be restrictive may be regarded as invalidating the indorsement as a good discharge, and the cheques in such cases may be returned by the paying banker marked "Indorsement irregular" Examples are —

1 "Credit Thomas Robinson"
2 "For Lodgment A/c,
Smith, Brown & Jones"

On the other hand, additions to an indorsement such as "Paid in", "Pay cash", "Received without prejudice", and "Received cash" are in order, but in the last two cases a receipt stamp is required if the amount of the cheque is for £2 or over

Effect of Indorsement: Liabilities of an Indorser.

To be legally effective an indorsement must, of course, consist of the proper signature of the person who is entitled to indorse the instrument, or his duly authorised agent, since a forged or unauthorised signature is wholly inoperative and confers no right on a subsequent holder to enforce payment of the cheque or bill so indorsed (Section 24)

The liabilities assumed by an indorser of a cheque or bill are thus set forth in Section 55 (2) of the Act

55. (2) The indorser of a bill by indorsing it—
(*a*) Engages that on due presentment it shall be accepted and paid according to its tenor, and that if it be dishonoured he will compensate

the holder or a subsequent indorser who is compelled to pay it, provided that the requisite proceedings on dishonour be duly taken,

(*b*) Is precluded from denying to a holder in due course the genuineness and regularity in all respects of the drawer's signature and all previous indorsements,

(*c*) Is precluded from denying to his immediate or a subsequent indorsee that the bill was at the time of his indorsement a valid and subsisting bill, and that he had then a good title thereto

Section 56 further provides that

56. Where a person signs a bill otherwise than as drawer or acceptor, he thereby incurs the liabilities of an indorser to a holder in due course

Strictly speaking, a signature on a cheque or bill by a person who is not a *holder* is not an indorsement, for a person so signing cannot be a *party* to the instrument, although he incurs the liabilities of an indorser. Such a signature is in effect more in the nature of a guarantee than an indorsement, and on the Continent is described as an "*aval*"

Negativing, Limiting, and Facultative Indorsements.

By Section 16 of the Act —

16. The drawer of a bill, and any indorser, may insert therein an express stipulation—

(1) Negativing or limiting his own liability to the holder,

(2) Waiving as regards himself some or all of the holder's duties

Thus, if Thomas Robinson is the payee or indorsee of a cheque, and wishes to escape liability thereon in the event of dishonour, he may sign his name on the back of the instrument in the usual way and add the words "*sans recours*" or "without recourse" after his signature, in which case a subsequent holder would be unable to proceed against the said Thomas Robinson if the cheque were unpaid. Or he may add such words as "*sans frais*" or "without expense", indicating that although he is prepared to accept liability for the amount of the instrument if it is unpaid, he will not bear any expense which may be incurred by the holder in the event of dishonour, as, for example, expenses resulting from the protest of a bill or cheque.

But if an indorser holds a bill or cheque through a prior forgery, the insertion of the words "*sans recours*" or "without recourse to me" would not relieve him of liability for conversion to the true owner of the instrument, for a person who holds by virtue of a forgery has no legal title to the instrument, however innocent he may be.

An indorsement in which the signer waives some or all of the holder's duties is known as a "*facultative*" indorsement. The following is an example.

"Pay James Brown or Order,

William Robinson
(*Notice of Dishonour waived*)".

The meaning of this addition is that the indorser does not require the holder to give him notice of dishonour if the bill is refused acceptance or payment

Cancellation of an Indorsement.

An indorser (and all subsequent indorsers who have indorsed prior to the cancellation) may altogether avoid liability if his signature is *intentionally* cancelled by the holder or his agent [Section 63 (2)] Bills and cheques are sometimes paid in by customers on which some of the indorsements are entirely obliterated by a black impressed stamp or some other means, and in such cases no action can be taken, in the event of dishonour, against the parties whose signatures have been so obliterated, or against subsequent parties who would have had a right of recourse against the parties whose signatures have been cancelled.

Bankers and Indorsements.

A paying banker should always demand the indorsement of the payee or indorsee to a cheque or bill as evidence that it has been duly paid in accordance with the customer's mandate If, however, the payee refuses to indorse a cheque in return for receiving the money, the banker should hand back the cheque with the answer "Payee's indorsement required" He could not thereafter be held liable by the customer for dishonouring the cheque, as it is only in the customer's own interests that a proper discharge should be obtained Moreover, the banker himself is not bound to assume unusual risks, for if he paid a cheque without indorsement the customer might hold him liable for not following the "ordinary course of business" Alternatively, the banker can demand a receipt for the payment, duly stamped 2d if the amount is £2 or over, and if the payee will not give such a receipt he renders himself liable to a penalty of £10

Although a banker must protect the interests of his customers by seeing that indorsements on all cheques and bills paid by him are to all appearances valid, complete and in order, it would not be reasonable to expect the *paying* banker to accept responsibility for the *authenticity* of all indorsements upon the many cheques passing through his hands This is the general position taken by the law as embodied in the Bills of Exchange Act, 1882, which lays down in precise terms the protection afforded to bankers who exercise *reasonable* care in relation to indorsements on customers' cheques

If the paying banker is not satisfied as to the validity or correctness of an indorsement, he should either return the instrument unpaid and marked "Indorsement requires confirmation" or "Indorsement irregular", or, if the instrument is presented for payment by the indorser

in person, he should get the latter to correct any defect or to re-indorse If the banker knows that an indorsement is not in the handwriting of the payee or indorsee, he should not pay or collect the instrument without confirmation of the signature, but he cannot insist that the writing shall be that of the payee, for Section 91 (1) provides that a signature need not be made by a person's own hand but may be written by or under the authority of the person whose signature it purports to be

The Act provides that, *until the contrary is proved*, indorsements shall be deemed to have been made in the order in which they appear on the bill, and the liability of the indorsers is determined by this order Hence it is clearly advisable that the payee's signature should appear first on the back of the bill, that other indorsements should follow in order, and that the signatures of special indorsees should immediately follow the relative special indorsements

Indorsements Generally.

In the following paragraphs consideration is given to what are regarded as the correct forms of the most important varieties of indorsement with which a banker has to deal As to what is the correct form of indorsement in any particular instance is chiefly a matter of practice, although in certain cases the manner of signing has been recognised by the Courts

Although it is desirable that all indorsements should be wholly or partly in ink, an indorsement is legally valid if made in pencil, or entirely by means of an impressed stamp, or if entirely printed, provided the impression or printing is properly authorised In practice, however, indorsements in pencil are generally discouraged owing to the liability to obliteration or alteration, although cheques bearing a pencilled indorsement forming one of a series of indorsements and followed by other indorsements in ink, are frequently paid without question And while the Courts would regard as valid an indorsement made wholly by impressed stamp, if it could be shown that the impression was made by or under the authority of the payee, it is highly desirable that such indorsements should be discouraged on account of the facilities which the method offers to fraud, and the difficulty of obtaining satisfactory proof—which a banker is fairly entitled to demand in such cases—that the stamp was impressed by authority Similarly, an indorsement entirely in printed characters would not usually be accepted without confirmation

No objection can, of course, be raised to an indorsement in which the name of the payee is impressed, but the signature in ink of the agent or official is added as is frequently done in the case of indorsements on behalf of a limited company or local authority

In the case of a first indorsement on a cheque or bill payable to order, or of an indorsement immediately following a special indorsement, the

general rule is that the signature should correspond in its important essentials with the name of the payee given on the face of the instrument or with the name of the indorsee specified in the special indorsement, as the case may be This means that the *surname* in the indorsement should be identical with the surname given as that of the payee or indorsee, whether it is given correctly or not, for, if the name is not correctly given, the Act authorises the holder to sign his name in accordance with the spelling as given, adding his proper signature if he thinks fit

On the other hand, it is not essential that *christian* names be written in full, even if they are so given on the face of a cheque or in a special indorsement, but if the indorsee chooses to give his christian name or names in full, then the spelling thereof must correspond exactly with that given on the instrument Moreover, there is no objection to the giving of the christian name in full, although initials only are given on the face of the instrument or in the special indorsement But a surname only will not suffice for an indorsement, even where no christian name or initial is given on the cheque or bill

Courtesy Titles.

As the guiding principle is that an indorsement should be the ordinary form of signature of the payee or indorsee, it is usual in practice to return for confirmation indorsements which include courtesy titles or forms of address, although the indorsement should be regarded as being in order if such expressions are merely descriptive On the other hand, it is usual in certain foreign countries to include courtesy titles with indorsements, and accordingly no objection should be raised on this ground to indorsements by foreign payees or indorsees

With the exception mentioned, a banker should not accept without confirmation indorsements in the form "*Mr* Thomas Robinson", "Thomas Robinson, *Esq*", "*Major* Thomas Robinson", or "*Dr* Thomas Robinson", for the recognised forms of signature in such cases are "Thomas Robinson", with or without descriptive expressions "Major" or "M D" in the last two cases

The abbreviation "Mrs" is regarded as both a courtesy title and a term of description, hence a cheque payable to, say, "Mrs Thomas Robinson" requires the usual signature of the payee, followed by descriptive words showing that she is the wife or widow of Thomas Robinson, *e g*,

"Jane Robinson,
Wife of Thomas Robinson"

A cheque payable to a spinster (*e g*, Miss Jane Brown), now married (as Mrs Jane Robinson) should be indorsed

"Jane Robinson (née Brown)".

Indorsements of Agents.

In accordance with Section 91 of the Bills of Exchange Act, it is sufficient if an indorsement is written by some person acting by or under the authority of the payee or indorsee, but, in order that the principal and not the agent shall be bound, it is imperative that the signature shall unmistakably indicate that the agent is signing on behalf of a named principal

As a rule, agents in this country sign on behalf of their principals by means of a *per procuration* signature, and in such cases the indorsement should appear in the following form, where Thomas Robinson is the principal and James Brown the agent —

per pro Thomas Robinson,
James Brown

or

p p Thomas Robinson,
James Brown

In this country, per procuration signatures in which the abbreviation "per pro", or "p p", does not *precede* the name of *the principal* (*e g*, "Thomas Robinson, *per pro* J Brown") are not accepted without confirmation But the form "James Brown, *per pro* Thomas Robinson", would appear to be legally valid, although by no means customary

A *per pro* signature on behalf of an individual or partnership is only *prima facie* evidence of the existence of a proper authority to sign

The *paying* banker is not, however, required to satisfy himself regarding the authority for a per pro indorsement if it otherwise purports to be in order But a paying banker will usually demand confirmation of a per procuration signature on behalf of a *company* or *local authority*, if no indication is given of the *status* of the agent signing, or if the status of the person signing is not such as would warrant the banker reasonably assuming that he has authority to sign Thus a cheque indorsed "per pro" by a Secretary or Director on behalf of a joint-stock company may be regarded as in order, whereas confirmation should be required if the person signing describes himself as a clerk or foreman.

The position of the *collecting* banker in relation to "per pro" indorsements is discussed in Chapter 24

Whereas the abbreviation "per pro" or "p p" is in itself a sufficient indication of the authority of the agent, the words "for", "per", or "pro" are not in themselves so indicative, and a signature by an agent which embodies these abbreviations should be refused if it is not accompanied by a word or words specifying his capacity

The mere addition to the agent's signature of words describing him as an agent will not make the indorsement that of the principal and exclude the agent's personal liability The principal must be *named*, and the signature must clearly indicate that it is on his behalf Thus, an indorsement "James Brown, agent to Robinson", on a cheque payable to "T Robinson" would not be accepted because the signature

is strictly that of James Brown, with the mere addition of descriptive words, and is not therefore binding on the principal

In accordance with the general rule regarding the powers of agents, an agent cannot usually delegate his authority to sign on behalf of another, so that any indorsements which indicate such a delegation should be returned for confirmation or for the signature of the agent himself, as for example, the following —

Per pro (or for) Thomas Robinson,
James Brown
per (or by) William Brown

Indorsements of Executors and Administrators.

As executors have implied power to delegate their authority to one (or some) of their number, no objection can be raised to the indorsement of cheques by one executor, provided he clearly indicates *that he is an executor*, and that he signs on behalf of himself and his co-executors The fact that a person signs for himself and his *co-executors* is, of course, clearly indicative that he *is* an executor, even though his signature is not followed by the designation "Executor" But executors have no power to delegate their authority to an *outside* person, and indorsements which are otherwise in order should be refused if the person signing does not indicate that he is an executor

Cheques payable to a deceased person should be indorsed by his executors in the recognised way, and if so discharged should be paid by a banker without question unless he has reason to doubt the authority of the persons signing, in which case he should ask for production of the probate or for confirmation by the presenting banker

If a will exists, the executors are the only persons entitled to deal with cheques or other property of the deceased, but in the absence of a will, power to deal with the property of the deceased is vested in an administrator or administrators appointed by the Court, whose powers of signing and indorsing are similar to those of executors as here defined.

Indorsements by Trustees.

Trustees cannot ordinarily delegate their authority to an outside person or persons, or to one or some of their number

Accordingly, a cheque payable to trustees must be indorsed in such a way as clearly to show that all the trustees have joined in the discharge, otherwise the indorsement should be returned for confirmation If the cheque is payable to a person whose estate is vested in the hands of trustees, the latter should indorse the instrument and indicate clearly that they sign as trustees of the payee concerned.

Indorsements on behalf of Partnerships.

It has been stated that any partner in a *trading* firm has implied power to bind the firm by signing its name on negotiable instruments, with *or without* the addition of his own name or of words indicating his authority Hence, if the partner's name is omitted, there is, as a rule, nothing to guide the banker as to whether the signature was or was not written by a partner, and his only safeguard is to ensure that the indorsement strictly conforms to the name of the payee on the face of the cheque, or, where there is a recognised practice in regard to any special form of indorsement, that the indorsement conforms to that practice

The necessity for seeing that the name of the firm in an indorsement corresponds exactly with that given on the face of the cheque arises from the fact that the names of firms are often so much alike as to cause confusion or to give rise to fraud On the other hand, if a firm's name is wrongly given, a partner of the firm is entitled, like any other indorser, to sign the wrong name, adding the correct name if he thinks fit

Indorsements on behalf of Limited Companies.

An indorsement is made on behalf of a joint-stock company when it is made in the name of the company, or made by or on behalf of or on account of the company by a person acting under its authority (Companies Act, 1929)

It follows that the mere writing or impressing of the name of a company by some one acting under its authority constitutes a valid indorsement, but although bankers will accept the mere signing of the name of a partnership as a good discharge, they will not usually accept without confirmation an indorsement on behalf of a joint-stock company, unless the name, authority and capacity of the signer are clearly indicated

Moreover, bankers will not, as a rule, accept such indorsements unless they are made by persons who are usually in a position to bind the company , for example, directors, general managers, secretaries, or, in the case of a company which is being wound up, the liquidator Indorsements by subordinate officials, such as ledger clerks or private secretaries, should not be accepted without confirmation

It is to be remembered, too, that officials who have express authority to sign on behalf of a company, have no right to delegate that power to others , accordingly indorsements which bear evidence of such a delegation should be returned for confirmation or authorised signature

As in the case of all other discharges, an indorsement on behalf of a company should correspond exactly with the name of the company as given on the face of the instrument or in the special indorsement, but if the name so given is inaccurate or incomplete, the indorser should sign in the incorrect form, adding the company's correct description

underneath The term "limited" should, of course, appear in the final indorsement, whether or not it is given on the face of the cheque, for this word must not be omitted in any signature on behalf of a limited company

Indorsements of Official and Fiduciary Payees.

The name of the payee on the face of a cheque is sometimes followed by a word or words describing an official or fiduciary position, thus indicating that the money is being paid to the person named in his official or fiduciary capacity In such cases the indorsement of the payee must be followed by a description corresponding to that on the face of the cheque Thus, cheques drawn in favour of "Thomas Robinson, Executor", or "Thomas Robinson, trustee of James Brown", should not be paid unless the indorsement includes the descriptions given, for the mere signature "Thomas Robinson" is not a sufficient indication that the money has reached the proper hands Similarly, cheques payable to "William Brown, Treasurer of Northtown U D C", or to "James Brown and Thomas Robinson, Collectors for the Parish of St Michael", should consist of the signatures of the persons named followed by descriptions corresponding to those given

Again, if a cheque is made payable to the holder or holders of an office for the time being without actually specifying the name or names of the individuals, as, for example to "The Treasurer, Northtown U D C" or to "The Collectors for the Parish of St Michael", the indorsement must include, not only the signatures of the persons holding the positions, but also the description as given On the other hand, the fact that the payee of a cheque *happens* to hold an official or fiduciary position does not make it necessary for him to indicate that capacity if the cheque is made payable to him personally, even though the money is intended by the drawer to be paid for official or fiduciary purposes The indorser may, if he wishes, add a description of his capacity, but the addition of such words should not be such as would make it necessary for the banker to demand confirmation of the signature

Indorsements by Mark.

Cheques or bills made payable to persons unable to write should be indorsed by the "mark" of the payee, properly authenticated, in the recognised form as indicated below, and the witness, who should be an independent party known to the illiterate payee and to the collecting or paying banker, should clearly state his name, occupation, and address under or alongside the word "witness"

His
John X Smith
mark

Witness
James Brown, Grocer,
17, High Street, Northtown

The paying banker should demand confirmation of the discharge in the case of any material departure or omission from this recognised form, and a similar procedure should be adopted in cases where a reasonable doubt exists as to the validity of the discharge For instance, the form " × Jane Smith, her mark, in the presence of J Jones, High Street, Northtown " should not be accepted, as it does not clearly indicate that " J Jones " *signs* as a witness

Indorsements of Impersonal Payees.

Bankers sometimes rely on Section 7 (3) of the Act to justify their treating as payable to bearer cheques which are clearly intended to be exchanged into cash, as, for example, cheques drawn payable to " Housekeeping or order ", " Wages or order ", " National Health Insurance Stamps or order ", " Cash or order ", etc

Although this practice seems reasonable on the ground that no person is indicated who can give a discharge for the payment, bankers are justified in refusing to pay cheques so drawn unless they are indorsed by the drawer or cashed by him or his known agent If payment is refused, the answer " Irregularly drawn " should be written on the face of the cheque But a banker who had been accustomed to treat such cheques as payable to bearer would run considerable risk of liability to his customer if he refused to cash them without giving reasonable notice of his intention

The practice should not, however, be applied to cheques drawn with the obvious intention that the money shall pass into public or local taxation accounts In all such cases the discharge of a recognised official should be obtained Thus, a cheque payable to " Income Tax or order " should be discharged by the Collector of Inland Revenue, a cheque to " Borough Rates or order " discharged by the Rate Collector and so on

Similarly, the drawer's indorsement should be required on cheques payable to a specified account, presumably in his own name, as for example on cheques to " Farm Account or order ", or to " Deposit Account No 2 or order "

Although order cheques, payable to apparently non-existing payees, such as " Queen Anne " or " Father Neptune ", were at one time treated as payable to bearer, it is probably safer nowadays for a banker to demand confirmation or indorsement in such cases

Indorsements in Foreign Languages.

An indorsement in a foreign language should not be accepted unless the banker is satisfied as to its correctness and completeness As a rule, no difficulty is experienced in dealing with indorsements in a European language, but care is needed in connection with indorsements *in oriental*

characters. These should not be accepted without confirmation unless the banker has reason to be satisfied as to their correctness. Such indorsements are sometimes accompanied by a translation, but the translation should not be regarded as correct unless it is certified by a notary or confirmed by a banker. The Council of the Institute of Bankers suggest that if such indorsements are not accepted, the answer given by the paying banker should be—

"*Fourth* (etc.) indorsement requires notarially certified translation, or will pay on banker's confirmation".

Indorsements on Dividend and Interest Warrants.

Warrants for dividends distributed by a company must be discharged by the payee or payees, but, in the case of joint payees, the common practice of accepting the discharge of one payee only (usually the first) is recognised by the Bills of Exchange Act, 1882. The provision does not extend to warrants in respect of *interest* paid on loans, and such orders must be discharged by all payees.

Since a registered company is not allowed to enter in its Register of Members any notice of trust relating to shares, the investments of trades unions, friendly societies, etc., are registered in the names of officials or trustees, who must discharge the warrants in their own names.

The discharge of a dividend warrant in the form "*per pro.*" is not accepted unless a power of attorney has been registered with the company issuing the warrants, hence paying bankers almost invariably require warrants so discharged to bear a statement signed by the issuing company to the effect that a power of attorney has been exhibited to the company in respect of the person signing.

CHAPTER 23

THE PAYMENT OF CHEQUES AND BILLS.

THE legal obligation of a banker to honour the cheques of his customer implies that a banker who refuses or neglects to act upon the mandate of his customer, properly given, may render himself liable for breach of contract, and may have to pay substantial damages for injury to the customer's credit and reputation.

This general obligation of the banker is, however, subject to a number of important provisos First, the customer must have an account upon which the banker usually allows cheques to be drawn, *i e*, a *current* or *drawing* account Secondly, the state of the customer's account must warrant the payment, *i e*, he must either have sufficient funds to his credit in the hands of the banker or there must be an arrangement for an overdraft adequate to cover the cheques Thirdly, the cheques must be signed by the customer and must be drawn in legal form Fourthly, there must be no legal reason or excuse for refusing the payment Finally, in accordance with the provisions of the Act relative to the presentment of bills for payment, each cheque must be presented by the holder or his authorised agent, during recognised business hours at the "proper place of payment," *i e*, the branch where the customer's account is kept, unless there is an arrangement by the bank to encash them elsewhere

Customer must have a Current Account and Sufficiency of Funds.

There is clearly no obligation upon a banker to pay cheques drawn by a customer unless the customer has a *current* account, and the payment is warranted by the state of that account But it is very important that the banker should ensure that the dishonour of the cheque is really justified before it is returned First, it should be ascertained that all credits paid in by or for the customer have been duly entered in his account This safeguard is desirable in the interests of the banker's business, although legally the customer cannot regard money paid in as being immediately available Even in the case of actual cash, the banker is entitled to a reasonable time in which to make the necessary entries in his books

Secondly, if the customer has more than one account in the same right, it is advisable although not essential to ascertain whether the

combined balance on all the accounts will justify the payment, since it is possible that the customer may have relied, in drawing a cheque, on his having on balance more funds at the branch than were necessary to meet it Finally, if the customer has a *deposit* account but not a current account, the banker, though quite justified in returning cheques drawn against the former, would usually be better advised to notify his customer so that the necessary arrangements for payment can be made

In ascertaining whether a customer's balance is sufficient to warrant payment of a cheque, the banker is justified in reserving sufficient funds to meet any outstanding cheques which he may have marked at the customer's request, or for clearing purposes

Much controversy surrounds the question as to whether a banker who has credited a customer with the amount of items paid in for collection is entitled to refuse payment of cheques presented before the proceeds are received The judgments in the famous *Gordon Case*, 1903, left the matter in doubt, but, in the more recent case of *Underwood* v *Barclays Bank*, 1924, the Court of Appeal made it clear that, in the absence of an express or implied agreement giving the customer a right to draw cheques against uncleared items, a banker is entitled to return such cheques with the answer "Effects not cleared" As a rule, only customers known to be financially weak are in practice not allowed to draw against uncleared funds, cheques of good customers being usually paid without question

It is not, of course, essential that a customer should have a *credit* balance in order that his cheques should be paid On the contrary, if there is a definite arrangement that the customer may overdraw up to a certain limit, the banker cannot dishonour cheques issued in reliance on such an arrangement without first of all giving reasonable notice that he wishes to terminate the agreement Such notice may, however be given at any time, and, when it has been given, the banker's only duty is to pay cheques which may have been drawn by the customer prior to the receipt of the notice Any cheques subsequently drawn may be refused payment in the ordinary way

Cheques must be Signed by the Customer.

Only in very exceptional cases can a customer be charged with a cheque bearing a forged or unauthorised *signature*, as, for example, where the banker can prove to the satisfaction of the Court that the customer, by his actions, has so misled him as to cause him to pay a cheque which would otherwise have been refused , or if the customer has in some way induced the banker to think that the signature on a cheque is a genuine one , or if the drawer, having received notice of the forgery of his signature to a cheque, does not at once take steps to warn any innocent holder and the banker, so that the latter can refuse payment

of the cheque when presented In any of such circumstances, the customer is "*estopped*", or precluded, from denying that the forged signature is his signature

Moreover, the banker can debit his customer with cheques bearing *unauthorised* signatures if the customer has expressly ratified the actions of his agent in so signing, or if he is estopped from denying their validity, as, for example, when he has not objected over a period to his account being debited with cheques drawn by an agent who has no authority to sign on his behalf

Every case of this kind must be determined by the circumstances, but if a banker is unable to debit his customer with a cheque bearing a forged or unauthorised signature, he is generally entitled to a refund of the money from the person to whom it was paid This right is indisputable if the person who received the money acted without good faith, but if the presenter had *no* knowledge of the forgery, the banker cannot recover unless the money is demanded back within a reasonable time and before the position of the person receiving the payment may have been altered to his detriment

Alteration of the Sum Payable.

The requisite that a cheque must be signed by the customer implies that any material alterations thereof must be duly authenticated by the signature or initials *of the customer*, so that a banker who pays a cheque bearing an *apparent* material alteration which is not authorised by the drawer will be unable to debit the amount to his customer's account

The position is not, however, quite so clear in those cases where a cheque bears a *non-apparent* material alteration.

Until recently it was considered that, so far as the drawer was concerned, a non-apparent material alteration of the amount on the face of a cheque was similar to any other material alteration in its effect of avoiding the instrument except as against a holder in due course, and of rendering the banker who paid the wrong amount liable to stand the loss as having made a payment contrary to his customer's mandate

In the famous case, *London Joint Stock Bank* v *MacMillan and Arthur*, 1918, however, it was decided by the House of Lords that a banker cannot be held liable for having paid a cheque bearing a *non-apparent* alteration of the amount, *if the customer, by his negligence in drawing the cheque, has facilitated the alteration* In this case a clerk of the firm MacMillan and Arthur presented for signature to one of the partners a cheque which he had prepared ostensibly for £2, but with spaces left round the figure 2 and with no amount written in the body of the instrument Having obtained the signature, he altered the cheque to £120 and, the alteration not being apparent, received the money from the bank and absconded.

The firm maintained that the cheque, having an unauthorised material alteration, could not be debited to their account, but, in giving judgment in favour of the bank, Lord Findlay said "A cheque drawn by the customer is in point of law a mandate to the banker to pay the amount according to the tenor of the cheque It is beyond dispute that the customer is bound to exercise reasonable care to prevent the banker being misled If he draws the cheque in a manner which facilitates fraud, he is guilty of a breach of duty between himself and the banker, and he will be responsible to the banker for any loss sustained by the banker as a natural and direct consequence of this breach of duty The customer is bound to take usual and proper precautions to prevent forgery"

Legal Reason or Excuse prohibiting Payment.

Apart from any question as to irregularities in the form of cheques presented for payment, a banker's obligation to pay his customer's cheques is determined by any legal reason or process which prohibits him from carrying out his duty In this connection, Section 75 of the Act provides —

> 75 The duty and authority of a banker to pay a cheque drawn on him by his customer are determined by—
>
> (1) Countermand of payment
>
> (2) Notice of the customer's death

In addition, the banker's authority is terminated in any of the following cases --

> (3) Receipt by the banker of notice of the customer's insanity, or bankruptcy, or, in the case of a limited company, of its winding up
>
> (4) Service upon the banker of a garnishee order, or of any injunction or similar order from the Court prohibiting transactions upon the account
>
> (5) Receipt by the banker of notice of an assignment by the customer of the credit balance of his account.
>
> (6) In the case of trust accounts, knowledge that the customer intends to apply the funds in breach of the trust, and
>
> (7) Knowledge of any defect in the title of the person presenting the cheque

The position of the paying banker in relation to garnishee orders and notice of assignment is discussed in Chapter 13

Countermand of Payment.

Only the drawer of a cheque is entitled to stop payment thereof, so, if a banker is advised by the true owner of a cheque that it has been lost or stolen, he should at once advise the drawer of the fact, or request the true owner to do so, with the object of obtaining written instructions

to stop payment of the instrument If in the meantime the cheque is presented, the payment should if possible be postponed pending the receipt of such instructions But if the cheque either originally or by indorsement is payable *to bearer*, the banker may be compelled to pay if the title of the presenter appears to be quite satisfactory, since a full legal title to a bearer instrument vests in an innocent holder On the other hand, if the cheque is payable to order and had not been indorsed by the holder before loss or theft, payment should be definitely refused, as the presenter cannot claim through a forged indorsement

The drawer's right to stop payment of a cheque exists up to the last moment when payment may be made or refused by the banker For example, in the case of cheques presented through the clearing, the banker has up to the close of business on the day of presentment to decide whether he will pay or not, so the drawer's right to stop payment exists until the close of business on that day

A banker is not justified in definitely stopping payment of a cheque in reliance upon instructions communicated by telephone or by an unauthenticated telegram, unless in the former case he is reasonably certain that the instructions are given by the drawer himself or by his known agent The proper course in such circumstances is to postpone payment of the cheque pending confirmation of the stop, a suitable answer being, "Payment countermanded by telegram (telephone), and postponed pending confirmation" Such an answer reasonably protects the credit of the customer, and, at the same time, gives the banker an opportunity of obtaining authenticated instructions from him

In giving a bank instructions to stop payment of a cheque, the drawer must provide sufficient details to enable the banker to identify the cheque beyond all reasonable doubt, and these details must be exact, *e g*, as to the number of the cheque (*Hilton* v *Westminster Bank, Ltd*, 1926)

A banker who pays a cheque which has been effectively countermanded cannot debit the amount to his customer, nor can he recover the payment from the person who received the money unless the recipient acted without good faith or had no title to the instrument

Notice of Death, Insanity, or Bankruptcy.

In order effectively to prevent a banker from paying cheques, notice of his customer's death, bankruptcy, or insanity must be *express* or *constructive* As to what is constructive notice is usually a question of fact, but a banker cannot reasonably be expected to act upon unconfirmed rumours, though he cannot safely disregard information which is apparently reliable, as, for instance, an announcement in a responsible newspaper

Considerable difficulty surrounds the question as to the precise moment when a banker's authority to pay cheques is revoked by reason of his customer's bankruptcy As from the date of the *commencement of the bankruptcy*, all property of the debtor, including the balance on his current account (if any), vests in the trustee, who, by virtue of the doctrine of "Relation back," can with certain exceptions claim any such property which has passed through the debtor's hands or through the hands of third parties since that date In practice, difficulty arises by reason of the way in which this date is fixed, for Section 37 of the Bankruptcy Act, 1914, provides that a person's bankruptcy relates back to the date of the act of bankruptcy upon which a receiving order is made against him, or, if he has committed more than one act of bankruptcy, to the date of the first of such acts committed within three months before the presentation of the petition

The general result is that the trustee can reclaim from the debtor's banker any funds of the debtor paid out by the bank *after the commencement of the bankruptcy*, as defined by Section 37, *unless* the payment is protected by Sections 45 and 46 of the Bankruptcy Act, 1914 Section 45 protects payments by or to *the bankrupt himself*, provided (*a*) that they take place *before the date of the Receiving Order*, and (*b*) that the person receiving or making the payment has *no notice of an available act of bankruptcy* Section 46 protects payments made *before the date of a receiving order* provided (*a*) that the payment is made to the *debtor* or his *assignee*, (*b*) that, at the time of payment, the person paying has *no notice of the presentation of a bankruptcy petition*, and (*c*) the transaction is pursuant to the ordinary course of business or is otherwise *bonâ fide*.

Thus, a payment by a banker *to the debtor himself* in good faith and in the ordinary course of business will be protected even if the banker knows of an available act of bankruptcy, *so long as* he has no notice that a petition has been presented against the debtor, if such is the case, and so long as the payment is made *before the date of the Receiving Order* But this protection does not extend to payments made by cheque[1] *to third parties*, so that if, after the debtor has committed an available act of bankruptcy, the banker pays a cheque drawn by the debtor in favour of *a third party*, the banker may have to refund the money to the trustee if the debtor is afterwards made bankrupt, even though the banker *had no knowledge of the act of bankruptcy* Except as is provided by the Bankruptcy (Amendment) Act, 1926, dealt with below, no transactions with a debtor are protected after a Receiving Order has been made *whether the banker has knowledge of the order or not*, so that if cheques are paid after the date of the order the banker may be called upon to repay their amount to the trustee

1 N B —In England and Wales (but not in Scotland) a cheque does not operate as an assignment of funds in the hands of the drawee (Section 53), so the holder of a cheque is not an *assignee*, within the meaning of Section 46 of the Bankruptcy Act, 1914

Postponement of Advertisement of Receiving Order.

The words in italics in the preceding sentence are of importance, for bankers are not always able to ascertain that a Receiving Order has been made, particularly if the Court in the interests of the debtor suspends publication or advertisement of the Order

The hardship of this position was clearly brought out, but unsuccessfully challenged, in the case of *In re Wigzell*, 1921, where the advertisement of a Receiving Order made against a debtor was postponed by the Court, and, during the postponement, the debtor's bankers, without any knowledge of an available act of bankruptcy or of the Receiving Order, received £165 to the debtor's credit and paid out £199 against cheques drawn by him It was held in two lower Courts and confirmed by the Court of Appeal that the banker was liable to refund the £165 received by him to the trustee subsequently appointed and that he could not take credit for the sum of £199 paid out

This injustice was to some extent removed by Section 4 of the Bankruptcy (Amendment) Act, 1926, which now protects a banker who, without notice of a receiving order having been made against his customer, pays or transfers money or property of that customer to a third party on or after the date of the receiving order *but before notice thereof has been gazetted in the prescribed manner* But the banker will be protected *only* if the trustee can recover the money paid from the person receiving the payment, so that, if that person cannot be traced or cannot be made to pay, the banker will have to make good the amount to the estate as in the past

In view of these considerations, the banker's best safeguard is to keep himself as fully informed as possible in regard to the general standing of his customers, and to refuse to transact business with, or to discontinue business with, persons whose financial position is known to be unsound All operations on an account should be suspended as soon as the banker receives notice of the presentation of a petition or of the making of a Receiving Order against the customer If a trustee is subsequently appointed, any credit balance vests in him and will in due course be claimed, but if no Receiving Order is made and no trustee is appointed, the banker should not permit dealings with the balance unless and until he is satisfied that the threat of bankruptcy and the likelihood of his being involved in loss are removed

Knowledge by the Banker of an intended Breach of Trust.

A banker must refuse payment of cheques drawn upon a trust account if he has reliable notice that the drawer is committing a breach of trust But this does not imply that the banker must query every cheque drawn, he is liable only if the circumstances are such that any reasonable man would be put on inquiry

Defect in the Title of the Presenter.

In any case where the paying banker has good grounds for suspecting that the presenter's title to a cheque is defective, payment should be postponed pending inquiries or pending the drawer's confirmation By so doing the banker incurs no liability either to the holder or to the drawer So far as the holder is concerned, there is no privity of contract between him and the banker, so that he has no right to enforce payment against the banker even if he has an absolute title to the instrument, *e g*, if he is a *bonâ fide* holder for value of a bearer cheque On the other hand, the drawer could not claim that his credit was damaged if the banker postponed payment in the circumstances mentioned

The Payment of Post-dated Cheques.

Although the Bills of Exchange Act provides that a cheque is not to be regarded as invalid by reason of its being post-dated, considerable care must nevertheless be exercised by a banker in regard to cheques which bear a date after that on which they are presented for payment The position is, in fact, fraught with such danger that it is the general banking practice to return all cheques of this kind with the answer "Post-dated", with or without the addition of the words "will pay on drawer's confirmation"

The guiding principle in regard to a post-dated cheque is that it must not be paid or debited to the drawer's account until the date indicated thereon, for unless the drawer has made an obvious mistake, it is to be presumed that in issuing the cheque his intention was that it should not be paid until the arrival of the date written by him Hence, a banker who pays a post-dated cheque before its date is virtually disobeying his customer's mandate, and will consequently have to stand any loss which results from his action, as may arise, for example, if the cheque has been lost or stolen and is "stopped" by the drawer before its date Moreover, the banker may render himself liable to an action for damages for injuring his customer's credit, if, through having paid such a cheque against a customer's balance, he is compelled to dishonour cheques subsequently presented because the balance is insufficient Finally, if the banker seeks to protect his customer by paying the cheque but not debiting his account until the due date, the customer may fail in the meantime and the banker be left with the cheque on his hands

Cheques must purport to be Properly Indorsed.

While the paying banker must obtain for his customer a reasonable and proper discharge on each cheque payable to order, and is, therefore responsible for seeing that the indorsements on all such cheques are technically correct and apparently in order, it would obviously be unreasonable to expect him to accept responsibility for the *authenticity*

of the signatures He cannot possibly know the signature of every holder through whose hands a cheque may pass in the course of its career

Yet, in order to obtain an effective discharge, a banker must pay a cheque "*in due course*", and payment in due course is defined by Section 59 (1) as "payment made at or after the maturity of the bill to the holder thereof in good faith and without notice that his title to the bill is defective"

In paying cheques, therefore, a banker runs the risk that if he pays a person who is *not the holder*, as, for example, a person who holds a cheque by virtue of a forgery, the payment will not operate as a discharge unless the banker brings himself within the scope of the protection afforded by the Act and discussed below.

The Protection of the Paying Banker.

Fortunately, the difficulties with which banks are faced by reason of forged or unauthorised indorsements were recognised at a comparatively early stage in the development of the cheque system, and statutory protection in this regard is afforded to them by three important sections of the Bills of Exchange Act, 1882, *viz*., Nos 60, 79 and 80

Section 60 protects the paying banker in the following terms against forgery on cheques paid by him on account of his customers —

> **60** When a bill payable to order on demand is drawn on a banker, and the banker on whom it is drawn pays the bill in good faith and in the ordinary course of business, it is not incumbent on the banker to show that the indorsement of the payee or any subsequent indorsement was made by or under the authority of the person whose indorsement it purports to be, and the banker is deemed to have paid the bill in due course, although such indorsement has been forged or made without authority

While this section applies generally to *all* cheques, whether *crossed* or *uncrossed*, the Act imposes on the paying banker certain additional duties in regard to the payment of *crossed* cheques, and provides that, if those duties are properly discharged, the banker will be afforded a certain degree of additional protection

Section 79 provides that a paying banker will be liable to the true owner of a crossed cheque for any loss which that owner may sustain if (*a*) he pays a crossed cheque otherwise than to a banker, or, if it is crossed specially, otherwise than to the banker named in the crossing, or his agent for collection being a banker, or if (*b*) he does not refuse payment of a cheque crossed to more than one banker

On the other hand, the paying banker is protected by Section 79 against the claims of the true owner if he, in good faith and without negligence, pays, either to someone other than a banker, or to someone other than the banker named, a cheque which bears a non-apparent or obliterated crossing, or a crossing which has been added to or altered

otherwise than as authorised by the Act, provided, in the latter case, that the alteration or addition is not apparent The Section further provides that a payment so made shall be valid as against the drawer Still more general protection to the banker paying crossed cheques is afforded by Section 80 in the following terms —

> **80.** Where the banker, on whom a crossed cheque is drawn, in good faith and without negligence pays it, if crossed generally, to a banker, and if crossed specially, to the banker to whom it is crossed, or his agent for collection being a banker, the banker paying the cheque, and, if the cheque has come into the hands of the payee, the drawer, shall respectively be entitled to the same rights and be placed in the same position as if payment of the cheque had been made to the true owner thereof

In brief, therefore, the paying banker is protected against forged indorsements (*a*) on *uncrossed* cheques, by Section 60, provided he pays in good faith and in the ordinary course of business, (*b*) on *crossed* cheques, by Sections 60 and 80, provided he pays, in good faith and without negligence, in accordance with the crossing, and in the ordinary course of business

Provided the banker brings himself within the requirements of these Sections, the payment of the cheque is good for all purposes, so far as he is concerned, even though payment is made to a banker collecting for a person who has no right to the instrument, or even though the cheque bears a forged indorsement But to obtain the protection, the banker must strictly comply with the various provisions of the Section which applies in the particular circumstances

"Good Faith".

Both Sections 60 and 80 require payment to be made in *good faith*, which is, of course, a matter that can be decided only from the facts of each case According to Section 90 of the Act, "A thing is deemed to be done in good faith, within the meaning of this Act, where it is, in fact, done honestly, whether it is done negligently or not" And as Sir John Paget points out[1], "It is difficult to conceive, still more to formulate, conditions involving absence of good faith on the part of a corporation, such as a Joint Stock Bank, with relation to paying cheques" Nevertheless the bank will be responsible for lack of good faith on the part of any of its employees, so that it would be liable under this Section if a cheque were paid by a cashier in spite of the fact that he had good reason to doubt the genuineness of an indorsement.

Payment Must be Made "In the Ordinary Course of Business"

The phrase "the ordinary course of business", used in Section 60, is not so difficult to appraise There is little doubt that the payment

1 *Law of Banking*, 3rd edn., page 240.

would be out of the ordinary course of business within the meaning of the Section if the banker paid a cheque bearing a forged indorsement an unreasonable time before or after his usual business hours, or if he paid a cheque without examining the indorsements thereon, or if he paid a *crossed* cheque otherwise than in accordance with the crossing as required by Section 79 of the Act

Payment of a cheque in due course and in the ordinary course of business does not necessarily imply that *cash* for a cheque is to be handed across the counter The cheque is duly paid either by the transfer to the holder of the amount in legal tender currency or by the holder's unconditional acceptance of the banker's own draft or cheque in full discharge, or merely by entries in the banker's books, *i e*, as between one customer and another, or as between the paying banker and the collecting banker

In the case of an *uncrossed* cheque, which either originally or by indorsement is payable *to bearer*, such payment will be valid even though the person in possession of the cheque is not the true owner, either because he has found or stolen the instrument, or because he has knowingly taken it from a finder or thief And payment will be valid even though a cheque, ostensibly payable to bearer, actually bears a forged indorsement

When payment is made in legal tender over the counter and there is no question of a mistake of fact as between the banker and the recipient, the payment is complete and irrevocable as soon as the presenter of the cheque touches the money, and this is so even though the banker finds out before the presenter leaves the bank premises that the drawer's account does not justify the payment, or that he has overlooked a "stop" placed against the cheque

Payment in due course is also made if the banker sends by post legal tender or a draft, in exchange for a cheque presented by the drawer or another banker through the post, for Section 45 of the Act provides that "Where authorised by agreement or usage a presentment through the post office is sufficient" But this should not be taken to apply to the holder of a cheque as distinct from the drawer or another banker, and any cheques so presented for payment by a holder should be returned with the request that they should be presented by the holder in person or through a banker

Cashing Crossed Cheques.

Since Section 79 prohibits payment of a crossed cheque to anyone other than a banker, or to the banker named if the cheque is specially crossed, the banker on whom a cheque is drawn runs a serious risk if he cashes a crossed order or bearer cheque over the counter for a customer or for a stranger By so doing, the banker not only places himself

outside the protection afforded by Section 60, in that he pays other than "in the ordinary course of business", and by Section 80, in that he pays other than in accordance with the crossing, but he also becomes directly liable under Section 79 if it turns out that the cheque was wrongly appropriated In such circumstances, not only will the banker have to pay the amount of the cheque to the true owner as damages for conversion of the latter's property, but he will also be unable to insist upon debiting the amount to the drawer's account, since payment of a crossed cheque in contravention of the crossing constitutes disobedience of the customer's mandate Hence, the banker stands to lose the amount of the cheque *twice* over, unless the drawer, in the event of the money having actually reached the payee, charitably permits the banker to debit the cheque to his account For these reasons, the paying banker is never really safe in cashing a crossed cheque over the counter unless he is paying it to another banker

Cheques Crossed "Not Negotiable" and "A/c Pay Only".

The fact that a cheque is crossed "Not negotiable" ar evidence, in the form of more than one indorsement, that negotiated or transferred, does not deprive the banker wh the protection of Section 80, on the ground of negligence previously pointed out, a "not negotiable" crossing d the cheque *not transferable* The words merely act as a w transferee of such an instrument shall not be capabl better title to it than was possessed by his immediate duty is imposed upon the paying banker to inqui title was, in fact, passed when the instrument was

The same position arises if the cheque bears o unauthorised additions to a crossing as "Account P Payee only" or "Account A B", with or without transferable" or "not negotiable" There is nothi to prevent payment of a cheque even though it h ments, although the paying banker is justified in re as ambiguous or embarrassing documents which he such answer as "Form of cheque irregular" or In practice, most bankers now refuse to *collect* suc the account of the payee, so that paying banke troubled with these points

"Not Transferable" Cheques.

The position is, however, quite different in the ca are clearly intended to be "not transferable", pro that the cheque is not transferable is indicated i

manner, as, for example, where it is drawn payable to "John Brown *only*", or "John Brown, *not transferable*", with the words "Order" or "Bearer" crossed out and initialled by the drawer, and with or without the words "not transferable" written on the face of the instrument

Unless the paying banker takes reasonable steps to ensure that the proceeds of such an instrument actually reach the payee, he will lose the protection of Section 60 on the ground of not having paid in good faith, and of Section 80 on the additional ground of negligence Accordingly, a not transferable cheque, if presented by another bank, should be paid only if the collecting banker confirms that the money has been placed to the credit of the payee If the cheque is presented over the counter, it should be paid only on proof that the presenter is the payee, or someone authorised to receive payment of the cheque on his behalf In no case should such a cheque be paid if it bears any evidence that it has been transferred, otherwise the paying banker will incur liability to the true owner, and be unable to debit his customer with the amount thereof

ıt of Documents other than Cheques.

Section 60 of the Act applies only to bills of exchange pay and drawn on a banker, *i e*, cheques proper as defined by similar but *wider* protection is afforded to bankers by he Stamp Act, 1853, which applies to *any document drawn* the payment of money to order on demand The latter e, protects the banker in respect of instruments which heques as, for example, a banker's draft on demand ch on another branch, or drawn by a branch on head Such documents do not fall within the definition e they are not addressed *by one person to another*, a fice of the same bank, or two branches of the same l in the eye of the law as one and the same entity tion is afforded to bankers in respect of *crossed* Section 17 of the Revenue Act, 1883, which is 9

ık's Liability.

ker does not bring himself within the protection of Section 80, he cannot debit the amount of a cheque orsement to the account of his customer, and if the debited it must be refunded

crossed, the crossing is to be construed as part of date, whether it is put on by the customer himself nolder, and that mandate must be implicitly obeyed

if the banker is to be regarded as having paid in due course If the banker disobeys that mandate in any particular, he will be unable to debit his customer with the amount of the cheque, and he will be liable to the true owner of the cheque, *i e*, the person who is legally entitled to the instrument and its proceeds, in an action under Section 79 of the Act, and, if such an action succeeds, the banker will be compelled to pay the value of the document to the true owner, being left to recover if possible from the person to whom the cheque was paid It follows, therefore, that a banker may have to pay the amount of a cheque *twice*, once to or for the person fraudulently obtaining the money, and once to the true owner

It should be observed that the true owner of a cheque is not necessarily the drawer, so that this liability of a banker to a *third party* is an exception to the general rule that, in paying cheques, he is accountable only to his customer

Marking Cheques as "Good" for Payment.

The "marking" of a cheque means the placing thereon of the signature or initials of a banker (accompanied, as a rule, by the word "Good"), in indication of the fact that at the time of the marking he has in his hands sufficient available funds of the drawer to justify his regarding the cheque as being "good" for payment The exact legal significance of such a marking depends upon whether it is done on the instructions of the drawer, or at the request of the payee or holder, or of another banker, but its general effect is to facilitate negotiation or acceptance of the cheque as a means of payment

Marking a Cheque on the Instructions of the Drawer.

A customer sometimes requests his banker to mark his cheque as good for payment when he wishes to satisfy the payee that there is not the slightest doubt that the cheque will be met, as, for example, when the cheque is being taken by the payee in exchange for the deeds of a house, or in payment of a bill of exchange, or in payment for negotiable securities If the banker complies with such a request, he is thereafter justified in regarding the cheque as having been constructively paid He can retain on the account sufficient funds to meet it when presented, and, if necessary, dishonour any cheques subsequently presented which would deplete the amount so retained

A cheque marked at the drawer's request may be paid when it is presented even though in the meantime the drawer may have died, or become bankrupt or insane, and even though a garnishee order is served on the banker attaching the balance on the drawer's account, for funds to the amount of the cheque are regarded as having been definitely

appropriated to meet it. Furthermore, the drawer has no right to countermand payment of a cheque marked at his request if the cheque has once left his possession, for the banker, having "undertaken a moral and professional obligation, founded on recognised custom, towards any other banker who may present the cheque for payment,"[1] cannot be expected to agree to a countermand which may operate to his detriment

The marking of a cheque at the request of the drawer does not in any sense *bind* the banker to the payee or subsequent holder, for the marking is neither an admission of liability to pay the instrument nor an acceptance of the cheque within the meaning of the Bills of Exchange Act.

Cheques Marked at the Request of the Payee or Holder.

In this country the marking of cheques at the request of the payee or of a subsequent holder is almost unknown, but, if it is done, the banker cannot be held liable *in respect of his signature or initials* on the instrument, although Sir John Paget[2] apparently inclines to the opinion that, by so marking a cheque at the request of a specific holder, the banker impliedly undertakes to pay the cheque and will be bound to do so, if it is presented by another banker He argues that, as the object of the marking is to facilitate negotiation of the instrument, the banker must presumably stand by his implied guarantee of the validity and value of the cheque for any purpose to which it may thereafter be applied

If, however, the customer stops payment of the cheque after it has been marked but before it is presented for payment, as he is undoubtedly entitled to do if he so desires, the banker cannot pay the cheque to the debit of his customer's account, and if he does pay he will have to bear the loss himself

When, therefore, a request is made by the holder that a cheque should be marked, bankers in this country safeguard themselves where possible by issuing their own drafts payable on demand, thus providing the holder with a fully negotiable instrument and enabling them to debit the amount at once to the account of the customer

Cheques Marked at the Request of Another Banker.

As between bankers and bankers, there is a long established custom whereby cheques received too late in the day for presentment through the usual clearing channels are marked as "Good" for payment by the paying banker, at the request of the collecting banker

[1] Paget, *Law of Banking*, 3rd edn , page 194
[2] *Law of Banking*, 3rd edn., page 196.

The marking of cheques in accordance with this custom undoubtedly constitutes a constructive payment of the cheque by the banker, entitling him specifically to appropriate the necessary funds of the drawer to meet the cheque when it is finally presented, and to return any cheques presented subsequent to the marking which would deplete the funds so appropriated It cannot well be otherwise, for this marking of cheques for clearance purposes has been legally recognised as an implied undertaking or promise to pay on the part of the banker on whom the cheque is drawn

It follows, therefore, that the appropriation by the paying banker of funds to meet a cheque marked for clearing purposes is on a par with such an appropriation made in respect of a cheque marked at the request of the drawer, and is not affected by the drawer's death, bankruptcy, or insanity, or by the service of a garnishee order attaching the balance of his account The money is regarded as having been specifically applied for a particular purpose which the banker is bound to fulfil, and thereafter payment of the cheque cannot be countermanded by the customer

The Dishonour of Cheques by Non-Payment.

The provisions of Section 47 regarding the dishonour of bills by non-payment apply generally to cheques, so, on the dishonour of a cheque, an immediate right of recourse against the drawer and indorsers accrues to the holder, and he can, if necessary, bring an action against them to enforce payment

This right is, however, subject to the holder's giving proper notice of dishonour in accordance with the rules set forth in Sections 48-50 of the Act The notice may be given in writing or by personal communication, but must be given within the prescribed time to the drawer and indorsers, or their authorised agents, otherwise such parties will be discharged

In the case of the drawer, notice is *dispensed with* if the drawee-banker is under no obligation as between himself and the drawer to pay the cheque, or if the drawer has countermanded payment The effect of this is that the drawer need not be given notice of dishonour if he has no funds at the bank, or if he has stopped payment, or if the banker is relieved of his obligation to pay because the drawer is dead, bankrupt, or insane But the drawer should at once be given notice if the cheque is dishonoured on technical grounds, as, for example, because it is incomplete or irregularly drawn.

The return of a dishonoured cheque to the drawer or an indorser is, in point of form, deemed a sufficient notice of dishonour [Section 49 (6)] If, however, the holder has any doubt as to the drawer's integrity or worth, he should forward a separate notice of dishonour, and retain the cheque pending a settlement

The Return of Unpaid Cheques.

As to what is a reasonable time for giving notice of dishonour is defined in Sub-section 49 (12) By virtue of these provisions, a paying banker must *legally* return an unpaid cheque presented by a person residing in the same place (including a banker presenting through the local clearing) in time to reach that person not later than *the day following receipt*, while he must return a cheque presented by post by a person residing in a different place not later than the day following receipt, or, if there is no post on that day, by the first post thereafter

This is the legal position, but it may be varied by the custom and practice of bankers in connection with the local and central clearings, the rules of which must be strictly followed, otherwise the banker may lose his protection in connection with the payment and collection of cheques In regard to local clearings, it is usually provided that cheques must be paid or returned on the day of receipt, and the same rule operates between the City banks in regard to cheques presented through the Town Clearing By the Rules of the Clearing House, unpaid Metropolitan and Country cheques must " be returned by post *on the day of presentation* direct to the Bank or Branch Bank whose name and address are on the crossing " Thus, although a country branch has *legally* until the close of the day following presentation in which to pay or return a cheque received in the clearing, the recognised practice of bankers requires that unpaid cheques must be sent off on *the day of receipt*, and this rule must be obeyed

This principle does not, however, apply to cheques presented *direct* by post, in which cases the paying banker may exercise his legal right to return unpaids by post on the day following receipt In practice, however, such cheques are returned on the day of receipt, and a paying banker holding a cheque over until the next day would, as a matter of courtesy, advise the presenting banker of the fact Similar remarks apply in the case of cheques presented for payment by another customer of the same branch

The Rules of the London Clearing House provide that " No Return can be received without an answer in writing on the Return why payment is refused " Accordingly, the reason for the return of a clearing cheque unpaid is clearly written on the face of the instrument by the paying banker, this practice applying also to cheques presented through the local clearing

A cheque which is presented by the holder in person must at once be paid or refused payment, unless the banker has very good grounds for postponing payment, as in the circumstances which have previously been referred to The banker is not, however, compelled to give a reason for dishonour in such a case, although it is usual in practice to write the reason on the cheque

Cheques which are dishonoured on account of the insufficiency of available funds should be marked "Refer to drawer" in preference to "Not sufficient", for the latter answer may be regarded as giving undue information concerning the state of the customer's account As has been pointed out, the banker is entitled to have cheques drawn in clear and unambiguous form, otherwise he cannot reasonably be expected to carry out the letter of the customer's mandate He is, therefore, justified in returning as irregularly drawn cheques which do not conform to the accepted requirements On the other hand, if the banker can without difficulty get into touch with the drawer, it is always better to have a mistake rectified or confirmed by the signature or initials of the drawer himself than to return the cheque, for the return usually gives trouble to the holder, to the drawer and to the bank itself

Payment of a Customer's Bills.

In the absence of an express or implied agreement, a banker is under no obligation to pay bills of exchange, other than cheques, which are accepted payable at the bank by the customer, although such an acceptance is in itself a sufficient authority to the banker to pay the bill and to debit his customer with the amount

In practice, however, bankers usually take from their customers an authority on a special form to pay bills which are domiciled with them, the authority embodying an undertaking by the customer that he will not hold the banker liable if it should turn out that the bill or bills bear a forged indorsement or forged indorsements If such an indemnity is not given, a banker cannot debit his customer with the amount of a bill which has been paid to a person claiming through a forged indorsement, for, as was clearly indicated in the case of *Vagliano Bros* v *Bank of England*, 1897, payment to such a person does not operate as a discharge of the bill

In paying bills accepted by his customer a banker has no special protection under the Bills of Exchange Act, 1882 Moreover, the payment of bills does not arise out of the ordinary relationship of banker and customer, and, in assuming this duty, a banker merely undertakes the work of an agent acting on behalf of a customer As an agent he must pay in good faith, without negligence and in the ordinary course of business This means that payment must be made in the usual banking hours on a business day, in accordance with the usual banking practice, and without notice of any defect in the title of the person presenting the bill for payment The bill must be examined to see that it is correct as to form, that it contains no material alterations unauthorised by the drawer, that all indorsements are complete and in order, that the acceptor's signature is genuine, that the bill is properly stamped, and that it is not overdue Furthermore, payment must not be made

if the acceptor has given the banker instructions not to pay, or if the banker's authority to pay is revoked by reason of the death, bankruptcy, or insanity of the customer

Subject to these conditions, and assuming there is no question of forgery, a banker is perfectly safe in paying a customer's acceptance even over the counter to a person who appears to be in *bonâ fide* possession thereof—*Vagliano Bros* v *Bank of England*, 1897, *Auchterlonie & Co* v *Midland Bank Ltd*, 1928

In no circumstances would a banker be wise in undertaking to pay bills domiciled with him by a person who is not a customer Nor should a banker undertake to remit by post cash or a draft in exchange for a bill domiciled with him In such a case the holder should be required to present the bill for payment at the branch of the bank at which it is domiciled, either personally or through his known agent, or through another banker

Bills to be Retired.

Bankers with whom bills are domiciled are sometimes requested by their customers to pay the instruments before they actually fall due, in which event, the bills are said to be "retired" or withdrawn from circulation The arrangement not only permits the acceptor to discharge his liability on the bill as soon as he has the necessary funds available, but also enables him to obtain possession of any documents of title to goods which may be attached to the instrument, and which are deliverable only on payment of the amount of the bill

As a rule, payment of a bill before its due date is made *under rebate*, *i.e.*, the acceptor is allowed a deduction from the amount of the bill equal to the interest on that amount for the unexpired period which the bill has still to run before maturity Such interest is calculated at $\frac{1}{2}$ per cent per annum above the current rate allowed on short deposits by the London joint-stock banks

As a bill of exchange is not paid in due course until it is paid "at or after maturity" (Section 59), a retired bill is not discharged and must not be cancelled by the holder, or by the banker who pays it on behalf of the customer On receipt from the holder the bill should merely be handed to the acceptor or kept at the bank pending receipt of his instructions.

CHAPTER 24

THE COLLECTION OF CHEQUES AND BILLS.

As a general rule, a banker who collects the proceeds of cheques, bills, and other documents is in the position of an agent acting on behalf of his principal—the customer, and, as such, he incurs certain liabilities if he fails properly to discharge the duty entrusted to him. The actual extent of this duty will depend upon the facts of each particular case and upon the recognised practice in the circumstances, but a banker will in any case be liable to his customer for any loss or damage which may result from his negligence or omission to use reasonable care, skill, and diligence

In carrying out the functions of a collecting agent, the banker has no duty towards the persons from whom the proceeds are collected, and he incurs no responsibility in the event of any loss arising, so long as he acts in good faith and does not give any personal undertaking or make any misrepresentation concerning the documents Thus, a banker who presents a documentary bill for payment incurs no responsibility if the documents are not in order, and is not liable if he does not ensure that they are genuine

Banker Collecting on his Own Behalf.

A banker is sometimes placed in the position where he is regarded as collecting cheques and bills *on his own behalf*, as, for example, where he has cashed open cheques over the counter, or where he is collecting the proceeds of cheques specifically paid in to reduce a loan due to him or where he is collecting cheques against which he has already given his customer the right to draw, although the proceeds have not actually been received

In such circumstances (assuming, of course, that he acts in good faith and fulfils the other requirements of Section 29) the banker becomes "a holder in due course" of the instrument collected, and is legally regarded as collecting the proceeds for himself, although such proceeds ultimately rest in the customer's account. When he collects merely as an agent, the banker is in the position of a "holder", from the fact that he is technically the bearer of instruments which either originally or by indorsement are payable to bearer. But in no case does he become liable *on the instrument* itself unless it is signed by him or on his behalf

The Liability for "Conversion" and for "Money had and Received."

In one important respect the collecting banker runs a risk of incurring liability to persons other than the customer for whom he collects, and that is in respect of the common law obligation imposed upon any member of the community to refrain from "converting" property belonging to another *Conversion* means the wrongful interference with the goods of another, which is inconsistent with the owner's right of possession, and may be constituted by taking, using, or destroying the goods or exercising over them some control which is inconsistent with the owner's right For the purpose of this definition the term "goods" includes a bill of exchange, cheque, or promissory note

From a banker's point of view, possibly the most important fact is that the wrong of conversion may be committed *in perfect innocence*, so that immunity from liability in this respect cannot be secured even by the exercise of the utmost care and skill Moreover, the liability exists even in the case of a person who is acting merely as an agent for another, for conversion is a *tort* which renders the person committing it *personally* liable, in addition to rendering liable the principal on whose behalf the agent was acting when the wrong was committed Nevertheless, the person suing can recover damages from one party only

Thus, it follows that, if a banker can be shown to have converted the goods of another, then, however innocently he may have acted, he will be liable to make good the value to the *true owner*

The remedy of the true owner in respect of conversion of his property is to sue the person converting in an action for conversion, trover, or detinue of the property, and if he succeeds he is entitled to the return of the goods or to damages, together with the costs of the action In the case of a negotiable instrument, the damages will be the face value of the instrument

In an action for conversion of a negotiable instrument, it is usual for the true owner to join with his claim for conversion a claim for "money had and received" to his use, the plaintiff being thus free to recover on either ground The claim for "money had and received" against a person who had no knowledge of the rights of the true owner is based on an *implied* promise, which the law *imputes* to a person dealing with the money of another, to repay that money to the lawful owner when it is demanded

When a Banker may be Liable for Conversion.

Since the business of a banker involves such frequent handling of goods and instruments belonging to others, he must, in the absence of statutory protection, run considerable risk of liability for conversion And although he runs the greatest risk of incurring this liability when he

is acting as an agent for collection, he may, as we have seen in the preceding chapter, incur liability for conversion when he acts as a *paying* banker, by paying an instrument to some one other than the true owner

There are *five* cases in which a banker may, *in the absence of statutory protection*, render himself liable for conversion —

1 *Paying a cheque bearing a forged indorsement* Since payment of a cheque to anyone who holds through a forgery is not a payment to the " holder ", it does not constitute a valid discharge of the instrument But a paying banker is safe if he can bring himself within the protection afforded by Sections 60 and 80 of the Bills of Exchange Act, 1882 (Chapter 23) He is also protected by Section 19 of the Stamp Act, 1853, and by Section 17 of the Revenue Act, 1883, in respect of documents other than cheques which fall within those sections (Chapter 25)

2 *Collecting a cheque, bill of exchange, or promissory note bearing a forged indorsement, or in respect of which the customer has no title or a defective title* So far as bills of exchange and promissory notes are concerned, the liability is absolute, but in connection with crossed cheques the banker is protected by Section 82 of the Bills of Exchange Act, 1882 (discussed below), and in regard to certain conditional orders by Section 17 of the Revenue Act, 1883 (Chapter 25)

3 *Paying to a person who holds under a forged indorsement a bill of exchange or promissory note made payable at the bank* In this case there is no statutory protection (Chapter 23)

4 *Taking for value a bill of exchange, cheque, or promissory note bearing a forged indorsement, or a cheque crossed " not negotiable " to which the title is void or defective* A banker who gives value for an instrument in any of these circumstances has no statutory protection, and is liable to the true owner for conversion of his property

5 *Delivering to the wrong person goods which have been entrusted to him for safe custody* (Chapter 19)

The Collection of Cheques for a Customer.

Uncrossed or Open Cheques —In collecting *uncrossed* bearer or order cheques for a customer a banker is afforded no protection, and, in the event of such instruments bearing a forged indorsement, or of the customer having no title or a defective title, the banker incurs the ordinary common law liability for converting the property of the true owner In such circumstances, the banker may be able to debit the amount of the cheque to the customer concerned, but this fact does not release him from his liability to the true owner

If the banker is collecting *uncrossed* order cheques on his own behalf, he is liable to the true owner only if the cheque bears a forged indorsement,

but he can in any case enforce his rights as transferee against any indorsers of the cheque who indorsed after the forgery, and also against his immediate transferor if that person has omitted to indorse If, however, the question is not one of forgery, but is merely one of absence of title or defective title on the part of the person from whom the banker took the instrument, the banker in such a case is a holder in due course with power to enforce payment against all prior parties to the instrument

CROSSED CHEQUES —In regard to *crossed* cheques, whether payable to bearer or order, the banker obtains statutory immunity or protection from his common law liability of conversion by virtue of Section 82 of the *Bills of Exchange Act*, 1882, which provides as follows —

> **82.** Where a banker in good faith and without negligence receives payment for a customer of a cheque crossed generally or specially to himself, and the customer has no title or a defective title thereto, the banker shall not incur any liability to the true owner of the cheque by reason only of having received such payment

The provisions of this section are further extended in the banker's favour by virtue of Section 1 of the *Bills of Exchange* (*Crossed Cheques*) *Act*, 1906, which reads —

> **1.** A banker receives payment of a crossed cheque for a customer within the meaning of section eighty-two of the Bills of Exchange Act, 1882, notwithstanding that he credits his customer's account with the amount of the cheque before receiving payment thereof

This act was passed to negative the effect of the Court of Appeal decision in the famous Gordon Case (*i e , Capital & Counties Bank v Gordon*, 1903), in which it was decided that, by *crediting as cash* cheques paid in by a customer, a banker becomes a holder for value and is to be regarded as collecting *for himself* and not *for his customer*

But it is to be noted that this amendment applies only to *crossed* cheques, and does not therefore affect the banker's position in relation to open or uncrossed instruments Moreover, it is not entirely clear whether the protection afforded by the Crossed Cheques Act is confined to cases where the customer's account is merely credited with the amount of cheques paid in or whether it extends also to cases where the banker has given value for the cheques, as where he has permitted the customer immediately to draw against them. In *Sutters v Briggs*, 1922, Lord Birkenhead expressed the opinion that the latter was the more likely interpretation, but there is no definite ruling on the point If the banker is a holder in due course, he will not, of course, need any statutory protection , but, in cases where he is unable to claim the rights of a holder in due course owing to a prior forgery, or where the cheque bears a "not negotiable" crossing, the question of statutory protection assumes great importance and is one which will ultimately have to be decided by the Courts

Analysis of the Protection Afforded by Section 82.

In order to claim the protection of Section 82, the banker must act strictly in accordance with its provisions, although, as Sir John Paget[1] has pointed out, it is doubtful whether any section of any other Act has been so watered down by legal decisions, with the result that the banker's position is so hedged about with pitfalls and technicalities that the section really affords him but scant protection

First, the banker must act "*in good faith and without negligence,*" and this applies to the *whole* transaction, from the receipt of the instrument from the customer to the receipt of the proceeds from the paying banker Secondly, he must collect *for a customer*, and not for himself or for a person who cannot be regarded as a customer.

Since it is to be presumed that modern joint stock banks do not act otherwise than in good faith in all their dealings, the question of good faith in relation to the collection of cheques is not very important, although a bank will be liable if it is shown that there was an absence of good faith on the part of any of its employees

"Good faith" and "negligence" are not mutually exclusive terms, for Section 90 provides that a thing is deemed to be done in good faith within the meaning of the Act where it is in fact done honestly whether it is done negligently or not

What Constitutes "Negligence"?

The matter of negligence is, however, one of great importance, for although the question as to what constitutes negligence has to be decided in the light of the circumstances, the term is capable of a very wide interpretation, frequently to the detriment of the banker The matter is also of importance inasmuch as the Section imposes on the banker a statutory duty to the true owner to avoid negligence, although it is a general principle that a banker's duty is to his customer and to no other, and, generally speaking, there can be no negligence where there is no duty. Moreover, when a collecting banker relies upon the protection of Section 82, the burden of proving that he has acted "without negligence" is upon him, since the true owner's case is complete as soon as conversion is proved *prima facie* against the banker.

The general test of negligence is whether the person on whom it is sought to impose liability has acted as a reasonable business man would act in like circumstances if dealing with his own affairs, but decisions given by the Courts appear to place the duty of a collecting banker somewhat higher than this, and the ease with which he may deprive himself of the protection of Section 82 is clearly demonstrated by the following cases which have been held to constitute negligence in the collection of cheques —

[1] Gilbart Lectures No. 4, 1916.

1 *Omission to verify the correctness of indorsements on cheques payable to order* The collecting banker must ensure that the indorsements on all cheques presented by him are technically correct and in accordance with the recognised practice Thus in *Bavins, junr, and Sims* v *London & South Western Bank*, 1900, the Court of Appeal held that the collecting banker was negligent in not detecting that an indorsement and a signature to a receipt did not correspond with the name of the payee

2 *Omission to verify the existence of authority in the case of per procuration signatures if there are any circumstances connected with the transaction which should put the bank on inquiry* It was clearly laid down in *Morison* v. *London, County, and Westminster Bank, Ltd*, that Section 25 of the Bills of Exchange Act, which puts a person on inquiry regarding a procuration signature, has no bearing on Section 82, and that it does not in any case give the true owner any right to recover the money once the instrument has been discharged In spite of this, the collecting banker should act with care in accepting procuration indorsements, for, although the mere omission to verify the existence and extent of the authority for such an indorsement is not sufficient to constitute negligence, a wide variety of attendant circumstances have been held sufficient to put the banker on inquiry Hence, a banker should not accept procuration signatures on behalf of limited companies, partnerships, local authorities and official payees, unless he knows that the signatories have the requisite power both to indorse *and to deal with the instruments as they propose*

3 *Collecting for the private account of an official a cheque made payable to his company or firm and indorsed by him on its behalf* This has been so explicitly maintained as negligence in various cases that a banker should exercise extreme care before accepting for credit of a person's private account cheques payable to a company which he represents, and indorsed by him as agent on its behalf (*Hannan's Lake View Central, Ltd*, v *Armstrong*, 1900, *A L Underwood* v *Bank of Liverpool and Martins*, 1924, *Stewart* v *Westminster Bank, Ltd*, 1926)

But, as was pointed out by Mr Justice Mackinnon in *London & Montrose Shipbuilding Company, Ltd*, v *Barclays Bank, Ltd*, 1926, the mere fact that a cheque made payable to a limited company and properly indorsed on its behalf by an agent is paid into a *third person's* private account, does not *of itself* put the bank upon inquiry as to whether the transaction is in order, for, if such were the case, no cheque negotiated by a company to whom it was made payable could be safely collected by a banker without elaborate preliminary inquiries In delivering judgment, Mackinnon, J, said "*Underwood's* case was a totally different case It was no doubt the cheque of a company indorsed by an official of the company and paid into a third party's account, but that third party was the very official of the company who had been indorsing, and it had been going on for a long time"

4 *Accepting for a customer's private account cheques drawn "per pro" by him, or by him and another, on behalf of his firm and made payable either to himself or to another* In *Morison* v *London, County & Westminster Bank, Ltd*, 1914 (decided, however, on other grounds), the Court of Appeal held that the bank was *prima facie* guilty of negligence in accepting for an employee's private account cheques drawn by him "per pro" on his firm's account, either at the same bank or at another bank, the cheques being made payable either to the firm or to the employee himself, and being indorsed by him in his own name or "per pro" the firm, as the cases required Similarly, in *Lloyds Bank, Ltd* v *Chartered Bank of India, Australia, & China*, 1928, the defendant bank was held to be guilty of negligence in collecting for an employee's private account cheques drawn by *him and another* on the plaintiffs' account in favour of the collecting bank

5 *Collecting for a partner's private account cheques payable to the partnership* A banker has no right to assume without inquiry that a partner is entitled to place to his own account cheques payable to the firm

6 *Placing to a customer's private account cheques payable to him in an official or fiduciary capacity*, as, for example, cheques payable to 'Thomas Robinson, Collector of Taxes", "The Collector of Taxes", 'The Collector of Inland Revenue", "Borough Rates", "Water Rates", etc In no circumstances should cheques so payable be accepted for a private account, but the mere fact that a person is a public official, or that he acts in a fiduciary capacity which involves his having other people's money in his hands, does not of itself put the banker on inquiry in regard to other cheques paid in to a private account

7 *Omission to obtain a reference from a new customer*, or to follow up a reference given by a customer on opening an account Thus, in *Cadbroke* v *Todd*, 1914, the bank was regarded as negligent for not having obtained a reference, while in *Turner* v *London & Provincial Bank*, 1903, it was accepted as proof of negligence on the part of a bank that it did not *take up* a reference which was given by a new customer

8 *Taking a cheque crossed "Account Payee" for other than the payee named* The words "Account Payee" or "Account payee only" or "Account James Brown", etc, have no statutory recognition, and do not impair the negotiability of a cheque, but they are now sufficiently recognised in practice and by the Courts that a banker who disregards them and, without making reasonable inquiries, collects a cheque bearing the words for some one other than the named payee, is likely to lose the protection of Section 82 on the ground of negligence in *Akrokerri (Ashanti) Mines, Ltd*, v. *Economic Bank*, 1904, the judge considered that such an addition to a crossing on the face of a cheque constituted a direction to the receiving banker as to how the proceeds of the instrument were to be dealt with *after receipt* This clearly implies that the cheque can be taken and collected only for the named

payee, and would apply as much in the case of a cheque payable to a named payee *or bearer*, as it would in the case of an instrument payable to order

This view was confirmed by the Court of Appeal in *Underwood* v *Bank of Liverpool & Martins*, 1924, where Lord Justice Scrutton stated "While this addition (*i e*, 'Account Payee only') does not affect the negotiability of an order or bearer cheque, I agree with the view that, when such a cheque is paid into the account of a person who is not the payee, the bank is put on inquiry".

But the bank is not expected to make inquiries unless it is in a position to do so So that where a London bank collected for a foreign correspondent a cheque crossed "A/c payee only" and bearing several indorsements, the London bank was not expected to inquire into the validity of the foreign negotiations (*Importers Co*, *Ltd*, v *Westminster Bank, Ltd*, 1927)

9 *Where the operations on an account are of an unusual nature* Sudden increases in the amounts of payments in, or other unusual operations on an account, may be an important factor to be taken into consideration when determining the question of negligence Thus, in the case of *Lloyd's Bank, Ltd.* v *Chartered Bank of India, Australia and China*, 1928, where cheques for large amounts drawn by an official on the plaintiffs' account were paid into an account of a small nature in that official's name, and the funds so paid in were immediately withdrawn by payments to stock-brokers, the bank was held to be put on enquiry as to the source of the payments

Collecting Cheques crossed "Not Negotiable"

The point has not actually been before the Courts, but certain judges have expressed views which seem to indicate that they would regard as negligence the collection of "Not negotiable" cheques for a person other than the payee. There would appear to be little justification for this attitude, however, since a banker in such circumstances can scarcely be accused of acting negligently in the interests of the true owner, as the words "Not negotiable" do not in themselves limit the transferability of the cheque Their legally recognised effect is to operate as a *warning* to transferees that they will be affected with any defects of title, but this effect ceases when such a cheque once reaches the hands of the collecting banker, who is not usually in the position of being a transferee of cheques in his hands for collection.

Estoppel as against the True Owner.

In certain circumstances a banker may escape liability for negligence on the ground that his acts or omissions have been induced or encouraged

by the action or inaction of the true owner, who is thereby estopped from succeeding against the bank on the grounds of conversion. This was the case in *Morison* v *London, County & Westminster Bank*, 1914, where an employee, Abbott, had for years fraudulently paid into his private account cheques drawn by him "per pro" on behalf of his firm, Bruce Morison & Co The employer, Morison, had actual knowledge of some of the misappropriations, but took no steps to warn the bank, or to complain of the transactions, in spite of the fact that he had from time to time received his pass book The Court held that, by his conduct, the plaintiff (*i e*, the true owner) must be held to have adopted the cheques and was, therefore, not entitled to succeed against the bank, in spite of the fact that it was technically guilty of conversion and of negligence The circumstances of this case were exceptional, but it made clear the fact that there is a limit beyond which the Courts will not raise the standard of care which a banker is supposed to exercise in the interests of a person to whom he owes no duty except the general duty of not depriving another of the possession of chattels which belong to him.

"Receives Payment for a Customer".

In order to obtain the protection of Section 82, the banker must act throughout simply and solely *as an agent for his customer* in collecting the cheque and receiving payment of the proceeds, but by virtue of the Bills of Exchange (Crossed Cheques) Act, 1906, already mentioned, the banker is not deprived of the protection merely because he has credited the amount of a cheque in process of collection to the customer's account before the proceeds have actually been cleared

The protection *may* not apply, however, if there are circumstances indicating that the banker is not acting *on behalf of a customer*, as, for example, where he is collecting a cheque of which he is himself the holder for value by reason of having cashed the cheque for a customer or a stranger, or of having explicitly accepted a cheque in reduction of an overdraft, or of having expressly or impliedly agreed to allow the customer to draw against credits as soon as they are paid in, without reserving the right to refuse payment of cheques so drawn (See *ante*, page 330) But a banker does not become a holder for value merely because he credits cheques to an account before he receives the proceeds, for, in the absence of agreement, such entries do not empower the customer to draw at once, nor do they affect the banker's right to return cheques drawn against uncleared items (*Underwood* v *Barclays Bank*, 1924)

If a banker receives cheques payable in words to himself, but accompanied by a request to credit them to a customer, he can properly be regarded as receiving the proceeds on behalf of a customer within the

meaning of the Act. (*Lloyds Bank, Ltd* v *Chartered Bank of India, Australia and China*, 1928)

Unfortunately there is no strict definition in the Bills of Exchange Act or elsewhere as to what constitutes " a customer " for the purposes of this section, and therefore the matter must be decided in accordance with recognised practice and custom Undoubtedly, a person is a customer who has some sort of an account with the banker, whether it is a current, deposit, bills discounted account or a deposit receipt. And a bank collects *for a customer* when it collects for another bank for which it acts as clearing agent. (*Importers Co.* v. *Westminster Bank, Ltd* , 1927)

But in *Ladbroke* v *Todd*, 1914, it was decided that *one* transaction was sufficient to constitute a person a customer, so that a banker would be rightly regarded as acting for a customer in collecting cheques representing the first credit by which an account was opened A person does not, however, become a customer merely by calling at a bank from time to time to cash cheques drawn in his favour (*G W Rly* v *London and County Bank*, 1901)

Sir John Paget has expressed strong disagreement with the decision in *Ladbroke* v *Todd* He considers that one transaction does not make a " customer " within the meaning of Section 82, and contends that there must exist some " use or habit " before the relationship is established But it would doubtless be safer to rely on the decision quoted, particularly as it can be argued that, as soon as the banker assumes the liabilities essential to the relationship of banker and customer, he is entitled to the protection afforded to a banker in respect of his dealings with his customers

Furthermore, " it is conceived that a person who has an account at a branch is a customer, not only of the branch, but of the bank as a whole within the meaning of the Section " [1] If this view is accepted, a branch which collects crossed cheques on behalf of a customer of another branch or of the head office is protected by Section 82 But this protection does not extend to cheques included in credits for customers *of other banks*, in respect of which the collecting banker is liable to the true owner, although he would no doubt be indemnified against loss by the banker for whom the credit was accepted

If the banker is not collecting for a customer, then he must be regarded as collecting for himself as a holder for value, but some difficulty arises in connection with the subject of *banker's lien* A banker has a lien on all cheques, bills and notes of his customer which come into his hands in the ordinary course of business in respect of any loan or overdraft owing to him by the customer, and by virtue of Section 27 (3) of the Act, any holder who has a lien on a bill or cheque is deemed to be a holder for value to the extent of the sum for which he has a lien

What therefore is the position of a banker who collects cheques in respect of which he is deemed to be a holder for value by reason of his having a lien over them? The question remains to be decided by the Courts, but in the opinion of Sir John Paget, the fact that a banker has a lien over a cheque does not warrant his being deprived of the protection of Section 82 on the grounds that he is a holder for value and not an agent for his customer

The Document must be a Crossed "Cheque".

As the section specifically mentions the word "*cheque*", the banker will not be protected unless the instrument collected conforms in all respects with the essential requisites of a cheque which we have previously discussed Accordingly, the section would not apply to drafts on demand drawn by a branch on its head office, or *vice versa*, for such documents do not comply with the requirements that a cheque must be drawn by *a customer on a banker*

Nevertheless, the banker is protected in respect of certain documents *issued by customers* which are not strictly cheques by virtue of the provisions of Section 17 of the Revenue Act, 1883, which is discussed in Chapter 25, wherein consideration is also given to the application of the crossed cheques sections of the Act to dividend and interest warrants

The Cheque must be Crossed generally, or specially to the Collecting Banker.

The protection of Section 82 cannot be obtained unless the cheques collected are crossed generally or specially *when they come into the hands of the bank* seeking the protection, and it is not sufficient for this purpose if the collecting banker crosses the cheques himself

To safeguard himself, therefore, the collecting banker should ensure (*e g*, by inserting a request on his paying-in slips and passbooks) that all cheques for collection are crossed before they are paid in by his customers, who, it will be remembered, have authority as holders to cross cheques either generally or specially, or to add the words "Not negotiable" to an existing crossing

Not Transferable Cheques.

A collecting banker would clearly obtain no protection if he collected for anyone other than the payee a cheque which by its terms was made "not transferable" in accordance with Section 8 (1) of the Act, as, for example, where it was drawn "Pay John Smith *only*" In collecting the proceeds of such a cheque the collecting banker must see that they are received by the named payee, and as evidence of this he is required

in practice to confirm the indorsement of the payee with his own stamp and signature

"Not Liable to the True Owner".

The liability here covered means any liability which the collecting banker might incur in an action by the true owner for conversion, or for money had and received, or for any other reason The true owner of a cheque, as has been previously indicated, is the person who is entitled to the property in and possession of the cheque, and freedom from liability to the true owner implies that the banker is secure from all claims which may be made by or on behalf of any other parties

There can be only one true owner of a cheque or bill, and where, for example, a bearer cheque has been stolen and has come into the hands of a holder in due course, he, and not the person from whom it was stolen, is the true owner A banker therefore incurs no liability in collecting a cheque for a holder in due course, except to that holder and then only for negligence

The Collection of Bills of Exchange.

As the crossed cheques sections of the Bills of Exchange Act, 1882, apply only to cheques proper, a banker obtains no protection if he undertakes the collection of bills of exchange as distinct from cheques on behalf of his customer or, of course, if he collects such instruments on his own behalf In undertaking to collect bills, the banker accepts the functions of an agent for his customer As such, he must strictly carry out the rules laid down by the Act regarding the presentment of bills, and, in the event of his failure to act without negligence or to act in good faith, he will be liable to his customer for any loss which may ensue

A banker is not entitled to refrain from presenting a bill merely because he knows or has been informed that the bill will not be paid by the acceptor, or because he knows that the bill was merely accepted to accommodate the drawer or one of the indorsers If presentment is to be made through another banker or an agent of the collecting banker, the bill must be sent off in time to give such banker or agent reasonable time in which to make the necessary arrangements for the presentment, particularly if the place where the bill is payable or the place of residence of the drawer is distant or difficult of access Furthermore, the collecting agent must, if necessary, be given time in which to determine whether any special expenses will be incurred by the presentment

A banker is liable for delay in making presentment unless such delay is excused by the Act, or for omitting to present the bill at the proper place, or for neglecting to have it duly noted or protested in the event

of non-payment Apart from this, the banker will be liable also to the true owner for conversion or for money had and received if the bill bears a forged indorsement or if the customer has no title or a defective title In such circumstances the banker will usually be able to fall back on his customer, but his liability to the true owner exists quite independently of any such recourse that he may have

If the acceptor wishes to pay, payment should not be accepted in the absence of special instructions unless it is made in legal tender currency, or by draft of a reputable banker or by a marked cheque If an unmarked cheque is offered, the bill should not be surrendered to the acceptor, but should be attached to the cheque and a promise made to deliver it when the proceeds of the cheque are received from the drawee banker Otherwise the banker as agent of the holder of the bill will be deemed to have waived his rights on the bill in favour of his rights on the cheque, and all parties prior to the holder will be discharged from further liability, the holder being left with his right of recourse only on the cheque itself

If the banker is offered part payment of the bill, or a payment on account, he should accept the amount tendered and indorse the bill with a receipt acknowledging the amount received and clearly specifying that it is accepted as a part payment only without prejudice to the rights of all parties liable on the instrument Such a receipt given by the banker in the ordinary course of his business does not require a receipt stamp On no account should the bill be surrendered in such circumstances It should be noted for the unpaid balance, and notice of the dishonour of the bill in respect of the amount unpaid given to all parties liable thereon A foreign bill will also require protesting for the balance unpaid

If a bill is unpaid by the acceptor on presentation it should be at once noted by the bank, and if it is a foreign bill, it should be protested also If a bill payable at the acceptor's place of business is not paid on presentment, a note should be left with the acceptor giving full particulars of the bill and informing him that the bill lies at the bank awaiting payment Then, if payment is not received by the close of business on the same day, the instrument should be noted or protested in the usual way

If the bill has documents attached which are to be given up on payment, the collecting banker should hand over the documents only if he is paid in cash or by a banker's draft or marked cheque, unless, of course, he has any special instructions in this connection from the person on whose behalf the proceeds are being collected In any case it is no business of his in the absence of special agreement to see that the documents are in order, although he must see that all documents received by him are duly transferred to the person entitled to have them.

Short Bills.

Where current bills are left by a customer, they are either credited to his account under discount or held until they become due In the latter case they are called *Short Bills* The expression "short" in this connection does not refer to the time the bill has to run before maturity, but relates to an old custom of entering them in a customer's account and pass-book short of the cash column until they were paid The present-day meaning of *short bill* is a bill left for collection and credit at maturity, as distinct from a bill left for discount

The property in a short bill remains with the customer and should the banker become bankrupt it must be returned to the customer

The Treatment of Unpaid Cheques and Bills.

Upon receipt of a cheque or bill which has been returned unpaid, the collecting banker should at once notify his customer, and will be liable for negligence if such notice of dishonour is not given within the time required by the Act As a rule, cheques and bills returned unpaid are forwarded to the customer from whom they were received, together with a covering letter giving the reason for the return The banker is entitled as a matter of recognised practice to debit his customer's account with the amount of a returned cheque, even though the instrument may not have been indorsed by the customer or even though it may have been cashed for him, or have been applied in reduction of a loan or overdraft granted by the banker

In the case of a cheque which was cashed for a person who is not a customer, the instrument itself should *not* be returned to such person by the collecting banker, but notice of the dishonour should be sent together with a request for immediate payment of the amount If the cheque itself be returned, the banker will be deprived of the only evidence of his right of action against any of the parties to the instrument, including the person for whom it was cashed if that person's indorsement was obtained

Similar steps should be taken in the case of dishonour of a bill which has been discounted for a customer or other person, but the banker cannot hold any person liable if his indorsement has not been obtained to the instrument, except in cases where payment is refused because the instrument bears a forged or unauthorised signature, in which case the transferor will be liable under Section 58 (3) of the Act as having warranted to the banker that the bill was genuine

CHAPTER 25

OTHER BANKING INSTRUMENTS.

In the present chapter it is proposed to consider a number of important instruments (other than cheques and bills) with which a banker has to deal in the course of his business either as a banker or as an agent for his customers

Promissory Notes.

The legal definition of a promissory note is contained in Section 83 of the Act, which reads as follows —

> **83.** (1) A promissory note is an unconditional promise in writing made by one person to another signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money, to, or to the order of, a specified person or to bearer
>
> (2) An instrument in the form of a note payable to maker's order is not note within the meaning of this section unless and until it is indorsed by the maker
>
> (3) A note is not invalid by reason only that it contains also a pledge of collateral security with authority to sell or dispose thereof

Specimen Promissory Note after Date Payable with Interest.

£100 LONDON, *17th September*, 19

Three months after date I promise to pay James Brown, or order, the sum of one hundred pounds with interest thereon at the rate of 5% per annum until payment

THOMAS ROBINSON

In this example, Thomas Robinson is the *maker* (*i e*, the person primarily liable in respect of the promise) and James Brown is the *payee*, who becomes liable on the instrument only if he indorses it to a third person

It will be observed that the definition of a promissory note differs very little from that of a bill of exchange contained in Section 3 of the Act, so that the exact purport of the various terms in the definition of a promissory note can be determined by reference to the analysis of the definition of a bill of exchange in Chapter 20, *ante*.

Although the several requisites of the definition must be complied with, it is not imperative that a promissory note should be in the recognised form indicated above, so that a note running "I, Thomas Robinson, promise to pay" will be quite in order if it is written out by the said Thomas Robinson, even though his signature does not appear at the foot of the instrument Similarly, a note running "I do acknowledge myself to be indebted to A in £100 to be paid on demand for value received" was held to be valid as a promissory note, as the words "to be paid" were construed as embodying a promise to pay.

Section 83 (3) recognises the common practice of taking a promissory note in conjunction with other securities, such as mortgages, bills of sale, etc, as an additional safeguard, for although the mortgage, etc, may be perfectly valid and effectual in itself, the existence of a promissory note signed by the debtor affords a more speedy remedy against him in case of default, and will, of course, prove particularly useful if the mortgage or other security should prove to be worthless

In *Kirkwood* v *Carroll*, 1903, a promissory note was held to be valid which contained the following clause "No time given to, or security from, or compensation entered into with either party, shall prejudice the rights of the holder to proceed against any other party"

A note payable to the maker's order in accordance with Sub-section 83 (2) would be one running "On demand I promise to pay myself or order", but, as provided in the sub-section, is not valid unless and until it is indorsed by the maker If such indorsement is in blank the note becomes payable to bearer, but if the instrument is specially indorsed it becomes payable to order Similarly, a note made by the maker in favour of himself and another person, or a joint note made by two or more persons in favour of one of their number, is not a valid note until it is indorsed by the payee who is also a maker, the general objection in all such cases being that the same party is both promisor and promisee on the same instrument On the other hand, a joint *and several* note signed by two or more persons is valid if payable to one of their number

Signatures on Promissory Notes.

Where a note is drawn by two or more makers, their liability thereon is construed as *joint* or *joint and several* according to its tenor A note which is worded "we promise to pay", and is signed by two or more makers, is a *joint* note only In a joint note, all the makers should be sued together if an action is necessary, for if any party is left out, and, on judgment being obtained against the others they do not satisfy the debt, the party omitted cannot then be proceeded against In other words, the holder of a joint note has *only one* right of action If the maker of a joint note dies, his estate is not liable on the instrument.

The effect of a note made in the terms "We *jointly and severally* promise to pay", etc, is that each party who signs the note is liable for the full amount thereof Action may be taken against all together, or against each separately, and, if, on judgment being given against one, he does not satisfy the debt, action can be taken against the others until the debt is satisfied A note drawn "I promise, etc", and signed by two or more persons, is a joint and several note

Liabilities of the Maker.

The maker of a note (*a*) engages that he will pay it according to its tenor, (*b*) is precluded from denying to a holder in due course the existence of the payee, and his then capacity to indorse, but not the genuineness of his indorsement (Section 88)

The maker of a promissory note is the party primarily liable on the instrument, and in this respect he differs from the drawer or maker of a bill of exchange Generally speaking, the liabilities of the maker of a promissory note correspond with those of the *acceptor* of a bill of exchange, but, whereas the maker of a note originates the instrument and is the party primarily liable, the drawee of a bill is not liable as acceptor until he signs, and, if he does not sign, the drawer is the party ultimately liable Moreover, it will be remembered that (*a*) while a note cannot be made conditionally, a bill may be accepted conditionally, (*b*) the maker and payee of a note are immediate parties in direct relationship with each other, whereas the acceptor and payee of a bill have no direct relationship unless the bill is payable to the drawer's order, (*c*) whereas the maker of a note will be discharged unless the note is presented for payment at the place mentioned in the body of the instrument, the acceptor of a bill is not discharged by the omission to present at the place of payment, unless it is *expressly* stipulated that he will be so discharged unless the bill is presented for payment at the place indicated

In the event of non-payment of a note, the measure of damages recoverable from the maker will be determined as in the case of bills

Presentment of Promissory Notes for Payment.

A promissory note does not, of course, require acceptance, for the signature of the party primarily liable (*i e*, the maker) appears thereon before issue

To render the maker of a note liable, presentment for payment is necessary only when the note is made payable at a particular place, but to render an indorser liable, presentment of a note for payment is *always essential*, and, if the note is expressly made payable at a particular place, then it must be presented at that place, otherwise an indorser

is discharged Moreover, such presentment must be made within a "reasonable time", but in considering what is a reasonable time, regard must be had to the nature of the instrument, and to the purpose for which it was issued Thus, although twelve days has been held to be an unreasonable time before negotiation in the case of a cheque, it was laid down in one case that ten months was not an unreasonable time before presentment for payment in the case of a promissory note on demand which was held as a continuing security

Application to Promissory Notes of the Law Relating to Bills.

The provisions of the *Bills of Exchange Act* apply *mutatis mutandis* to promissory notes in the same way as bills, except for the sections relating to (*a*) Presentment for acceptance (notes are never accepted), (*b*) Acceptance, (*c*) Acceptance *supra protest*, (*d*) Bills in a set, (*e*) Protest,—a foreign note on dishonour requires no protest

In applying the provisions the maker of a note is deemed to correspond with the acceptor of a bill, and the first indorser of a note is deemed to correspond with the drawer of an accepted bill payable to drawer's order

All promissory notes other than those on demand are subject to days of grace, unless the words "Pay without grace" are included, or the note is drawn payable on a certain date *fixed*, *e g*, "I promise to pay John Brown or order the sum of ten pounds on 1st June next, *fixed*" Also, if a note is payable by stated instalments, days of grace apply to each instalment The rules governing the liabilities of indorsers apply to promissory notes as in the case of bills of exchange As a promissory note is not accepted, the period of a note payable after sight is deemed to begin to run from the date on which the instrument is first exhibited to the maker

Bankers are not protected if they pay promissory notes bearing forged indorsements, as Section 60 of the *Bills of Exchange Act* applies only to cheques proper Promissory notes other than bank notes are subject to the Statute of Limitations

A joint and several promissory note differs from a bill of exchange accepted by two or more drawees in the fact that the parties primarily liable on the note (*i e*, the joint makers) are jointly *and severally* liable, whereas the joint acceptors of a bill of exchange (*i e*, the parties primarily liable) are only liable jointly and cannot in any circumstances be liable severally. On the other hand, a promissory note cannot have two makers who are liable in the alternative nor can it have two or more makers who are liable severally, and not jointly and severally Thus a note, signed by two makers, and running "On demand one of us promises to pay", would be invalid.

Material Alteration of a Promissory Note.

In special reference to promissory notes the following have been held to be material alterations sufficient to avoid the instrument as against a party who has not assented to the alteration the alteration of a joint note to a joint and several note, the addition of a new maker to a joint and several note, the erasure or cutting-off of the name of a maker from a joint and several note, the alteration of the place of payment or the insertion of a place of payment where no such place was previously included, the alteration of the stamp or date, and the alteration of the number on a bank note On the other hand, the alteration of the words "Or order" to "Or bearer", or the addition of the words "On demand" on a note in which no time for payment was expressed, have been held to be immaterial alterations insufficient to avoid the instrument as against any parties thereto

Lost Notes.

The maker of a lost promissory note may be compelled to give the holder a duplicate of the same tenor, provided the holder gives a satisfactory indemnity against the claims of all persons who may come into possession of the lost instrument (Section 69) Moreover, if such an indemnity is given, the loss of a note cannot be set up in an action by the holder to recover the amount of the instrument from the maker or other parties thereto (Section 70)

This matter is of special importance in reference to bank notes If the loser of such notes can give the issuing banker sufficient particulars of the instruments to identify them, he may claim fresh notes for the same amount on giving a satisfactory indemnity

But since bank notes are payable *to bearer*, the finder of such a note has a good title to the instrument against all the world except the loser, and if the finder pays a bank note away for value to a person who takes it as a holder in due course, *i e*, without notice that it has been lost, that holder has an absolute title to the note and even the original owner cannot reclaim it from him Moreover, although the finder himself cannot obtain payment of a lost note from the issuing-banker if a stop has been registered against it, a *bonâ fide* holder to whom the note has been transferred for value can insist upon payment, and the banker will be compelled to pay if the answers of that holder to his inquiries are satisfactory

The Doctrine of Principal and Surety Applied to Promissory Notes.

Banks frequently advance money to a customer against a *joint and several* promissory note signed by him and one or more persons who

are regarded as sureties for the due payment of the instrument. In such cases, each of the signers is *prima facie* liable to pay the full amount of the instrument at maturity if it is payable after date, or when the banker demands repayment, if the instrument is payable on demand, and, until comparatively recently, it was generally considered that, if a person who signed as surety was sued in respect of the note, evidence was inadmissible to show that such a person was merely a surety and not a principal. In such cases the general rule of law was held to apply that parol evidence is inadmissible to vary or add to a written contract. Now, however, the principle has been recognised that a person who signs a promissory note as a surety is entitled to prove that the creditor was cognisant of the fact that he was a surety and not a principal, and in certain circumstances he may avoid liability.

The importance of this lies in the fact that the creditor, in such circumstances, must treat the parties in accordance with the relationship of debtor and surety, and not as joint and several debtors equally liable for the due payment of the instrument. Thus the ordinary rules relative to suretyship and guarantees will generally apply, so that any special arrangement made with the principal debtor for payment without the surety's knowledge, or any time given to the debtor by the holder of the note, will operate as a discharge of the surety.

Promissory Notes as Security.

Sometimes an overdraft on current account is secured by a promissory note on demand signed by the customer to whom the loan is granted, or by the customer and one or more sureties. Usually, such a note will be made payable to the bank, but if it is drawn in favour of the customer whose account is secured, his indorsement should be obtained before the instrument is accepted.

A note payable *on demand* thus taken as security will be perfectly valid until the expiration of six years from its date, but, thereafter, action on the instrument will be barred by the Statute of Limitations unless, after the expiration of the period, there is an acknowledgment of the debt in writing, or a payment of interest or part payment of the principal. Accordingly, a banker who thus grants a long period loan against a note payable on demand, should arrange for a new note to be drawn and signed before the expiration of six years from the date of the original note, otherwise he will be unable to sue the makers.

If a note payable *after date* is taken, it cannot, in the absence of evidence to the contrary, be regarded as a continuing security. It should, therefore, be accompanied by a Memorandum of Deposit, signed by the customer and any sureties. This should state that the note is deposited as security for any sums which shall from time to time be due or become due from the customer, whether that advance is obtained

by the customer alone or jointly with other persons, on current account or otherwise, and whether the bank may have taken or may thereafter take any further security for the due payment of the debt The Memorandum will require renewal when the note is renewed

In any case where a note is renewed, the old note should not be cancelled until the new note has actually been signed by the debtor, and, where there are sureties, either by the old sureties or by new sureties acceptable to the bank (See also Chapter 17)

In agricultural districts, bankers frequently advance money to customers for short periods by way of *discounting* promissory notes payable after date There is, of course, no essential difference between this procedure and that involved in discounting a bill of exchange

Conditional Orders to Pay.

Customers such as railway companies, government departments, friendly societies and local authorities frequently issue documents in the form of cheques embodying orders to pay, which, by reason of the fact that the order to the banker calls for fulfilment of a condition before payment can be made, do not conform to the legal requirements that a cheque must be an *unconditional* order in writing Such instruments are often worded "Pay or order, the sum of provided the receipt below is duly signed and dated"

An instrument so worded obviously imposes a duty upon the paying banker to see that the direction is obeyed before payment is made, and accordingly the insertion of such a condition precedent to payment prevents the document from being a cheque within the meaning of the Bills of Exchange Act Moreover, it is doubtful whether such an instrument can strictly be regarded as being payable upon demand, for payment cannot be *demanded* until the condition precedent to payment has been fulfilled A document of this kind does not, in fact possess the essential characteristics of a negotiable instrument, for, even if it is made payable to order or to bearer, it cannot strictly be regarded as being negotiable or even transferable, since it would obviously be incongruous for a banker to pay anyone other than the payee who had given his receipt for the money

Such documents are, however, to be regarded as conditional *only if the condition is imposed on the drawee banker* and not merely on the payee For example, documents are sometimes issued by customers which are precisely similar in form to an ordinary cheque, but bear on the face a note to the effect that an attached receipt must be signed before the instrument is *presented* for payment, or merely such words as "The receipt at back hereof must be signed, stamped, and dated"

Since the direction in these cases is merely *addressed to the payee*, the documents can properly be regarded as cheques, and therefore as fully negotiable instruments (*Nathan* v *Ogdens*, 1905)

Nevertheless, the position of the paying banker in such a case is a difficult one, for although the direction is clearly addressed to the payee, it is nevertheless calculated to catch the eye of the paying cashier, and could be disregarded by him only at the risk that the customer might contend that his instructions had not been fully obeyed Even if a receipt form is merely attached to or stamped on the back of a cheque, and no direction is given that the receipt is to be signed before presentment, the paying banker would run considerable risk in ignoring the existence of the receipt, for while there may be nothing in the order to pay which could be regarded as making it conditional, a duty would undoubtedly be imposed on the paying banker to see that his customer's wishes were fulfilled so far as is reasonably possible

Similar difficulties arise in connection with dividend warrants which bear a statement at the foot to the effect that they will not be paid after the lapse of three months (or other period) from the date of issue, unless they are specially indorsed or initialled by the secretary of the issuing body In *Thairlwall* v *Great Northern Railway*, 1910, it was held that such a statement was addressed to the payee or holder and did not impose a condition on the drawee-banker sufficient to make the document not a cheque

In practice, paying bankers insist upon complete discharges to such instruments before they will honour them upon presentment, but difficulty sometimes arises in obtaining a receipt stamp from the payee or holder, particularly where a receipt has already been sent to the drawer in respect of the amount It must be remembered, however, that the banker's duty is to his customer, and there is no duty in connection with such a cheque as between banker and the payee or holder Accordingly, the banker incurs no liability by insisting upon the completion of such a document in accordance with the customer's instructions If these instruments are made payable to order, the indorsement of the payee will usually be required in addition to his signature to the receipt, whether that receipt appears on the back or on the face of the instrument

Protection of Bankers in respect of Conditional Orders.

If the direction inserted in documents of the type here discussed is such as to make the order to pay conditional, the general effect will be to deprive both the collecting and paying bankers of any protection afforded to them by the Bills of Exchange Act, 1882, in respect of documents which are strictly cheques

In the case of an *open* or *uncrossed* conditional order, neither the collecting nor paying banker obtains any protection as against the true owner, if the payee's signature or an indorsement is forged or if the holder has no title or a defective title to the instrument Section 60 of the Bills of Exchange Act will not protect the paying banker against

a forged indorsement because it applies to cheques only, while Section 19 of the Stamp Act, 1853, probably affords no protection because it refers only to drafts or orders drawn on a banker and *payable to order on demand*, whereas a conditional order is not payable to order unless it is specifically expressed to be so payable and it cannot properly be regarded as payable on *demand*

If a document of this kind is *crossed*, the collecting and paying bankers are brought within the scope of the protection afforded by Section 17 of the Revenue Act, 1883, which reads as follows —

> **17.** Sections 76 to 82, both inclusive, of the Bills of Exchange Act, 1882, and Section 25 of the Forgery Act, 1861, shall extend to any document issued by a customer of any banker, and intended to enable any person or body corporate to obtain payment from such banker of the sum mentioned in such document and shall so extend in like manner as if the document were a cheque Provided that nothing in this Act shall be deemed to render any such document a negotiable instrument

There is no doubt that, by virtue of this section, a paying banker incurs no liability to the true owner of a conditional order if he pays the amount thereof to another banker *for account of the payee*, in good faith and without negligence, and strictly in accordance with the crossing In like manner, the collecting banker is protected if, in good faith and without negligence, he collects such orders *for the payee*, if the payee is a customer

But in view of the last clause of this section that "nothing in this Act shall be deemed to render any such document a negotiable instrument", it is not quite clear whether the paying and collecting bankers are protected in respect of a conditional order which bears evidence of having been transferred, in the form of more than one indorsement Some authorities, including Sir John Paget, consider that the word "negotiable" in the clause referred to must be read as having the meaning "*transferable*"—a well-recognised use of the term—and, if this is the case, neither the paying nor collecting banker would receive protection in respect of a conditional order which bears evidence of having been negotiated

The general position of bankers in regard to these documents is thus highly unsatisfactory, in spite of the fact that they are frequently met with in practice, and bankers must therefore exercise the greatest possible care in dealing with them Paying bankers, especially, should require any customers who wish to issue conditional orders to give the bank a satisfactory indemnity against the claims of the true owner of any such instrument paid by the bank to a person with a defective title thereto

Orders issued by Local Authority Treasurers.

An additional complication arises from the fact that conditional orders issued on account of local authorities are almost invariably drawn not upon a banker, but upon *a treasurer*, who may or may not

be the manager of the branch at which the account of the local authority is kept There is no protection of any kind against the claims of a true owner if such a document bears a forged indorsement and is paid to or collected for a holder having no title or a defective title The protection of the Bills of Exchange Act is excluded because such a document is not a cheque, while Section 19 of the Stamp Act, 1853, and Section 17 of the Revenue Act, 1883, do not apply as the documents are not drawn *on a banker* The only loophole would seem to be that the paying treasurer may bring himself within the protection afforded by Section 17 of the Revenue Act in respect of *crossed* conditional orders if he can show that, as between himself and the local authority, he is to be regarded as the banker and not merely as the treasurer Similarly, the collecting banker will be protected by Section 17 of the Revenue Act, if he can bring himself within its provisions, but it seems that both the paying banker and collecting banker will lose the protection if the instrument dealt with bears evidence of having been transferred

The position of the paying banker in regard to these documents is generally so unsatisfactory that it is usual for the banker to obtain from the authority an undertaking to indemnify him against any loss which he may sustain by the payment of such conditional instruments

But even this does not relieve the treasurer of his personal liability to the true owner of the instrument for conversion, although, in practice, it is usual for the treasurer to be given an indemnity by the authority covering any claims which may be made against him by reason of the payment of such conditional orders to persons who have no title or a defective title

The matter is one which bristles with difficulties, and the remedy would appear to be that these orders should always be made payable *to bearer*, instead of to order, in which case payment thereof in good faith and in the ordinary course of business to the holder would be valid for all purposes

In no circumstances should per procuration signatures be accepted on the receipts or in indorsements to instruments of the kind here referred to, unless such discharges are guaranteed by the collecting bankers.

Documents in the Form of Receipts.

Bankers are sometimes called upon to pay instruments which have no similarity to a cheque, but are merely drawn up in the form of a receipt for a certain amount which it is intended shall be paid by the banker upon presentation of the receipt duly dated, signed, and, if necessary, stamped. Documents of this kind are sometimes issued by Government Departments, and not infrequently bear an intimation that presentment must be made within a prescribed period after issue

Neither the paying nor collecting banker obtains any protection in respect of such documents as against the claims of the true owner if the signature on the instrument is forged, or if the person receiving payment has no title or a defective title to the document Apart from this, the paying banker cannot debit his customer with an amount paid against a forged signature to a receipt

As a rule, the paying banker is furnished with a list of the persons who are to receive payment in respect of such instruments, and it is desirable also that he should obtain from the drawer or drawers a satisfactory indemnity against the claims of any person or persons who may seek to hold the banker liable in respect of a wrongful payment

Dividend and Interest Warrants.

Both dividend and interest warrants are usually made payable to a named payee *or order*, and the discharge of that payee is required in the special space provided for the purpose on the face of the instrument, indorsement not usually being necessary

Occasionally, these warrants are made payable to a named payee *or bearer*, but even then they should in no circumstances be paid without the signature of the payee, for apparently the fact that a space is reserved on the face of such a warrant for the signature of the proprietor overrides the usual effect of making a negotiable instrument payable to a named payee or bearer

As a rule, a *per pro* signature on behalf of an individual or individuals will not be accepted either by the paying banker or by the issuers of the warrant unless, in special circumstances, a form of authority is exhibited to and approved by the latter Dividend warrants made payable to a limited company or corporation should be discharged by its authorised officials in the manner prescribed, while if the warrant is made payable to a partnership, any one of the partners may sign the firm's name or sign for the firm in the usual way In this connection, it is to be noted that the authority of an official, partner, or other person to sign and indorse cheques or bills does not necessarily extend to the discharge of dividend or interest warrants, and for this reason a banker should act carefully before accepting signatures on such instruments by delegated authority

By well-established custom, recognised by the Bills of Exchange Act, Section 97 (3), *dividend* warrants made payable to *joint payees* may be discharged by any one of the payees named, who may either sign his own name alone or may sign for himself and the other or others Such a signature is apparently valid and may be accepted by the paying banker or issuers of the warrant even though the joint payees are actually trustees of the money received.

In the case of *interest* warrants, however, the signature of one joint payee is not accepted, the discharge of all payees being usually required before payment

Dividend Warants are frequently made out to the order of, say, "A Jones", and immediately below is some such direction as "A/c A Jones, S Smith and D Craig" Bankers must *not* place such a warrant to the credit of the personal account of the named payee, *e g*, "A Jones", unless they are quite satisfied that the transaction is straightforward and legitimate The addition of the other names definitely indicates that the payment is made in respect of stock jointly held by the three persons named, and in the event of any fraudulent application of the warrant, the banker could not be heard to say that he understood the direction "A/c A Jones, etc", to be a mere note for the guidance of the payee Even assuming that such dividend warrants are in the form of cheques and that they are negotiable and crossed, a banker runs grave risk in collecting them for the named payee's private account

Dividend or interest warrants must bear the ordinary cheque stamp, with the exception of interest warrants issued by the Government in payment of interest on Consols and other state securities

The Protection of Bankers in Respect of Dividend and Interest Warrants.

The protection afforded to the paying and collecting banker in regard to dividend and interest warrants depends on whether the instruments are or are not in strict cheque form If they conform to the legal requirements of a cheque, then they are, of course, covered by the relative sections of the Bills of Exchange Act, but if they do not conform to these requirements, the position is not quite so clear

Section 95 of the Act provides that the crossed cheque provisions of the Act "shall apply to a warrant for payment of dividend", and presumably includes dividend warrants which are not in strict cheque form This means that the paying banker will be protected by Section 80 of the Act if he pays a crossed dividend warrant in good faith, without negligence and in accordance with the crossing, and that the collecting banker will be protected by Section 82 if, in good faith and without negligence, he collects crossed dividend warrants for his customers only But it would appear that the collecting banker obtains *no* protection in respect of dividend warrants which are not strictly cheques if he credits their amount to the accounts of his customers *before actually receiving payment*, for the *Bills of Exchange (Crossed Cheques) Act*, 1906, applies only to cheques proper, and makes no mention of dividend warrants or other documents which are not cheques

It will be observed that Section 95 above does not specifically include *interest* warrants as distinct from dividend warrants, but by

virtue of Section 17 of the Revenue Act, 1883, *interest* warrants which are not in strict cheque form may be validly crossed provided that they are issued by a customer and drawn on a banker

In the case of *open* or *uncrossed* dividend warrants, the paying banker will obtain the protection of Section 60 only if the document is in strict cheque form, although he may be protected by Section 19 of the Stamp Act, 1853, if there is nothing in the instrument which makes it not payable on demand The collecting banker, as usual, obtains no protection if he collects an open or uncrossed dividend warrant in respect of which the holder has no title or a defective title, or on which an indorsement is forged

Difficult questions sometimes arise in connection with the negotiability of dividend warrants which are not strictly cheques, for, while Section 95 extends to such documents the provisions of the crossed cheques sections of the Bills of Exchange Act, it does not recognise them as negotiable instruments Nevertheless, there is little doubt that dividend warrants can properly be regarded as negotiable by mercantile custom so long as there is nothing on the face thereof affecting their negotiability, as, for example, the words "Not Negotiable" forming part of a crossing, or an indication that the instrument is payable to a named payee *only* Clearly, if such a document is by its terms of payment not transferable, then a collecting or paying banker would undoubtedly lose any protection to which he might otherwise be entitled if the instrument was paid to, or collected for, a person other than the named payee

Coupons and Bonds.

A BOND is a written obligation under seal whereby one person undertakes to pay a specified sum of money to another person on a specified day, or on the happening of a specified event The term is frequently applied to an undertaking or promise given under seal whereby a company, corporation or government promises to pay the bearer or the registered holder a specified sum of money Bonds to bearer pass by delivery, and are now generally regarded as negotiable instruments whether they are issued by a home, foreign or colonial undertaking Registered bonds (*e g*, Registered Exchequer Bonds) are similar to other registered securities which are transferable by deed of transfer, the property therein being vested in the registered holder for the time being, to whom the interest or dividends are payable as they fall due

As a rule, interest and dividends on the capital represented by bearer bonds (as also in the case of share warrants and scrip certificates) are paid by the issue with the bonds of sheets of *coupons*, which are small pieces of paper bearing the number of the relative bond and being

numbered (and sometimes dated) consecutively The coupons embody a warrant for the interest or dividend from time to time payable on the bond, and are cut off at half-yearly or other intervals as they fall due to be presented for payment at the place indicated thereon Usually, coupons bear on their face an indication of the place at which they are payable, but if this is omitted the place is intimated to holders by advertisement in the financial papers (Refer here to page 253).

When the coupons attached to a bond are exhausted, a fresh supply may be obtained by the holder on presenting to the issuing company a slip, known as a *talon*, which is usually attached to the bond

If a talon is not attached, as is sometimes the case, the bond itself will have to be presented in order that the new coupon sheets may be obtained

Coupons generally are exempt from stamp duty, but an exception occurs in the case of coupons attached to scrip certificates, which must bear a twopenny impressed stamp

Coupons falling due on a Sunday or Bank Holiday are payable on the *succeeding* business day, for, like cheques, they cannot be debited to the paying customer's account until the date on or after which payment is due

Postal Orders and Money Orders.

Both postal orders and money orders are expressly marked "Not Negotiable", and, accordingly, the innocent holder of such an order which has been lost or stolen can obtain no title to the instrument as against the rightful owner These orders may also be crossed generally or specially, in which case they will be paid only to a bank or through the bank named in the crossing If a postal order is thus crossed, the name and signature of the payee need not be inserted in the spaces provided before payment will be made by the Post Office

Bankers frequently receive postal and money orders as part of credits paid in by their customers, and have subsequently to obtain payment thereof through the nearest Post Office If, in presenting *postal orders* for payment, the banker acts simply and solely as an agent for collection, he is protected as against the claims of the true owner by Section 25 of the *Post Office Act*, 1908 This provides that a banker who collects for a principal a postal order or document purporting to be a postal order, shall not incur liability to *anyone except that principal* by reason only of having received payment of, or having held, or having presented for payment, any such order or document As a general rule, however, bankers cannot avail themselves of this protection by reason of the fact that, in practice, they credit these instruments as cash *before actually receiving payment thereof*, in which circumstances

a banker will be liable to the true owner for conversion if the customer has no title or a defective title

The collecting banker has no such statutory protection in regard to *money orders*, and, in the case of his customer's having a defective title is liable to the true owner for conversion Moreover, encashment of *money orders* is provisional only, since the Post Office is permitted by its regulations to return *at any subsequent time* any order which is found to be irregular, and the presenting bank must thereupon refund the money (*London and Provincial Bank* v *Golding*, 1918)

Bankers' Drafts upon Demand.

A banker's draft upon demand is an order addressed usually by a branch of a bank to its Head Office, instructing the latter to pay a specified sum to a named payee or to his order These drafts may, however, be drawn by the Head Office on one of its branches, or by one branch upon another Since the drawer and drawee of such a draft constitute only one legal person, the instrument is not a cheque or a bill of exchange within the definitions given by the Bills of Exchange Act On the other hand, by virtue of Section 5 (2) of the Act, the holder of such a draft has the option of *treating it* as a bill of exchange or as a promissory note A banker's draft cannot be made payable *to bearer* on demand, otherwise the issuing banker will render himself liable to a penalty under the Bank Charter Act, 1844

As a banker's draft is not a cheque it cannot be effectively crossed and is not within the protection afforded to bankers by the Bills of Exchange Act, 1882 But though the banker paying such an instrument bearing a forged indorsement is not covered by the Bills of Exchange Act, he is protected by Section 19 of the Stamp Act, 1853, since this relates to "*any* draft or order drawn upon a banker for a sum of money payable to order on demand ".

As the crossing on a draft on demand is of no legal effect, the paying banker can incur no liability by paying such an instrument in disregard of the crossing, as, for example, by cashing a crossed draft over the counter or by paying its amount to a banker other than the one named in a special crossing In practice, however, a banker would usually endeavour to abide by the obvious intention of the drawer or holder if such an instrument presented for payment bore a general or special crossing, for he cannot obtain the protection of Section 19 of the Stamp Act, 1853, unless he acts *reasonably and in good faith*, and unless he sees that the draft *purports* to be correctly indorsed

Bankers' drafts upon demand take the same stamp duty as cheques, while drafts which are made payable after sight or after date require the same *ad valorem* duties as bills of exchange

The term "banker's draft" does not include drafts on demand or after sight or after date drawn *by one banker upon another*, for such instruments are merely cheques or bills of exchange, and as such are subject to all the usual statutory provisions relative to those instruments Neither does the term include drafts or orders drawn by one banker on another banker for the settlement of clearing differences or other accounts between the bankers concerned Documents of the latter kind are described as "bankers' payments", and are exempt from stamp duty

Deposit Receipts.

A deposit receipt is an acknowledgment given by a banker, discount house or other person, acknowledging the receipt of money on deposit, and specifying that interest at a stated rate will be paid on the amount, which is declared to be withdrawable either at call, on demand, or after a specified period of notice Other receipts specify that the money deposited is left with the bank for a *fixed period*, although it may be repaid before the expiration of that period subject to a reduction or forfeit of interest

If a deposit receipt is desired in the names of more than one person and is to be repaid to either of two persons or to one or more of several, a form of authority to that effect should be signed by all the parties

A joint deposit receipt is payable to the survivor or survivors upon the death of one or some Receipts in joint names, in the absence of instructions providing for repayment to either, should not be paid to one of the payees unless definite written instructions are produced, otherwise the banker may be liable on a bad payment

Position of the Paying and Collecting Banker.

Deposit receipts are not negotiable or even transferable, although they may be made the subject of a bequest or assignment, so that a banker will be liable, even if he acts in good faith, if he pays to a party who produces the receipt indorsed by the depositor, and such person is not entitled to receive the money Probably the only line of defence open to the banker who pays anyone other than the depositor, where the title is defective, is that afforded by the doctrine of *estoppel*—which might preclude the depositor from denying that the person who presented the receipt was entitled to it

Since a banker is never really safe in paying a deposit receipt to someone other than the depositor himself, his best course, if he is called upon to do so, is to require the properly discharged receipt to be handed to him with an authority, signed by the depositor, sanctioning the payment to the third party

To protect themselves against the possibility of paying the wrong person, bankers clearly enface their receipts with a notice to the effect that payment will be made only on presentation of the instrument by the depositor in person.

A further result of the fact that a deposit receipt is not transferable is that any banker who *collects* such an instrument on behalf of any person other than the true owner will be liable to the latter for conversion of his property. A collecting banker has no statutory protection whatsoever in regard to the collection of deposit receipts, and he should therefore refuse to present such instruments for payment unless he has every reason to be satisfied with the title of the presenter. This point is of importance because persons sometimes open accounts at a bank by paying in for collection a deposit receipt issued by another bank.

Assignment of a Deposit Receipt.

Although a deposit receipt is not a negotiable instrument and is not transferable, it is nevertheless a chose in action, which can be *legally* assigned like any other debt or chose in action.

To be valid, the assignment must be in writing, signed by the depositor, written notice of the assignment must be given to the banker who issued the receipt, and the assignment must be *absolute* and not merely by way of charge. Accordingly, if a banker receives notice that the amount of a deposit receipt has been properly assigned, payment of the deposit can be made to the assignee and to no other, and the banker may regard the signature of such assignee as a good discharge for the payment.

In the case of *In re Griffin*, 1899, the mere indorsement of a deposit receipt followed by delivery was held to constitute a good *equitable* assignment, in spite of the fact that the receipt bore in two places the words "This receipt is not transferable."

Moreover, in the case of *In re Mead*, 1880, it was held that even if the cheque form on the back of such a receipt was filled in for *part* only of the amount of the deposit, it would be valid as a cheque on the banker, requiring payment of the sum mentioned to be made to the person indicated. The banker is not, however, bound to honour cheques drawn against deposit receipts unless he has specially undertaken to do so.

Garnishee Orders and Deposit Receipts.

Funds on a deposit receipt repayable *on demand* will be attached by the service of a garnishee order, but if repayment is subject to the *giving of notice* or to the *return of the receipt*, the funds will not be attached unless the receipt has been returned or notice has been given by the customer before the order is served.

On the other hand, money on deposit receipt for a *fixed period* would be attached by a garnishee order as being a debt which is *accruing due*, but here again the order would not operate to attach the funds if the return of the receipt was an express condition precedent to withdrawal.

Loss of Deposit Receipt.

Where a deposit receipt is lost or mislaid, and the depositor requires the money, it is the practice of bankers to obtain an indemnity against the recovery and presentment for payment of the lost document. Strictly, the banker is not entitled to demand this, inasmuch as the receipt is not a negotiable instrument.

PART IV.

BANKING AND THE EXCHANGES.

The matter in the following chapters is based on the Fifth Edition of the author's "Principles and Arithmetic of Foreign Exchange" (MacDonald & Evans), to which the reader is referred for further information on this important subject.

CHAPTER 26

THE THEORY OF THE EXCHANGES.

JUST as the modern banking and credit system has become necessary to facilitate the exchange of goods within a community so the machinery of foreign exchange has been developed to facilitate the exchange of goods and services between nation and nation

If all nations used the same kind of money, a transaction between individuals of two different nations would be settled very much in the same way as a transaction between two citizens of the same state But nations are not thus content to adopt a uniform monetary system On the contrary, each seeks a currency unit of its own, distinct in design, in size and in value The Frenchman pays for his goods in terms of *francs*, the German in terms of *reichsmarks*, the American strives to become a *dollar* millionaire, while the inhabitants of China and Mexico still further complicate the situation by using a monetary unit of the same name as that of the United States, but one which differs from the latter not only in weight and fineness, but also in the metal of which it is constituted

The Meaning of Foreign Exchange.

Foreign Exchange, considered from the standpoint of study and research, is that branch of the science of Economics which investigates the principles which govern the exchange of these various moneys one for the other Considered as part of the world credit mechanism, Foreign Exchange comprises those operations which enable wealth in terms of the currency of one country to be translated into wealth in terms of the currency of another country In brief, foreign exchange is the *mechanism* whereby world currencies exchange Unfortunately, the term "Foreign Exchange" is not always used in these general

senses. Writers in the press frequently use it to mean the *rates* at which currencies exchange or the *Rates of Exchange*, while it is not unusual to find the expression used to mean *foreign money*, as where a person is described as a "dealer in foreign exchange"

The Basis of Foreign Exchange.

Foreign exchange arises from international commerce, that is, the transfer of commodities or services between the various countries of the world No country exists in complete isolation from the rest There is a ceaseless interchange of wealth in all its forms from one country to the other, and this ceaseless interchange gives rise to debts which it is the function of the foreign exchange mechanism to settle in the manner most convenient both to debtor and creditor

International debts arise in ways other than through the buying and selling of goods and the exchange of services Debts arise between nations also as a result of the loaning of capital by one to another, as a result of stock exchange operations involving the purchase and sale of international securities, and in consequence of banking and financial operations, tourist payments and government finance and expenditure

The Settlement of International Debts.

Now, an obvious and direct method of settling an international debt would be to transmit to the creditor an acceptable quantity of gold, that metal which functions as an international currency, universally recognised as a medium of exchange and a standard of value And, in the early stages of international commerce, gold was so used to settle the great majority of foreign debts Nowadays, however, trade has grown to such an extent that gold has been superseded for all but exceptional international payments

The reasons for this are not far to seek The transmission of gold is expensive, troublesome and frequently subject to considerable risk Even when it is used as an internal medium of exchange it suffers heavy loss through abrasion Moreover, gold is required for other purposes than the settlement of international debts, while there is the insuperable difficulty that the total amount of gold in existence is not nearly enough to cover all transactions for which it would be required if no alternative were available

The Use of Credit Instruments.

The difficulties attending the use of gold and other precious metals have been overcome by the use of credit instruments, *i e*, by the transfer of *rights* to gold

Let us suppose, for example, that J Jones, of New York, sends £1,000 worth of electrical equipment to G Green, of London, and that B Brown, of London, sends £1,000 worth of worsted cloth to S T Day, of New York If both transactions are made at the same time, the result is that London owes £1,000 to New York and New York owes £1,000 to London Now much waste of time and labour may be saved if J Jones draws a bill of exchange on his debtor G Green requesting him to pay £1,000 at a fixed future date to him (J Jones) or " his order " —which we may assume to be the New York National Bank This bank buys the bill from Jones (for its face value less discount) and in due course has the amount of £1,000 collected from G Green by its London agents, the Lombard Bank, and placed to its credit in their books In anticipation of this credit, the New York National Bank can issue a draft on the Lombard Bank for £1,000 in favour of Jones' compatriot, S T Day, who remits the instrument in payment to his creditor, Brown Eventually Brown obtains payment of the draft, either by presenting it direct or through his own bank, and in this way the debts arising from two quite distinct transactions are settled by means of credit instruments, without any transfer of gold

The Banks function as Intermediaries between Debtors and Creditors.

It should be clear that business houses trading overseas save themselves considerable time, trouble and expense by resorting to the banks in the manner here described

The banks make a business of buying and selling foreign bills, and act as intermediaries between debtors in one country and creditors in another From exporters, financial houses, government departments and allied sources, the banks buy up trade bills and other rights to money in foreign centres, as, for example, bankers' drafts, telegraphic transfers, travellers' cheques, circular notes and maturing coupons payable abroad, arranging with their agents in the centres concerned to collect the proceeds and to hold them on current account at their disposal Against the funds thus accumulated, the banks sell drafts and other forms of remittance to debtors in their own country who have payments to make abroad So it often happens to be more convenient for London bankers to hold funds in a foreign centre than in London itself, as when there is a particularly strong demand on this side for rights to money in that centre

The banks do not perform these valuable services for nothing. On the contrary, they expect to make profits not only from the difference between the price at which they buy and the price at which they sell, but also from favourable movements in the rates of exchange and in the rates of interest earned on the funds held abroad

The Utility of the Bill of Exchange.

The bill of exchange, which belongs to that important class of documents known as "negotiable instruments," is by far the most important credit instrument used in international settlements A bill of exchange signed by parties of good repute is always worth approximately its face value, while the fact that it has a ready sale in the money markets of the world makes it a convenient means for settling international transactions

Though such instruments as coupons, foreign bonds, scrip certificates, stock and share certificates, and share warrants to bearer, can be used for the transfer of funds from one country to another, the bill of exchange is the pre-eminent medium for settling ordinary trade debts and for financing international trade It is an unrivalled means for securing payment, for transferring credit and for raising temporary loans Enormous economy results from its use, claims and obligations of vast aggregate value being quickly and easily cancelled and set-off one against the other In the absence of the bill, the trader who exports goods to foreign countries would, in the ordinary course, have to wait several months before he received payment On the other hand, the importer would in many cases, have to settle for his goods weeks before he received them By drawing a bill of exchange, however, and discounting it with his bank, the creditor is enabled to obtain cash as soon as he has shipped the goods on account of which the bill is drawn The bill, being drawn payable at the expiration of several months or days, as the case may be, will not generally fall due for settlement by the debtor until he has received the goods, and in many cases has been able to realise them and obtain sufficient money to enable him to pay the bill when it is presented

The Exchange of Foreign Currencies.

Foreign Exchange, then, is concerned with the settlement of debts in foreign currencies and, obviously, any such settlement involves a "translation" from one currency to another A French creditor who has money to receive from England expects to be paid in francs, just as an English trader tries, wherever possible, to obtain payment for his goods in terms of sterling, the type of money which is immediately intelligible to him and acceptable by all those with whom he comes in daily contact

Now, the rate at which the unit of one currency will at any particular time exchange for another, or the *price* of the unit of one currency in terms of another currency, is called a *rate of exchange* There are two ways of expressing rates of exchange on the London Money Market Some rates are said to be quoted *certain* or *fixed* or *direct*, because the foreign unit is a fixed quantity although its price in English

money varies from time to time, and because the price of the foreign monetary unit is expressed in the same way as any other prices, *i e*, in terms of pounds, shillings and pence per foreign unit Other rates—in fact, the majority of rates—quoted in London, are expressed in terms of foreign currency to the £1, and are consequently known as *moveable* or *uncertain* or *indirect* The latter method is preferred, for one reason, because the English sovereign is one of the world's largest monetary units and so can be more conveniently quoted in terms of the smaller units than they in terms of the sovereign Another reason is that this method facilitates comparison of the London rates with the quotations for sterling in the world's financial centres

How the Rate of Exchange is Determined.

Just as the price of any commodity on any market varies from day to day according to the vagaries of demand and supply, so also the price at which any two currencies exchange one for the other varies from day to day or even from hour to hour

Now, the *supply* of a foreign currency in London at any particular time consists mainly of offerings of various forms of rights to that currency by persons who have exported goods, securities or money to the foreign country concerned The *demand* for the foreign currency comes chiefly from persons on this side who require rights to foreign currency to pay for goods, securities or money imported from the foreign country

Rights to foreign currencies are also in demand to pay for *services* rendered by other countries in connection with the transfer, insurance and financing of goods, while, conversely, rights to foreign currency are offered by British ship owners, factors, commission agents, accepting houses and other agencies which have payments to receive from abroad in respect of services rendered by them to foreign nationals

Thus we see that the demand for a foreign currency and its supply on the London Foreign Exchange Market at any particular time arise largely on trade account, and the *general direction of trade*, *i e*, the balance of trade indebtedness arising for settlement between the two countries concerned at any particular moment, largely determines the strength of both the demand and supply

In addition to that part of demand and supply which is based on payments for goods, securities and services, *i e*, *legitimate* demand, there is an important *speculative* demand and supply in the leading foreign currencies The Foreign Exchange Market, like the Stock Exchange, has bulls and bears who buy and sell various currencies in the hope of making profits by manipulating the rates of exchange, and such operations cause constant movements in the principal rates, sometimes very slight, at other times violent in the extreme.

The Worth of a Foreign Currency is its Purchasing Power.

Since the value of a foreign currency is determined by the relationship between demand and supply, it is clear that, *at any particular time*, a foreign currency is worth only what buyers on the market are willing to give for it or what the sellers are prepared to accept for it But *in the long run*, buyers of a foreign currency in this country will give for it only what it is considered to be worth in terms of goods and services People in Britain buy dollars to obtain *purchasing power* in the States, but ultimately the price they will give for dollars is determined by the quantity of goods which dollars will buy as compared with the quantity of goods which pounds will buy

"We judge the value of a foreign currency to us by its command over goods and services (*i e*, its purchasing power) as compared with the command of our own money over similar goods and services The greater the purchasing power of the foreign currency unit, the higher the price we are willing to pay for it As we have seen, purchasing power is indicated by the general level of prices, so that if prices in a foreign country are high compared with our own, the money of that country will not go very far, and we therefore expect to get more of its money in exchange for our own money If the franc or the peseta is not purchasing enough goods and services to satisfy our feeling of justice or equality at the moment, we will not pay a high price for it, and the higher the level of prices in the foreign country relative to our own prices, the less will we pay for the money of that country"[1]

The Purchasing Power Parity.

In brief, therefore, the value of the unit of one currency in terms of another currency is determined, at any particular time, by the market conditions of demand and supply, but, in the long run, that value is determined by *the relative values of the two currencies as indicated by their relative purchasing power over goods and services* In other words, the rate of exchange tends ultimately to rest at the point of equality between the respective purchasing powers of two currencies This point represents the *Purchasing Power Parity*

In illustration, let us consider a group of commodities in equal demand in both England and France For clarity, we will ignore transport costs and tariffs, and assume that goods included in the group in question can pass freely from one country to the other, and that, at a certain time, the articles concerned can be purchased in France for 10,000 francs and in this country for £100 Clearly, in such circumstances, people in the two countries would regard the purchasing power of 10,000 francs as equivalent to the purchasing power of £100,

[1] *The Principles and Arithmetic of Foreign Exchange*, by S. Evelyn Thomas Fifth edition, page 39

and in exchanging francs for pounds they would expect a rate of exchange of 100 francs per £1, *i e*, a rate based on the relative worth of the two currencies If they did not receive this rate, their actions would cause economic forces to come into play which would tend to bring about a modification in the exchange

The purchasing power parity theory maintains that the relation between two price levels is the fundamental factor responsible for exchange movements If the value of money in one place is high relative to its value in another, money will tend to flow from the place of low value to the place of high value The relative values of different currencies depend on their relative purchasing powers The rate of exchange between any two countries is directly determined by the demand for and supply of exchange, but is indirectly determined by the ratio between their price levels

The Purchasing Power Parity between Gold Currencies.

The purchasing power parity is, unfortunately, largely an abstract conception We cannot compare the *real* values of two currencies on an absolute basis because these currencies themselves function in their respective countries as the basis of all values, and price index numbers do not afford an *absolute* method of assessing the purchasing power of any currency Fortunately, all the most important countries of the world have adopted gold as a measure and standard of value, in terms of which we can not only assess the relative values of different commodities, but also compare the relative values of two different currencies by reference to *their relative purchasing power in terms of gold.*

Between gold standard countries, gold—the basis of all values—flows with comparative freedom Commodity prices in such countries are gold prices If gold becomes relatively scarce in one of these countries, prices in that country fall and other nations are encouraged to buy its goods The gold which tends to be sent in payment increases its stocks of the metal and restores its level of prices On the other hand, if a nation's gold supplies are unduly increased, commodity prices rise and the value of gold in that country falls Hence, the metal tends to move out of the country to places where its value is higher, whereas goods tend to flow in Commodity prices consequently fall, and the value of gold rises until a position of greater equilibrium is achieved

The result of these factors in all gold standard countries is that world stocks of gold tend to be distributed among the nations according to their relative requirements, and money (*i e*, gold) and goods tend to have the same value in all countries where gold is the standard Therefore the purchasing power of currencies based on a gold standard is the purchasing power of gold and such currencies exchange one

for the other at rates based on the quantity of pure gold which the standard coins respectively contain This basis is *the Mint Par of Exchange*

The Mint Par of Exchange.

We may define the Mint Par of Exchange as "The exact equivalent of the unit of currency of one country, expressed in terms of the currency of another having the same metallic standard, based upon the quantity and fineness of the metal contained in the two coins as fixed by law"

It follows from this definition that a Mint Par of Exchange can be established between any two countries which have the same metallic standard, even though coins do not circulate But we cannot calculate a Mint Par between a country with a gold standard of value and another country with a silver standard, because there is no fixed ratio between the values of the two metals the market price of one of these metals in terms of the other is variable and indeterminate On the other hand, it is possible to establish a mint par between two silver standard currencies, but, as will be explained later, such a par would have little practical utility

The Gold or Specie Points.

If, then, the currencies of two gold standard countries are freely interchangeable into gold, their purchasing power is the same as the purchasing power of gold and the purchasing power parity between them tends to coincide with the mint parity Moreover, the market rate of exchange must keep very close to the mint par, although it will rarely remain exactly at the mint par

Fluctuations around that point will be caused by the vagaries of demand and supply But debtors who have to pay debts in a foreign gold standard country will not pay a higher price in their own currency for a credit remittance to the foreign country than they would have to pay if they purchased gold at home and had it transmitted abroad in payment In like manner, no creditor would be content to sell his claim to a given amount of foreign currency at a lower price per unit than he would realise if he instructed his debtor to send gold to him in settlement

These limits to the price which debtors will pay for foreign remittances and which creditors will expect for their foreign claims are known as *gold points*, *specie points* or *bullion points* Between any two gold standard countries, there are two such limits one, the outgoing or *export* specie point, at which it is cheaper to ship gold to pay foreign creditors than to buy and use any other form of remittance, and the

other, the incoming or *import* specie point, at which it is cheaper for foreign debtors to send gold than to use any other form of remittance

The gold points are determined by two groups of factors (*a*) the expense of buying and selling the gold as determined by the prices at which gold can be purchased on the one side and realised on the other, and (*b*) the expenses involved in moving the metal between the two countries concerned

The expenses in both groups vary considerably from time to time, and so the gold points between any two countries are never fixed or invariable The expenses in the first group are usually determinable beforehand, since the majority of the purchases or sales are made by central banks at established prices, but those in the latter category are subject to greater uncertainty They include charges for freight, packing, carriage and insurance, together with commission to the banker or bullion broker undertaking the business, all of which vary with each shipment according to competition between shipping companies, competition between air and other means of transport, and the value of the consignment Varying allowances must also be made for interest for the time the gold is in transit, consideration being given both to the time taken and the rates prevailing in the respective money markets

The gold points are important not only for the fact that they act as limits to the prices of credit remittances between two gold standard countries, but also for the more fundamental reason that they afford an automatic indication that gold movements, or other alternative measures, are necessary to adjust the relative price levels between those countries If prices in country A are high as compared with those of other countries, *i e*, if the value of gold in country A is low relatively to its value in other countries, its imports increase and its exports fall off The purchasing power of country A's currency falls and the purchasing power parities move to the export specie points, until, ultimately, the position is corrected by the movement of some of the gold to the countries where its value is relatively high Thus gold flows out of country A and goods flow in

The Purchasing Power Parity between Inconvertible Paper Currencies.

During the Great War the gold previously in circulation in the gold standard countries disappeared into the reserves of the central banks The normal movement of gold to correct adverse exchanges almost entirely ceased, and the metal was used only in exceptional circumstances to make foreign payments In the majority of countries gold currencies were supplanted by inconvertible paper, the issue of which was severely inflated, *i e*, more currency was put into circulation than was required to satisfy the needs of trade at the existing level

of prices Many currencies became heavily depreciated, and prices soared to unprecedented heights

Now, we have seen that the rate of exchange between any two currencies tends to the point which marks equality between the relative purchasing powers of the currencies But since the internal purchasing power of an inflated currency varies each time its quantity is increased, it follows that the purchasing power parity between such a currency and gold standard currencies must also vary, and engender marked fluctuations in the prevailing rates of exchange Moreover, the anticipatory dealings of speculators "for the fall," and, on occasion, "for the rise" in the value of an inflated currency, cause further erratic movements which cannot be clearly related to changes in purchasing power

When both currencies are depreciating the position is still more complicated and uncertain The purchasing power parity between the two currencies is affected from two directions by every change in the value of either currency following on further issues of inconvertible paper On the assumption that both countries start from the position of a common gold standard, it may be stated in general terms that the purchasing power parity between their currencies will be determined by the relative degree to which the currencies are inflated Let us suppose that, in 1913, when the purchasing powers of gold currencies were deemed to be equal, the purchasing power parity between dollar and pound was \$5=£1 Now if, in a subsequent year, price index numbers show that the value of the dollar has fallen by 30 per cent, and that of the pound by 50 per cent, then the new purchasing power parity is

$$£1 = \$5 \times \frac{100}{70} \times \frac{50}{100} = \$3\ 57$$

Deviations from the Purchasing Power Parity.

In practice, it is found that there are considerable variations between the prevailing rates of exchange and the purchasing power parities as obtained by calculation These are attributed to a number of factors The first of these is the admitted inaccuracy and non-uniformity of the price index numbers used as the basis for the calculation of the parities Furthermore, index numbers of internal prices include many commodities which do not enter into international trade and which do not give rise to foreign exchange operations And even if an index number of the prices of commodities exchanged externally could be calculated, allowance would have to be made for the cost of moving the commodities from one country to another, and also for any export or import duties which have the effect of increasing

the cost of the commodities to the importing country. Then there are all those indeterminate influences affecting demand and supply which have their origin in speculation, as, for example, arbitrage and anticipatory operations, all of which must cause marked differences between the actual exchange rates and the calculated purchasing power parities.

The Importance of the Purchasing Power Parity Theory.

In spite of its practical drawbacks, the purchasing power parity theory is now recognised as the most adequate explanation of the manner in which rates of exchange are determined. It is the only theory which is applicable to all types of currencies, to all theories of money and to all conditions of the exchanges. It is the only theory which explains the relationship between currencies which are on an effective gold standard as well as the relationship between those which are hopelessly depreciated through the issue of inconvertible paper.

Moreover, the theory is more fundamental than the old balance of trade theory of the exchanges enunciated by Goschen and his successors. It does not merely state the fairly obvious fact that the rates of exchange are determined by the balance of indebtedness.

It explains *how* that balance of trade or of indebtedness *is itself determined* by the reaction on the rates of exchange, and by the effect on the international movement of goods, of the prevailing price levels in different countries. Finally, the purchasing power parity theory was the basic principle underlying the steps taken to reorganise the currencies which collapsed after the War, while it lies at the root of the methods now adopted by central banks to control credit and regulate exchange rates in their respective countries.

CHAPTER 27

EXCHANGE QUOTATIONS AND TERMINOLOGY.

In all great national newspapers, daily lists are nowadays given of the rates of exchange at which transactions in foreign currencies were effected in the various financial centres on the previous day In *The Times* and other newspapers such a list appears under the heading "Foreign Exchanges" This formerly gave the ruling rates for remittances TO London quoted on the previous day in the various financial centres enumerated Nowadays, in *The Times*, *The Economist* and other important papers, the lists give the rates quoted IN London on the previous day, for remittances to the most important places in the world Similarly, in other financial centres such as New York, Paris and Amsterdam, daily lists are issued and published in the newspapers showing the rates ruling in the foreign exchange markets for remittances to other countries

In former days, when a distinct market was held for dealings in bills, the prices were marked up at the end of the day, in a similar way to the marking up of prices on the London Stock Exchange To-day, however, most remittances are made by cable, rates fluctuate considerably hour by hour, and the rates given in the lists now published frequently differ considerably from one another.

The Double Quotation.

In nearly all cases, the tables of rates of exchange give two rates for each centre In certain cases (as in the table published by *The Times*), the quotations represent the *limits* or the *range* of market prices during the preceding business day, but, in other cases (as in the table published by *The Economist*), the two prices represent the rates at which purchases and sales of the foreign currencies enumerated were being effected *at a certain time* on the date indicated by the bank or financial house supplying the table

The fact that a buying and a selling price are sometimes given must not be taken to imply that one could certainly have done business at the rates published, either for sellers or buyers, though it is quite feasible that business was actually transacted at those rates Obviously, to every transaction there is both a buyer and a seller, and the rates given are those at which business was *offered*, the final rates at which transactions are effected being fixed only after some slight bargaining

EXCHANGE RATES.

Adapted from "The Economist," 11th January, 1930.

London on	Country	Monetary Units	Method of Quoting	Usance	Par	Jan 10, 1929	Jan 2, 1930	Jan 9, 1930
New York	United States	Dollar = 100 cents	dollars to £1	Cable	4 86$\frac{8}{32}$	4 85$\frac{1}{8}$–$\frac{3}{16}$	4 87$\frac{15}{16}$–8	4 87$\frac{3}{16}$–87$\frac{1}{4}$
Montreal	Canada	Dollar = 100 cents	dollars to £1	Cable	4 86$\frac{3}{8}$	4 86$\frac{5}{8}$–$\frac{3}{4}$	4 93$\frac{1}{4}$–$\frac{1}{2}$	4 92$\frac{1}{2}$–4 92$\frac{3}{4}$
Paris	France	Franc = 100 centimes	francs to £1	T T	124 21	124 05–10	123 90–92	123 90–92
Berlin	Germany	Reichsmark = 100 pfennige	marks to £1	T T	20 43	20 40–$\frac{1}{2}$	20 43$\frac{1}{4}$–$\frac{3}{4}$	20 39$\frac{1}{2}$–39$\frac{3}{4}$
Amsterdam	Holland	Florin = 100 cents	florins to £1	T T	12 107	12 08$\frac{1}{4}$–$\frac{1}{2}$	12 09$\frac{3}{8}$–$\frac{1}{2}$	12 08$\frac{1}{2}$–09$\frac{1}{4}$
Brussels	Belgium	Belga = 5 francs = 500 centimes	belga to £1	T T	35 00	34 89$\frac{1}{2}$–90$\frac{1}{4}$	34 88$\frac{1}{4}$–9	34 92$\frac{1}{2}$–93$\frac{1}{4}$
Milan	Italy	Lira = 100 centesimi	lire to £1	T T	92 46	92 68–73	93 21–3	93 10–12
Berne	Switzerland	Franc = 100 centimes	francs to £1	T T	25 22$\frac{1}{2}$	25 20–$\frac{1}{2}$	25 13$\frac{1}{4}$–14	25 13–13$\frac{1}{2}$
Oslo	Norway	Krone = 100 ore	kroner to £1	T T	18 150	18 19–$\frac{1}{2}$	18 20–$\frac{1}{4}$	18 20$\frac{1}{2}$–21$\frac{1}{2}$
Stockholm	Sweden	Krona = 100 ore	kronor to £1	T T	18 159	18 13$\frac{1}{2}$–14$\frac{1}{2}$	18 13$\frac{3}{4}$–$\frac{3}{4}$	18 14$\frac{3}{4}$–15$\frac{1}{2}$
Copenhagen	Denmark	Krone = 100 ore	kroner to £1	T T	18 159	18 18–$\frac{1}{2}$	18 20$\frac{1}{4}$–$\frac{3}{4}$	18 20–20$\frac{1}{2}$
Madrid	Spain	Peseta = 100 centimos	pesetas to £1	T T	25 22$\frac{1}{2}$	29 70–72	36 60–5	39 43–48
Lisbon	Portugal	Escudo = 100 centavos	escudos to £1	T T	4 50	109$\frac{1}{2}$–110	108$\frac{1}{2}$–$\frac{3}{4}$	108$\frac{1}{2}$–108$\frac{3}{4}$
Vienna	Austria	Schilling = 100 groschen	schillgs to £1	T T	34 58$\frac{1}{2}$	34 45–49	34 64–7	34 60–64
Prague	Czechoslovakia	Krone = 100 heller	krone to £1	T T	164 25	163$\frac{5}{8}$–$\frac{7}{8}$	164$\frac{3}{4}$–5	164$\frac{3}{4}$–164$\frac{5}{8}$
Belgrade	Yugoslavia	Dinar = 100 paras	dinars to £1	T T	25 22$\frac{1}{2}$	276–$\frac{1}{2}$	275–$\frac{1}{2}$	274$\frac{1}{2}$–275$\frac{1}{2}$
Budapest	Hungary	Pengo = 100 filler or garas	pengo to £1	T T	27 82	27 80–83	27 84–88	27 82–86
Bukarest	Rumania	Leu	lei to £1	T T	813 6	805–10	817–820	817–819
Sofia	Bulgaria	Leva	leva to £1	T T	673 659	669–74	673–6	670–676
Athens	Greece	Drachma = 100 leptae	drachmæ to £1	T T	375	374$\frac{1}{2}$–5$\frac{1}{2}$	374$\frac{1}{2}$–5$\frac{1}{2}$	374$\frac{7}{8}$–375$\frac{1}{2}$
Constantinople	Turkey	Pound £T1 = 100 piastres = 4,000 paras	piastres to £1	T T	110	995–1003	1040–1050	1020–1035
Moscow	Russia	Tchervonetz = 10 roubles	roubles to £1	T T	9 46	†9 42–44	†9 47$\frac{1}{2}$–49$\frac{1}{2}$	†9 48–50
Warsaw	Poland	Zloty = 100 grosz	zloty to £1	T T	43 38	43$\frac{1}{4}$–$\frac{7}{8}$	43$\frac{3}{8}$–$\frac{1}{2}$	43$\frac{5}{8}$–43$\frac{7}{8}$
Helsingfors	Finland	Markka = 100 penni	F marks to £1	T T	193 23	192$\frac{5}{8}$–$\frac{7}{8}$	194–$\frac{1}{4}$	193$\frac{3}{4}$–194
Kovno	Lithuania	Litas = 100 cents	lits to £1	T T	48 66	48$\frac{1}{4}$–9$\frac{1}{2}$	48$\frac{1}{2}$–9$\frac{1}{2}$	48$\frac{1}{2}$–49$\frac{1}{4}$
Reval	Esthonia	Kroon = 100 sents	kroon to £1	T T	18 159	18 08–18	18 17–24	18 17–24
Riga	Latvia	Lat = 100 graschi or santimes	lats to £1	T T	25 22$\frac{1}{2}$	25 10–20	25 23–30	25 23–33
Alexandria	Egypt	Pound = £E1 = 100 piastres	piastres to £1	Sight	97$\frac{1}{2}$	97$\frac{7}{16}$–$\frac{9}{16}$	97$\frac{7}{16}$–$\frac{9}{16}$	97$\frac{7}{16}$–97$\frac{9}{16}$
Buenos Aires	Argentina	Peso = 100 centavos	pence to peso	T T	47 62d	47$\frac{13}{32}$–$\frac{15}{32}$	45$\frac{1}{2}$–$\frac{5}{8}$	45–45$\frac{1}{8}$
Rio de Janeiro	Brazil	Milreis = 1,000 reis	pence to mils	90 days	16	5$\frac{7}{8}$–$\frac{29}{32}$	5$\frac{7}{8}$–$\frac{15}{16}$	5$\frac{7}{8}$–5$\frac{7}{8}$
Montevideo	Uruguay	Peso = 100 centesimos	pence to peso	T T	51	50$\frac{3}{8}$–51$\frac{1}{8}$	46$\frac{1}{4}$–$\frac{3}{8}$	45$\frac{3}{8}$–45$\frac{7}{8}$
Valparaiso	Chile	Peso = 100 centavos	pesos to £1	90 days	40	39 65	39 80	39 82
Lima	Peru	Libra = 10 soles = 100 centavos	Eng to Per £1	90 days	par	19$\frac{1}{2}$% prem	nom *	nom
Calcutta	India	Rupee = 16 annas = 64 pice = 192 pies	pence to rupee	T T	18	1 6$\frac{3}{32}$–1 6$\frac{1}{16}$	1 5$\frac{15}{16}$–1 5$\frac{3}{4}$	1/5$\frac{29}{32}$–1 5$\frac{15}{16}$
Bombay				T T		1 6$\frac{3}{32}$–1 6$\frac{1}{16}$	1 5$\frac{15}{16}$–1 5$\frac{3}{4}$	1/5$\frac{29}{32}$–1 5$\frac{15}{16}$
Madras				T T		1 6$\frac{3}{32}$–1 6$\frac{1}{16}$	1/5$\frac{15}{16}$–1/5$\frac{3}{4}$	1/5$\frac{29}{32}$–1 5$\frac{15}{16}$
Hong Kong	Hong Kong	Dollar = 100 cents	ster to dollar	T T	—	2 0$\frac{1}{4}$–$\frac{1}{16}$	1/7$\frac{1}{2}$–1 8$\frac{1}{16}$	1/7$\frac{3}{4}$–1 7$\frac{7}{8}$
Shanghai	China	Tael = 1,000 cash or li	ster to tael	T T	—	2/7$\frac{1}{4}$–$\frac{3}{8}$	2 1$\frac{1}{2}$–2 1$\frac{3}{4}$	2/0$\frac{3}{4}$–2 0$\frac{7}{8}$
Singapore	Singapore	Dollar = 100 cents	ster to dollar	T T	2s 4d	2 3$\frac{7}{8}$–$\frac{15}{16}$	2 3$\frac{11}{16}$–2/3$\frac{13}{16}$	2/3$\frac{11}{16}$–2 3$\frac{13}{16}$
Kobe	Japan	Yen = 100 sen	ster to yen	T T	24 58d	1 10$\frac{17}{32}$–$\frac{19}{32}$	2 0$\frac{1}{4}$–2 0$\frac{3}{8}$	2/0$\frac{1}{16}$–2/0$\frac{1}{4}$
Manila	Philippines	Peso = 100 cents	ster to peso	T T	24 066d	†2s 0$\frac{5}{16}$d	†2s 0$\frac{5}{16}$d	†2s 0$\frac{5}{16}$d
Mexico City	Mexico	Dollar = 100 centavos	pesos to £	T T	9 76	23$\frac{1}{2}$–24	10 10–20	10 00–25
Bangkok	Siam	Tical or baht = 100 satangs	ster to baht	T T	21 818d	1/10$\frac{3}{8}$	1/10$\frac{3}{8}$	1/10$\frac{3}{8}$

* 31st Dec † Rate for previous day ‡ Pence per Dollar

Moreover, in the case of sales of foreign currencies, as in the case of sales of other commodities, there is a " retail " and also a " wholesale " price Banks and dealers who are exceptionally well placed, and conduct operations on a very large scale, deal on the market at exceptionally favourable rates These rates are rarely divulged, hence it often happens that the quoted rates are simply those which serve for relatively small transactions between banks and their customers

When the margin between the buying and selling rates quoted by a dealer is small, the customer is said to obtain a " *close price*," otherwise the quotation is referred to as " *wide* " The mean of any two buying and selling prices is called a " *middle price*," to be clearly distinguished from *The Times* " middle rate of the day," which is the mean of the *extreme* buying and selling prices quoted by London bankers on the previous day

Where the difference between the quotations for buyers and that for sellers is only trifling, it is a sign that the rate was fairly steady , where, however, there is a good margin between the two figures, it is a sign that the rate was fluctuating and uncertain

Foreign Quotations : Official Rates of Exchange.

In certain newspapers quotations are given of the rates of exchange ruling on the continental bourses on the previous day In many cases only one rate appears, and this is usually called the *official rate*, for the reason that the rate is officially fixed by certain brokers appointed by a committee, and is arrived at by a consideration in the Bourse itself of the rates at which business has actually been done at a certain fixed hour, 1 30 in some cities, 2 30 in others This highly important custom settles the rate at which bills drawn in foreign currency on the country concerned have to be paid, the rate so fixed being valid up till twelve o'clock the next day, provided, of course, a bill bears no special exchange clause which entitles the collecting banker to collect at a different rate

Prior to 1921, a quasi-arrangement of the sort existed in London, and the published rates fixed at the bi-weekly meeting of bankers and brokers were regarded as more or less official Nowadays, *The Times* quotations are accepted for legal purposes here and abroad, but they are not accepted as a basis for dealings in the market

Dominion Exchange Quotations.

Since the sovereign of South Africa or Australia is intrinsically equal to our sovereign, the Mint Par between Britain and these countries may be expressed as £1 = £1; or, as is more usual, £100 = £100. Movements on either side of the parities are brought about, as in the case

of entirely different currencies, by changes in the relative purchasing powers of the Dominion and Home currencies, while those movements are limited, just as in the case of other currencies, by the cost of obtaining and shipping gold from the Home Country to the Dominions, and *vice versa*

Dominion currencies are not dealt with on the London Foreign Exchange Market, since transactions therein are entirely in the hands of the Dominion banks, while the actual method of quoting the rates of exchange between the various Dominions and London is not always the same Sometimes the rates are given as a *premium* or *discount* per cent, while at other times they are quoted as prices per £100 of the currency bought or sold. Usually, the quotation London on Australia is in English pounds per £100 Australian, and the quotation Australia on London is in Australian pounds per £100 English For example, if the London quotation for T T Melbourne is £99 10s, this amount in English pounds must be paid for the right to receive £100 Australian in Melbourne, while a *quotation of* £101 7s 6d *in Melbourne* means that this amount of Australian pounds must be paid there to obtain the right to £100 English in London

Again, the London rate on South Africa is usually given as a *premium* or *discount* in English pounds per £100 South African, while South Africa quotes London in terms of a *premium* or *discount* in South African pounds per £100 English So, if the London exchange quotation on South Africa is 1¼ % premium, it means that £101 5s English must be paid in London for the right to £100 South African in Cape Town, while if the quotation is ¾ % discount, it means that only £99 5s English need be paid in London to secure the right to £100 South African A quotation of 1½ % premium for London exchange in Cape Town means that £101 10s South African must be paid for the right to £100 English in London, or a rate quoted as ⅞ % discount shows that £99 2s 6d South African will buy the right to £100 English in London

Neither of these methods is fixed Some London banks quote rates on South Africa in terms of a price per £100, whilst others quote Australia in terms of a premium or discount per cent The two types of quotation are, of course, precisely the same in effect

Rates of Exchange for Forward Contracts.

The rate quoted by the Market for a *forward* deal (explained in Chapter 33) is, as a rule, not the same as that quoted for a "spot" deal Occasionally, the forward rates may be quoted at the same figure as the spot rate, in which case they are said to be at *par*, but, more usually, these rates are at a *discount* or at a *premium* on the spot price

If a rate of exchange is quoted "uncertain," *i e*, in foreign currency per £1 —

The forward rates are at a *discount* when they are *higher* than the spot rates, *i e*, when *more* foreign currency per £1 is bought forward

than is obtainable by a "spot" purchase, *i e*, forward foreign currency is cheaper than spot

The forward rates are at a *premium* when they are *lower* than the spot rates, *i e*, when *less* foreign currency per £1 is bought forward than is obtainable by a "spot" purchase, *i e*, forward foreign currency is dearer than spot

When the rate is quoted "certain," *i e*, in pence per foreign unit, forward exchange is at a *premium* if the rate quoted is *higher* than spot, and at a *discount* if the rate quoted is *lower* than spot

The discount or premium quoted for forward business must be added to, or deducted from, the "spot" quotation in order to arrive at the forward rate The amount of discount or premium is sometimes given as so much per month above or below spot, so that if the spot rate is known, rates for one month, two months and three months forward can at once be calculated At other times, however, the discount or premium for two or three months forward may not be two or three times the discount or premium for one month, and separate rates are accordingly quoted for business at one, two and three months

Thus, if the London-Paris spot rate is quoted at "124 00—124 05" and the forward rates are "1 month, 20c, 3 months, 60c, premium," the market rates for Paris would be as follows —

	Selling	Buying
Spot	124 00	124 05
1 month	123 80	123 85
3 months	123 40	123 45

Again, if lire are quoted at 92 75–85 in London, and forward rates are "1 month, 0 20 lira, 3 months, 0 75 lira, discount," the market rates for Milan would be —

	Selling	Buying
Spot	92 75	92 85
1 month	92 95	93 05
3 months	93 50	93 60

These forward rates are sometimes given as double-barrelled quotations in the same way as spot rates Thus forward rates on Paris may be given as "10-20c discount per month" when the spot rate is 124 00-124 10 As in the case of the spot rate, the two quotations are the bankers' prices for selling and buying respectively, and the forward rates are therefore as follows —

	Selling	Buying
Spot	124 00	124 10
1 month forward	124 10	124.30
3 months forward	124 30	124 70

EXCHANGE MAXIMS AND TERMINOLOGY

Favourable and Unfavourable Rates of Exchange.

A rate of exchange, quoted in terms of foreign currency per £1, is *favourable* to this country when our £ purchases more foreign money than the mint par, or, in those cases quoted in terms of so many pence per foreign unit of currency, when less of our currency has to be given for a foreign unit than is required by the mint par A favourable rate to England is one tending towards the incoming gold point, and an unfavourable rate is one approaching the outgoing specie point The inflow of gold is regarded with favour because gold is the basis of most currencies, a standing reserve is necessary to maintain the credit system of a nation, and increased gold supplies make credit cheaper and encourage trade by enabling money to be borrowed at low rates

When rates are quoted in foreign money to the £, *i e*, when quotations are movable or uncertain, helpful maxims often used by market men are "*High rates are for us, Low rates against us*", "*High rates are favourable, low rates are unfavourable*"

These maxims apply not only from the point of view of a nation, but also from the standpoint of the buyer of foreign currency per £ The London merchant who is buying exchange on Paris endeavours to obtain as many francs as possible for each £ he pays, whilst the seller of exchange tries to sell as few francs as he can for each £ he receives

"Buy High, Sell Low."

Another useful rule for guidance in foreign exchange dealings is that embodied in the phrases, "Buy high, sell low" This means that when rates are quoted, as is most usual in London, in terms of foreign money per £, it is better to buy more foreign units for each pound sterling, but more advantageous to sell as few as possible Francs, like candles or pens or books, become cheaper to buy when a greater number can be purchased with each pound of our own currency

Of course, if the rate of exchange is quoted in pence per foreign unit, then the maxim here given must be reversed We buy low and sell high, in such circumstances, as, for example, when we buy Japanese yen or Shanghai taels or Chilean pesos, all of which are sold, like other commodities in this country, at so many pence each

"The Better the Bill, the Lower the Rate."

When a rate of exchange is quoted in foreign money per £1, a *higher price* for a bill means a *lower rate* of exchange Hence lower rates are quoted in the London exchange market for those remittances which for any reason are regarded as superior to others Bank drafts, for

example, command higher prices, *i e*, lower exchange rates, than ordinary trade bills, while a short bill representing money due in a few days will be sold at a better price (*i e*, a lower exchange rate) than a long bill payable several months from the day of purchase

It costs more to buy a bill on U S A at $4 865 per £ than at $4 885 per £, for in the former case, less dollars are obtained for every £ paid in London . Similarly, while a long trade bill on Paris might be purchased at the rate of 127 francs to the £, only, say, 124½ francs to the £ would be obtained if the purchaser desired a bank sight draft on Paris

As in the case of the other maxims, the one here referred to must be reversed for exchange quotations in *home* currency per foreign unit, *e g*, pence per yen, peso or dollar In such cases, the rule for guidance would be " The better the bill, the *higher* the rate," just as one expects to give more pence for a decently bound book than for a paper-backed novel or magazine

" Rise and Fall."

When rates are quoted in foreign currencies to the £, the term " rise " indicates that more foreign money is equal to the £, in other words, that the foreign currency has *depreciated* in value A rise in the French rate from 124 to 125 50 francs per £, means that francs are worth less when valued in sterling A rise *in the rate* is, therefore, a fall *in the price* of francs, and also a fall in the price of remittances to France Conversely, a fall in the London rate on Paris, or any other centre similarly quoted, means that less of the currency of that centre is purchasable with each £1, *i e*, that the currency concerned has *appreciated* in value

Sometimes the terms " rise " and " fall " are used confusingly in exactly the opposite sense Thus the franc may be said to have " risen," by which it is meant that the *value of the franc* in terms of sterling has gone up or appreciated, *i e*, that the London rate of exchange on Paris has fallen The terms " to weaken " and " to become firm," also met with frequently in financial articles in the Press, are synonymous with the terms " depreciate" and " appreciate " respectively

Premium and Discount

When the exchange value of a foreign currency varies considerably from its par value, the extent of this variation is often expressed as a *premium* or *discount* on this par value Thus, if the New York-London rate stands at 4 85, the dollar is said to be at a premium in London and sterling at a discount in New York On the other hand, if London quotes dollars at $4 885, *i e*., over the mint par of 4 8665, then dollars

are said to be at a discount in London, while sterling would be at an approximately corresponding premium in New York

Methods of Transferring Funds Abroad.

There are, at the present time, a number of recognised methods of transferring funds from one financial centre to another The principal characteristics of the most important of these are briefly described below, and it may be stated that the rates of exchange applied to the different types of credit remittance vary chiefly according to the facility they offer for obtaining payment

BILLS OF EXCHANGE (B/E) This term covers bills drawn on demand or at sight (*short* bills), bills at term (*long* bills), cheques and bankers' drafts The number of bills drawn *and* accepted by traders (*trade paper*) has tended to decrease during recent years, while the number of bills drawn or accepted by banks and financial houses (*bank paper*) has increased greatly, indicating the tendency towards the substitution of bank credit for commercial credit which arose during the critical period of the Great War.

CABLE TRANSFERS OR TELEGRAPHIC TRANSFERS (T T) These are a most important form of remittance, but, as their use requires an elaborate system of authenticating telegrams or cables (there being no signatures to verify), they are, in practice, confined to the members (mostly banks) of the various exchange markets of the world and to the largest commercial concerns As their name implies, they are a form of " order to pay " expressed in telegraphic form instead of in the form of a bill or cheque

MAIL TRANSFERS (M T) The Mail Transfer is a form of remittance designed to economise the drawing of cheques or drafts by banks on one another, and to obviate the risk that the funds may fall into wrong hands It can be classed as a mailed form of telegraphic transfer, embodying instructions to a bank overseas to make a payment to a named payee, and is used mainly between first-class institutions where the payment to the named third party can be effected by a credit to account or by a payment to another bank

GUARANTEED PAYMENTS (Guaranteed Mail Transfers G M T) These are a comparatively recent innovation designed to relieve the purchaser of a sight draft or mail-transfer of the risk that the remittance sent by mail may not be delivered to time owing to delay in the arrival of the mail Since a delay of even one day in the case of large payments means substantial loss, most bankers will now sell payments which they *guarantee* shall be made so many days ahead The price is calculated from the current rate for cable transfers with due allowance for interest for the number of days which must elapse before the payment is actually

made abroad. The banker's instructions to his overseas agent are sent by deferred cable

STOCK EXCHANGE SECURITIES Certain obligations of Governments (in the shape of bonds), and of railways, oil, mining and other industrial companies (in the form of bonds, stocks and shares) are saleable in all the principal financial centres of the world, while the interest coupons are often expressed to be payable in one of several centres at the choice of the holder

Such coupons are naturally encashed in the centre offering the largest yield in the currency of the holder, and form a common method of remitting funds between two centres, while bonds, stocks or shares which are quoted on the stock market of the creditor centre, are also utilised to replenish balances in the absence of any cheaper form of remittance

BULLION is, of course, the final means of discharging indebtedness. Its use is, however, restricted to Governments and bankers, owing to (*a*) the highly technical nature of the operation of transfer, (*b*) the high costs of freight, insurance, loss of interest, etc , which can be reduced to practical proportions only in the case of large shipments of precious metal or coin, and (*c*) the fact that, as soon as the price of any foreign currency rises to a point at which a profit can be made by shipping bullion and selling the foreign currency so obtained, the banks are the first to be aware of the state of the market and to seize the opportunity of profit

Securing Payment of a Foreign Bill.

Payment of a bill payable abroad may be obtained in one of two ways, either by (*a*) negotiation, or (*b*) collection

NEGOTIATION In this case the bill is sold to a banker who pays over the proceeds, less discount, immediately, and usually holds the bill for collection on his own behalf at maturity This process is the same as discounting a bill, although in the case of foreign bills it is usually referred to as *negotiation*

COLLECTION In this case, also, the services of a banker will usually be required, but with this difference the banker acts only as a collecting *agent* for the holder of the bill, and does not buy the instrument The bill is sent by the banker to his agent abroad, with the request that he will present it to the foreign drawee for acceptance, and, at maturity, for payment, and arrange for the return remittance of the proceeds, which, when received, will be handed over by the collecting banker to his principal, less collecting charges

From an exporter's point of view, there is an important difference between the two methods By negotiating a bill, he is enabled to

secure command of the proceeds almost *immediately*, whereas, if he sends a bill for collection, he has to wait *until its maturity* before he gets command of the proceeds Whenever possible, therefore, exporters negotiate their bills and send them for collection *only when they are drawn direct upon the importer*, and consequently afford a security which is not always sufficient to induce a banker to negotiate them

It is this disinclination on the part of bankers to buy bills drawn upon ordinary merchants which has led to the extensive use of bankers' credits Bills drawn upon bankers under such credits are always saleable, and at a good price, whereas those drawn on unknown firms (however financially sound they may actually be) are not readily saleable, or even acceptable as security

Negotiation of Bills Drawn in Foreign Currency.

When purchasing bills drawn in foreign currencies, bankers must have regard both to the standing of the various parties to a bill, and to the condition of the currency in which the bill is drawn A bill drawn on and accepted by a first-class bank abroad would obviously be a more attractive proposition than one drawn on a foreign merchant, and would therefore command a better price, *i e*, a lower rate of discount Again, a bill drawn on a country whose currency is unstable or subject to restrictions would be more difficult to re-discount than one drawn on a country whose currency is stable and supported by a strong banking organisation

Since most currency bills are purchased from customers on a "tel quel" basis, the banker when making his calculations must take into consideration the basic rate or rate for purchasing demand drafts on the centre on which the bill is drawn, the rate at which the bill can be re-discounted on its arrival in the foreign centre, any stamp duties to which the bill is liable in the foreign centre, any charges for collection which the foreign bank may make, days of grace, if any, an appropriate allowance for possible delays of mails or other contingencies, and finally, his profit

Having purchased a currency bill from a customer, the banker may generally adopt one of two courses to secure the return of his expenditure of sterling If he elects to forward the bill to his correspondent banker in the centre on which it is drawn for discount on arrival and credit to his currency account, he is in a position to sell a T T or cable transfer and incur an overdraft until the arrival of the bill, *or* a demand draft whose presentation abroad will approximately coincide with the credit for the discounted bill, *or* forward exchange for delivery to coincide approximately with the credit for the discounted bill

In the first two cases the banker recovers his sterling at once In the third case he has to wait for the duration of the outward mail.

Which course he will adopt depends entirely upon the banker's exchange position, on the demands of his customers and on the comparative merits of the rates of exchange available for the three classes of remittance.

Should the banker not wish to re-discount a bill he has purchased, he may send it to his correspondent abroad for acceptance, etc., and have it held abroad in portfolio or returned to him until the due date approaches. Then, instead of selling T.T. or a cheque against his purchase, he may sell *forward exchange* for delivery on a date coinciding with the due date of the bill. In the latter case, the banker turns the transaction into *an investment deal with the exchange secured, i.e.*, he can calculate exactly what return he will receive on the sterling he has invested.

CHAPTER 28

FOREIGN EXCHANGE MARKETS.

In every important financial centre there exists a more or less organised foreign exchange market, wherein foreign currencies are bought and sold in much the same way as the principal commodities of commerce on the recognised produce markets The foreign exchange market in London stands foremost both for the extent of its dealings and the efficiency of its organisation, and a brief explanation of its functions should enable the reader to obtain a fairly clear understanding of the structure of the world's foreign exchange mechanism.

London's International Supremacy.

London's unique position among the world's foreign exchange markets and money markets is traceable to a number of factors Her pre-eminent position as the world's financial centre and commercial clearing house established the sterling bill as an international medium of exchange, utilised by other nations to settle transactions, not only with this country, but also among themselves Consequently, a large proportion of international settlement is effected through the medium of London financial institutions, and upon them falls much of the work involved in international credit operations

The extent of the financial business conducted by and through London may be judged from the fact that a well-known authority has estimated that, in pre-war days, as much as *nine-tenths* of British overseas trade, and more than *one-half* of the world's overseas trade were financed in sterling Although this position was necessarily modified by the War, London still maintains a predominant position and by this international business our bankers and accepting houses not only earn very large annual sums in the way of commissions, but also carry their reputation to every corner of the world

Many reasons may be advanced to account for London's eminence as a financial centre, and it is not possible here to do more than notice a few of the most important Britain's maritime supremacy, the spread of her people, and her allegiance to Free Trade, caused a world-wide extension of British trade, with the result that bills on London are to be found in all places where trade has penetrated The early adoption

of the gold standard by Britain gave her people a sound currency, and the world has come to recognise that British money is as good as gold, and that bills payable in London mean gold London is the largest free market for gold in the world—for a long period it was the *only* free gold market—while the organisation of her discount market and the efficiency of her money market are unapproached by those of other countries. In the third place, British accepting houses, banks and firms have a world-wide and unrivalled reputation for soundness and stability, while Britain's great wealth has contributed to make her people the creditors of the world, and has given them an interest in the affairs of all nations

Finally, there is the important, but frequently overlooked, fact that London was a pioneer in insurance business The London underwriting market, centralised at the world-famous institution known as "Lloyd's," has earned such a reputation for integrity and financial strength that the safety and security of vast international trading operations are dependent on the facilities which it affords

Predominance of London Acceptances.

One important result of these conditions is that London came to draw relatively few bills, but to accept many In the settlement of indebtedness between two parties by bills of exchange, only one party need draw, and, so far as our own country is concerned, that party until recent years was almost invariably the foreigner London bills have so long been more readily purchasable and saleable abroad than any other form of credit remittance, that, generally speaking, a foreigner who owed London money preferred to remit sterling while a foreigner who had money to receive from London preferred to draw in sterling on London and sell his bill locally In addition, great numbers of bills were—and, of course, still are—drawn on London in respect of trade which never touches these shores, and such bills, which are accepted by our bankers and accepting houses on foreign account, necessarily increase the world supply of bills on London and extend the world market therein

This arrangement proved equally acceptable to the British trader, who, until the Great War modified his outlook, neither professed nor desired any knowledge of the currencies of other nations, and was long content to leave the foreigner with any profit he could "snatch" from the exchange transaction which necessarily followed every transfer of goods or services For these reasons, pre-war rates of exchange on London were largely fixed by the foreign buyers and sellers of sterling exchange, and, since the pound sterling is the largest important monetary unit in the world and was dealt in as a commodity, prices were naturally fixed in terms of the country quoting, *i e*, quotations

came to be made in terms of a number of units of foreign currency per pound sterling

Conditions arising out of the War naturally brought about a considerable change, and a variety of reasons, including the depreciation of sterling and the hazardous conditions of international finance engendered by great fluctuations in the exchanges, led foreigners to demand payment for their exports *in their own currencies* Hence, it became much more the case than formerly for mercantile transactions to be settled in the currency of the country which supplied the goods

Fortunately, British banks have shown such praiseworthy initiative in developing their foreign exchange departments that dealings in foreign currency are no longer a "bugbear" to the British trader Existing arrangements relieve him of all trouble and difficulty, and at the same time reduce to a minimum the risk of loss on exchange operations

Just as "trade follows the flag," so banking follows trade, and the foreign branches of British banks nowadays afford complete facilities for financing home or foreign trade either in sterling or in any other currency At the same time, it will be clear that the British trader can no longer refuse to interest himself in foreign exchanges and foreign currencies He can no longer rest content to quote in sterling and rely on sterling settlements, for traders in other progressive countries are only too keen to capture foreign markets by issuing quotations and catalogues and accepting settlements in the currency most acceptable to their customers or correspondents

Yet it is pleasant to be able to record that sterling still maintains its superiority as an international currency, and that, in spite of the competition of other currencies, bills on London remain pre-eminently in favour throughout the world for settlements connected with trade of other countries as well as with our own trade

The Mechanism of the Foreign Exchange Market.

In Foreign Exchange, as in other branches of the commercial machine, the constant urge nowadays is for the saving of time and money The cry is always for speed—and for greater speed—in the settlement of business transactions, in the transfer of funds and in communication between one world centre and another As a result, the foreign exchange markets to-day consist of an elaborate organisation of telephones, telegraphs and cables between the banks, financial houses and brokers constituting each market, and between the various markets themselves

In the London Foreign Exchange Market this feature of the organisation reaches a high stage of perfection The one-hundred-and-fifty or so of *dealers* in the banks and financial houses are in constant

direct communication with about thirty of the forty or so firms of foreign exchange *brokers*, each of which specialises in a certain currency or in a certain group of currencies

The arrangements existing in the London Market differ considerably from those most customary abroad In nearly every foreign financial centre of any importance there is a meeting place or *Bourse*, where the exchange dealers have recognised pitches which they occupy for dealings with one another for certain fixed hours in the morning and afternoon, while for the rest of the day they deal from their respective offices on a system similar to that of the London Market

The Functions of the London Foreign Exchange Broker.

On the London Market, the bulk of foreign exchange business is transacted by the dealers, not direct with one another, but through the intermediary of the brokers, who instal and bear the expense of maintaining the private lines to the banks The business put through by the dealers may, of course, be on their own account, or on account of customers, or on behalf of agents abroad, but the brokers act simply and solely as agents between buyers and sellers They do not deal on their own account, but make their living out of commissions (which vary according to the currency dealt in) paid to them for their function of bringing buyers and sellers together

The broker's function is to keep his clients, the bank dealers, posted with the prices at which he finds buyers and sellers in the course of his enquiries round the Market If his judgment is consistently faulty and he "reads" certain of his clients as buyers or sellers at various prices when, in fact, they are not so interested, then the prices he quotes will be found to be unreliable, his clients will fall away from him and will seek some other broker who can supply more generally correct information The broker must also be an expert in mediation, or the art of compromise He has to try to bridge the gap between buying and selling prices by persuading one party to come to the other's price, or by persuading both parties to meet at the middle price

But while the broker's chief function is the linking up of supply and demand, he also performs a most valuable service as arbiter of the rates at which oral transactions are effected This is a vital function under present conditions since the broker is, as it were, constituted an impartial umpire between the two parties to a bargain, which, it may be added, is generally concluded before the parties concerned are aware of the identity of each other

The Broker's Contract Note

A peculiarity of the organisation of the London Foreign Exchange Market is that, although the banks conduct their exchange business

through the medium of brokers, yet, once a transaction has been arranged, the completion of the contract is effected *directly* between the *dealers* concerned So that each party may be aware of the identity of the other, and in order to confirm the terms of the contract, the broker forwards to buyer and seller respectively a "bought" and a "sold" contract note On each of these contract notes are given (*a*) the name of the other party to the contract, (*b*) details as to the amount of currency involved, the rate of exchange, and the form of remittance, (*c*) the amount of brokerage, which is usually, though not always, shared between buyer and seller, and (*d*) *the value date*

VALUE DATE —This is the actual date, fixed by agreement or by custom, on which the contract is completed, *i e*, the date on which the currency is to be delivered in the foreign centre and sterling paid in London The terms "*valeur compensée*" and "*here and there*" denote that payment of the sterling and of the foreign currency is to be made on the same day, so that no loss of interest may accrue to either party In modern exchange transactions, it is always understood that payment is to be made "here and there"

Exchange Dealings.

The conjoint operations of the London banks and financial houses comprising the London Foreign Exchange Market may be compared with the operation of any form of clearing house The members of the Market, individually and collectively, form a clearing house for the settlement of international debts, where in theory the debts owing to and by parties in one country are set off or liquidated against the debts owing to and by parties abroad The foreign exchange dealer buys bills, cheques, drafts, mail and telegraphic transfers, coupons and bonds payable in foreign countries, and, when these are collected, the proceeds are placed to the credit of his bank with its foreign agents Against such credit balances (or sometimes against overdrafts which the bank is allowed) he sells drafts, mail transfers, T T 's, etc, according to the requirements of his customers —debtors who have to remit abroad —and the difference between his buying and selling prices constitutes his profit

When a dealer wishes to carry out an exchange transaction in a certain currency, he rings up one or more of the brokers dealing in that particular currency in order to ascertain the ruling market price From each broker he receives at once a double-barrelled quotation, at which it is certain or practically certain that the broker in question can find respectively sellers and buyers When the dealer is satisfied that the rate of exchange quoted by any broker is as good as he can get, he indicates the amount which he wishes to buy or to sell, as the case may be, and is forthwith told the names of the other parties to the

bargain, which is subsequently confirmed in writing by the Exchange Contracts Department of the dealer's institution.

The Dealer's Position Sheet.

It is no part of a foreign exchange dealer's business to speculate in the currencies in which he deals. On the contrary, he aims at maintaining a *level* book, *i.e.*, at making the total of his sales and purchases balance each other as far as possible, since, if he has overbought or oversold to any considerable extent he may incur risk of loss if the rates of exchange move against him. In order that he may be able to see at a glance the exact state of his sales and purchases in each currency, all dealings therein are entered on a *Position Sheet*, which the dealer keeps carefully posted throughout the day.

The dealer does not, of course expect his purchases and sales to balance one another exactly, and in the ordinary course a balance of, say, a few thousand francs either way would merely be left to adjust itself in the ordinary course of business. But if at the end of the day his Position Sheet indicates that he has *largely* oversold or overbought any particular currency or currencies, he will purchase or sell cover to an equivalent extent in order to even up his position. Thus we have the most important result that the operations of the foreign exchange dealers tend to equilibrate demand and supply in foreign currencies—a factor of vital significance (as will be explained later) in bringing about that daily adjustment of international debits and credits which is essential to the continued maintenance of the gold standard.

CHAPTER 29

FLUCTUATIONS IN THE EXCHANGES.

SINCE the rate of exchange between any two currencies is determined, at any particular time, by the relation between demand and supply on the respective exchange markets, and, in the long run, by the purchasing power parity between the two currencies, it is clear that there must be two groups of factors which bring about changes or movements in the rate of exchange First, there are those influences which produce changes in the daily (and even hourly) relationship between the demand for and the supply of exchange, and so have greatest effect *in the short period* Then there is the second group of influences which modify the relationship between the purchasing powers of the two currencies concerned and so have greatest effect *in the long run*

INFLUENCES MAINLY AFFECTING CURRENT DEMAND AND SUPPLY

On any exchange market, both the demand for and the supply of foreign exchange arise mainly from the necessity of settling legitimate business debts, and the activity of the market depends chiefly on the amount of those debts which are *in process of being settled* The words in italics are very important, since the *aggregate* of indebtedness outstanding between any two countries has no *immediate* effect on the prevailing rates of exchange It is only those debts which arise for immediate settlement that affect the current relationship between the demand for and the supply of exchange

The debts in process of settlement at any particular time spring from many sources Some spring from the exchange of commodities, others from the performance of services connected with trade in goods, many debts are created by banking operations, by the borrowing and lending of money and by the purchase and sale of international securities, whilst others are the product of speculation having little legitimate basis War is, of course, a prolific though spasmodic creator of international debts, and the Great War, in particular, left an enormous legacy of indebtedness, which, with the reparation payments being made by Germany and her late Allies, exerts a vital influence on present-day exchange conditions.

Trade Influences.

In view of the fact that the main source of indebtedness between any two countries is the reciprocal trade in goods, it follows that, in ordinary circumstances, the most important influence affecting the relationship between the demand for and the supply of a foreign currency on any foreign exchange market is the *direction* or *balance* of current trade between the two countries concerned

But debts of considerable magnitude will arise for settlement also in respect of a variety of services connected with this trade The international movement of goods involves expense in the form of freight, packing, and insurance , landing and warehousing charges , commission for the buying and selling factor or broker, and, probably, commission paid to a bank or accepting house for financing the transaction and ensuring due payment for the exporter

In the case of some countries (*e g* , Britain), services of this kind involve the receipt on balance of enormous annual payments from other countries

Stock Exchange Influences.

These comprise investment and speculation in international securities, the raising of long-period loans abroad, together with payments of dividends and interest on money borrowed, and repayments of capital All these give rise to debts, in the case of some countries of huge annual value, which have to be settled through the medium of the foreign exchange organisation

Overseas Investment.

It is well known that the capital of many of the world's leading commercial, industrial and municipal undertakings are held more or less internationally, and that the stocks and shares issued by such undertakings are freely dealt in on the world's principal stock markets Every sale of a foreign security creates a debt between the two countries concerned The purchasing or investing centre imports share certificates, debentures, scrip or bearer bonds from the other country, and pays for them in precisely the same way as it pays for imports of food or raw materials To effect these payments, either the centre selling the securities offers the currency of the importing country on the foreign exchange market, or the importing centre enters the market as a buyer of the currency of the selling country

Speculation in Stocks.

Closely allied with investment is speculation in international stocks, which implies chiefly the purchase of foreign stocks and shares in

anticipation of a quick rise in their price, with no immediate intention of holding them permanently for investment and income purposes Action of this kind tends to be more spasmodic than investment pure and simple, and consequently has a much more erratic effect on the exchanges In recent years we have witnessed many examples of the violent disturbance of the foreign exchanges by a sudden speculative demand in one country for certain securities of another, as may arise in consequence of some factor, such as high interest rates, which renders one centre particularly attractive to others for the speculative purchase of securities.

In all such speculative operations, as in the case of investment pure and simple, the purchase and sale of securities give rise to debts which the purchasing centre has to pay in return for the certificates and bonds imported from the selling centre Consequently, there is on one side a demand for the currency of the centre attracting the funds, and on the other an increase in the supply of the currency of the investing centre

Stock Arbitrage.

Speculation in international stocks often takes the form of an operation known as "stock arbitrage", involving the purchase of an international security on one stock market and its sale on another at a favourable difference in price

Operations of this kind are undertaken only by highly specialised firms who have an expert knowledge of the difficulties of the business, and their success depends on the existence of slightly different prices for the stocks concerned on the various markets The price differences are partly due to the fact that the quotations are in different currencies, necessitating conversion from one to the other, partly to differences in the relation between the demand for and supply of a certain stock at a given moment in different centres, and partly to the variation in the times at which the stock markets open and close

While the success of stock arbitrage depends on the existence of price differences, its effect is to reduce those differences Competition for the business is so keen, and communication between the various centres is so quickly established by telephone and telegraph, that any profitable margin soon disappears On the other hand, the number of securities available for arbitrage tends constantly to increase, while the extension of the telephone to new centres opens up new spheres of profitable operation

The Issue of Long Period Loans.

The enormous and increasing extent to which wealthy nations have lent their resources for various purposes to less fortunately situated

countries is striking testimony to the growth of economic interdependence and financial internationalism Funds seeking profitable employment are accumulated in the financial centres of the older, highly commercialised countries, whereas they are most urgently required for development purposes in remote new countries, with the result that there is a constant flow of loanable capital from the one group to the other.

The transfer of such amounts of capital has very important effects on the distribution of world indebtedness and so on the prevailing rates of exchange The actual effect depends on the manner in which the money borrowed is used, *i e*, whether it is withdrawn in cash, *i e*, gold, or whether it is used to buy goods or to pay debts already owing *in the lending country*, or to purchase goods or wipe off debts owing *in other countries*

If the money borrowed is used to purchase machinery and other manufactures of the lending country, there will be no immediate effect upon the exchanges of that country, since the proceeds of the loan will be distributed amongst the suppliers of the goods and no immediate foreign exchange transaction is involved

But if the money is applied to buy goods of a third country, that country offers currency of the lending country on the world's foreign exchange markets, and the exchanges of the lending country are adversely affected The same thing happens if the borrowing country spends the money internally Her nationals offer currency of the lending country for sale and thus depress its price, *i e*, influence the rate of exchange unfavourably to the lending country

"Every Foreign Loan Creates an Export".

It is frequently stated in justification of our policy in this country of allowing all and sundry to borrow on the London Money Market that "Every Foreign Loan Creates an Export", by which it is meant that, in general, the proceeds of overseas loans go out of the country almost entirely in the form of goods and rarely in the form of gold This argument is of course, very largely true, and it is frequently illustrated by reference to the vast outflow of manufactures which accompanied Britain's extensive foreign investments in the nineteenth century, and which have similarly resulted from the heavy loans made to continental countries in recent years by the United States and other lending nations.

Payment of Dividends and Interest.

The effect on the exchanges of the payment of interest on loans is entirely the reverse of the effect produced by the actual raising of the loan Payments of interest and repayment of capital by foreign nations

to this country cause a demand for exchange on London. Dividends may be paid by the despatch from London of coupons for collection and payment, or by the remittance of funds to a London bank against which interest warrants are issued and paid Similarly, when bonds mature or are drawn for payment, or when a loan is paid off in any other way the borrowing country has to pay by some means or other. On the other hand, when this country pays interest or sends dividends to foreign investors, the supply of British currency in foreign centres is increased and its value falls

Banking Operations.

The operations of bankers affect the rates of exchange through (*a*) the issue of letters of credit, circular notes, and travellers' cheques (*b*) arbitrage operations, (*c*) the transfer of bankers' funds from one country to another for short-term investment, as by the purchase of bills or otherwise

Bank Credits.

Letters of credit consist essentially of documents issued by bank with the object of enabling the grantees to obtain funds in places where they are not known on the strength of the recognised credit of the institution issuing the document, usually under the signature of its authorised officials

The main types of letters of credit are described in Chapter 34 At this point it is merely necessary to explain that their use facilitates the movement of vast quantities of goods and affords the greatest convenience to persons travelling abroad either for business or pleasure while they influence the exchanges because the drafts and bills drawn thereunder increase the supply of the currency of the country of issue in other foreign exchange markets

Arbitrage Operations in Exchange.

Exchange dealers occasionally undertake exchange operations with the sole object of realising profits from differences in the exchange rate ruling at various centres at the same time. Such operations, which have no definitely commercial basis, are known as *arbitrage dealing* or *arbitrage operations*. They are often hazardous, require special skill and can be profitably conducted only by bankers and brokers operating in conjunction with branch houses or agents in other financial centres

The exchange dealers of these institutions, being continually in touch with all the principal foreign centres both by telephone and cable, are quick to take advantage of any differences in the relative values of

currencies as quoted in each centre Thus, a dealer in a London bank may conduct a *simple* or *two-point* arbitrage operation by purchasing francs from his own market, say, at 124 to the £1, and immediately selling them to Paris by telephone for, say, 123 9 per £1, making a profit of ·10 francs or 10 centimes per £1, less telephone charges and other expenses involved

Compound Arbitrage Operations.

In practice, arbitrage operations are rarely as simple as this, since keen competition and close communication between dealers in the various centres soon remove those differences in the rates which make profits possible There are greater possibilities of gain (and of loss) in more complicated operations involving three or more currencies

For instance, a London dealer, while receiving a telephone call from Amsterdam, may have an assistant engaged with a telephone call to Paris, another assistant receiving cables from New York over a private telephone line to one of the big Cable Companies, while another assistant "works the Market", *i e*, keeps in constant touch with the London foreign exchange brokers so as to follow any changes in the Market here Rates are rapidly compared and the parities are worked out on calculating machines, with the result that it can be quickly seen how best to execute any orders in hand for account of customers, or whether any profit can be made by, say, buying Paris francs in Amsterdam, buying New York dollars in Paris with these francs, and covering the florins required in Amsterdam to pay for the francs by purchasing them in New York with the dollars obtained in Paris

Again, if the Paris exchange on London is high, a Paris banker, who is under the necessity of increasing his sterling balances, may find that his cheapest way of doing so is to buy Dutch florins in Paris and to sell these in Amsterdam for sterling in London His close connection with all important centres by telephone keeps him immediately informed of the trend of the market in the various currencies His constant aim is to buy in the cheapest market and to sell in the dearest If necessary, he will buy the sterling through two or more centres, since it matters little to the dealer, concerned with an important operation, whether the price in francs which he ultimately pays for sterling is obtained by the purchase and sale of one, two, three or even more currencies, *i e*, whether it involves a *two-*, *three-* or even *four-point compound arbitrage operation*

The Transfer of Bankers' Floating Balances.

The business of all important banks in the world is now internationalised to such an extent that they find it necessary to maintain

liquid balances of considerable magnitude distributed among the principal financial centres The total held in each centre depends, of course, on the nature and extent of the particular bank's business, but a large part of these funds is freely available for immediate transfer to whichever centre is for the moment offering the greatest inducement in the way of interest on short term deposits

Now the magnitude of these funds, the facts that they must be kept remunerative, that they can be moved easily and quickly from one place to another by telegraphic instruction, and that they are in the hands of those institutions which possess the requisite facilities for their rapid transfer, are together sufficient to give what is known as the *transfer of banks' floating balances* a place of predominant importance among the factors which now cause movements in the chief rates of exchange A rise in interest rates in a leading financial centre above the general level prevailing elsewhere is almost certain nowadays to cause a striking movement of floating balances to that centre Such a movement implies, of course, a demand abroad for the currency of the centre concerned, and it follows, therefore, that, if the movement is a considerable one, the rates of exchange on that centre must be very markedly influenced

Recognition of these facts lies at the root of the policy adopted by the world's leading central banks to control the exchange rates of their respective countries Interest rates are kept at a relatively *high* level if it is desired to attract foreign balances for investment and so increase the foreign demand for the currency of the nation concerned Conversely, interest rates are kept *low* relative to those prevailing in other important countries if it is desired to encourage the outflow of balances for investment abroad

The Continental Bankers' Investment Demand for Bills.

At the present time, the bulk of such balances seeking profitable investment abroad is transferred from one centre to another by telegraphic and cabled instructions between banks and their agents, the transfers taking the form of credits and debits in the *currency accounts* maintained by the banks with their correspondents In pre-war days, however, bankers' investments in foreign centres were effected almost entirely by the purchase of bills of exchange payable in the centre wherein it was desired to invest the funds, and such purchases by continental bankers of sterling bills were a pronounced feature of pre-war European finance, and a factor of the greatest importance in affecting the continental rates of exchange on London Since foreign bills are always discounted at the rate ruling in the centre wherein they are payable, a rise in discount rates on the London Money Market caused sterling bills to cheapen in foreign centres. Hence, a rise in the English Bank

rate could almost invariably be counted upon to create an increased demand for London bills and thus to influence the rates of exchange in favour of London.

These purchases of foreign bills for investment purposes are still of marked importance in their effect on sterling rates of exchange, and particularly on London–European rates, since Continental bankers have not departed from their practice of holding in their portfolios some proportion of bills on London to the exclusion of bills on other centres where rates are equally high, or possibly even higher

The Preference for London Bills.

The reasons for this preference for London bills are not far to seek. London bills are so widely used as an international currency, and have such an unequalled reputation for security, that they are easily obtained and freely negotiated, while they also have the advantage of being readily convertible into gold, if desired.

It must, of course, be understood that the existence of a high rate of interest in any centre does not necessarily mean that there will be a general investment of funds in that centre. The question of the financial status of a country receives even more consideration than the actual rate of interest ruling there, and funds will not be transferred to a country for investment if there is the slightest possibility of financial difficulty or political disorder which might militate against the instant removal of foreign-owned funds

It is for these reasons that, while Continental banks have always been willing to hold foreign, and particularly London, bills as investments, English bankers as a rule do not care to hold bills of exchange drawn on foreign centres, unless they are indorsed or drawn by a first-class London house In fact, London bankers were for long averse to investing their funds in bills of any kind drawn on foreign centres, and though the extension of British banks to the Continent and the great expansion of their business in foreign exchange has modified the policy of certain London banks in this direction, those banks who do now make such investments usually cover them by forward sales of currency for similar amounts

It is, of course, well known that foreign banks have always held considerable sums in sterling bills for the express purpose of using them to draw gold from London in the event of an international crisis, and that foreign central banks with liquid balances in London are content to be to this extent dependent upon us for the safe keeping of a considerable proportion of their reserves. Moreover, the constitutions of many central banks, especially in countries having a gold exchange standard, now empower them to hold a certain proportion of their reserves, whether against notes or deposits, in bills payable in the

chief gold centres, especially London and New York Such investment ensures that gold shall be readily available in time of need, while the bills themselves constitute a readily realisable asset, affording on occasion special opportunities for profit

Finally, there is the important point that, while London banks almost invariably retain their discounts until maturity, Continental bankers retain their holdings only so long as they find it profitable to do so Their bills are purchased, held or sold from time to time as the exigencies of securing a profit, or averting a loss, may dictate, and this fact affords us yet another explanation of the important influence exerted by the Continental bankers' investment demand for bills on the sterling rates of exchange

The Transfer of Funds by Forward Exchange Operations.

The investment of funds even in the soundest available bills carries with it a risk that some, or possibly all, of the outturn of the investment may be wiped out by an adverse movement in the rates of exchange between the date of purchase and the date of realisation

With the object of avoiding such a loss in these days of quickly moving rates, bankers in recent years have availed themselves of the machinery of the Forward Exchange Market in order to cover themselves against adverse movements They now transfer their funds to that centre which returns the best rate of interest by effecting what is called a "swap and deposit" operation, *i e*, the dealers effect an immediate "spot" purchase of the currency of that centre in the form of T T, and cover themselves against risk of loss by combining this purchase with a forward *sale* of the same currency to be completed on the date when they wish to get their funds back

If, for example, interest rates are higher in Paris than in London, a London dealer will buy spot francs and sell them, say, three months forward, *i e*, he pays out sterling in London and receives credit in Paris for an equivalent sum in francs These earn interest at a higher rate than the dealer would have obtained on the sterling paid out by him in London, and the difference represents his profit on the operation

In the same circumstances, dealers in Paris can make profits by selling sterling "spot" against three months' loans arranged with London bankers The drafts are paid on presentment in London and are debited to loan accounts, on which interest is charged for three months at the London rate The Paris dealers cover their sales of spot sterling by purchasing the same amount of sterling three months forward, at once investing the francs received from the sale of the spot sterling, say, in French bank bills, which yield the higher rate of interest At the expiration of three months, the francs received for the matured bank bills will be used to pay for the sterling bought three months forward, and this

sterling will be applied to wipe off the overdraft created in London In this way, a French dealer is able to make a profit from the difference in the interest rates ruling in Paris and London without employing any of his own money

If reverse conditions rule and interest rates are higher in London than in Paris, London dealers arrange overdrafts in Paris and sell spot francs against forward francs, investing the sterling proceeds of the sales of spot francs, say, in British Treasury Bills On their side, the Paris operators buy spot sterling and sell forward, and they also invest the proceeds in British Treasury Bills, or in some other equally safe and remunerative way on the London Money Market

As a rule, such "spot and forward" operations are conducted on a three months basis, but the investment may, of course, be for a shorter or a longer period according to the dealer's view of the relative interest position in the two centres concerned, and the likelihood of any change occurring therein And as compared with investment in foreign bills, the method here described has the further advantages that the funds transferred to a foreign money market may be used in a variety of ways as profitable opportunities present themselves , as, for example, on fixed deposit, or on the short loan market or in the purchase of short term securities, such as British Treasury Bills

Dealers who cover their spot purchases in this manner naturally lose the chance of netting an extra profit from a movement of the exchange in their favour But the business of using money to the best advantage is entirely distinct from speculation for a profit in exchange, and banks are more than content to take an additional interest profit and be secured against an exchange loss

Speculative Dealings in Exchange.

As distinct from "arbitrage", there is another type of speculative foreign exchange transaction which involves buying or selling foreign currency with the object of subsequently securing a profit from a rise or fall in its value Such transactions are very similar to the operations of bull and bear speculators on the stock and produce markets "Bulls" of a foreign currency buy that currency, not to make legitimate payments abroad, but because they expect its price to rise In like manner "bears" sell foreign currency they do not possess in the hope that a fall in its value will enable them to "buy in" later at a lower price When the exchanges are relatively stable, there is little scope for profitable operations of this kind, But in times of widely fluctuating rates, such as was the case during and immediately after the War, both extensive profits and serious losses may be made

In general, speculative purchases or sales of a foreign currency have the effect of accentuating exchange movements When the value

of an unstable currency is rising, speculators buy in anticipation of a further rise and so favourably influence the exchanges of the country of issue Conversely, a fall in the value of an unstable currency foreshadows a further collapse, and the depressing effect of sales by nervous holders is accentuated by the operations of bear speculators selling for a further fall

INFLUENCES AFFECTING RELATIVE PURCHASING POWER

Since a rate of exchange is determined in the long run by the relative purchasing power of the two currencies concerned, it follows that any factors which affect the purchasing power of either currency must also cause fluctuations in the rates of exchange

Now, every currency has really two purchasing powers (*a*) its purchasing power within the country of issue, *i e*, its *internal* value, and (*b*) its purchasing power outside the country of issue, *i e*, its *external* value

Clearly, the external value of a currency is the more important from the point of view of the foreign exchanges, but that external value tends in the long run to be determined by the internal value Moreover, while the use of price index numbers makes it possible to estimate the internal value of a currency fairly accurately, no such precise statistics are available in relation to the external value of that currency

The Purchasing Power of Currencies on a Gold Standard.

A currency's internal value depends very largely on the type of standard adopted Some countries have a silver standard, others a standard of inconvertible paper, but in most countries nowadays the gold standard is the basis of the currency and credit machine This does not imply that all such countries have what is known as a *full gold standard* or a *gold specie standard*, *i e*, a currency system in which notes are convertible without restriction into gold coin, both for internal and external purposes All that is necessary is that the value of the circulating medium, whether silver or paper, shall be kept on a par with the value of gold by the maintenance of either (*a*) the *gold bullion standard*, which implies that the legal tender currency is exchangeable for gold *bars*, but not necessarily for *gold coin*, *i e*, that gold shall be available for export but not necessarily for internal use, or, (*b*) the *gold exchange standard*, whereunder the external value of the currency is kept constant in relation to gold by ensuring its free convertibility for external purposes into gold or gold exchange, In brief, the maintenance of a gold standard of one of these three types implies the *convertibility* of the circulating legal tender currency into gold or its equivalent

When a currency is maintained on the gold standard both its internal and external purchasing power tend to be the same as the purchasing power of gold Exports and imports of gold automatically bring about the necessary equilibrium, since the metal flows out of the country when its value falls too low, and flows in when its value becomes too high The rate of exchange between any such currency and any currency of the same metal fluctuates about the mint parity, within the limits set by the incoming and outgoing specie points

If, in these conditions, one of the countries issues more currency than is actually required to satisfy the existing need of her people for exchange media, and there is no change in the volume or turnover of the goods exchanged, prices rise and the internal value of the currency (and so of gold) falls Credit, being based on the legal tender currency, expands, while retailers and wholesalers borrow more freely and increase their stocks of commodities Producers receive more in profits and wages, and increase their purchases of both foreign and domestic products and services The income and demand for goods of those who provide these products and services also are increased The extra demand for foreign products attracts additional imports, and may restrict exports by diverting exportable goods to the home market Imports therefore increase relative to exports, and the excess inflow of artificially cheapened goods must be paid for in some way

More important is the fact that the fall in the value of the currency tends to force its purchasing power parity with other gold standard currencies beyond the export specie point, causing gold to flow out and goods to flow in Credit contracts and the value of the currency rises, until equilibrium is again established at the point where the country has just sufficient currency for its needs and where the purchasing power parities between its currency and other gold-standard currencies approximate to the mint pars of exchange

In all gold-standard countries, these forces are constantly at work tending to establish equilibrium both in the value of gold and in the general level of prices The available supply of gold is distributed among these countries until each one has sufficient to maintain her credit system, to support adequately such internal currency as she requires for efficiency, and to serve the needs of her international financial position Hence, the use of the common gold standard makes for a steady and uniform world price level, and deviations therefrom in any one of the subscribing countries are automatically corrected so long as gold can move without restriction

But this does not mean that marked fluctuations never occur in the exchanges between countries on a gold standard. On the contrary, government restrictions on the export of gold may permit wide movements, and force the exchanges beyond the gold points unless the unfavourable position is otherwise automatically righted as, for instance, by a change

in the direction of trade, or by the falling due for payment to the country concerned of a loan made by her abroad ; or unless the country concerned takes other steps to remedy the position, as, for example, by obtaining further credit abroad or by raising the rate of interest with the object of inducing foreign purchases of her currency.

Credit and the Gold Exchanges.

Normally, credit expands or contracts fairly regularly in response to trade demands, but it has been explained in our examination of the trade cycle that, at times, the expansion is so great and the subsequent contraction so violent that widespread disturbance ensues, with marked detrimental influence on trade activity and business initiative, on the state of the currency, and the position of the foreign exchanges.

All monetary authorities now aim at regulating the volume of credit so as to minimise such disturbances and, so far as possible, ensure stability of internal prices and of the foreign exchanges. Monetary policy throughout the world is directed to prevent both periods of excessive buoyancy and periods of marked depression, and to maintain steady commercial and industrial growth without serious set-backs.

Such policy is controlled by the central bank of the country concerned working in close co-operation with the central government. When there are signs that credit is becoming unduly expanded, the central bank intervenes to curtail speculative activity by raising its discount rate. Similarly, industry is assisted during periods of depression by a lowering of interest rates with the object of providing cheap credit for legitimate trade purposes.

By such operations, the central bank is able to maintain a reasonable degree of stability both in the internal and also in the external value of its currency. But in all countries unforeseen events may cause a sudden and unexpected contraction in the volume of credit which the central bank will, for some time at least, be unable to counteract. Wars, strikes, bad harvests, natural disasters, such as floods and earthquakes, the failure of a bank or of a large industrial concern—all these are happenings which are liable to dislocate the credit mechanism and disturb the even basis of commerce and industry. In such circumstances, foreign trade is disorganised, foreign balances are withdrawn to other less disturbed countries, purchasing power parities are subject to wide variations, the foreign exchanges move unfavourably and gold tends to leave the country in considerable quantities.

Such conditions can be remedied only by the most careful action on the part of the central bank directed to restore confidence, provide currency and credit for legitimate needs, induce an inflow of foreign

balances and attract gold imports. The principles underlying this action are more closely examined in Chapter 30.

Inconvertible Currencies.

The problem of maintaining reasonable stability of the exchanges is quite complicated enough when the currencies concerned function on the tried basis of the gold standard; it becomes practically impossible when either or both of the currencies are depreciated through the *excess* issue of inconvertible paper money.

In such cases, the automatic adjustment of the gold standard is lacking. The external value of a depreciated inconvertible currency varies with every change in its purchasing power at home, and that value will continue to depreciate so long as inflation persists. And, naturally, the same factors which cause disturbances of credit and of the exchanges in gold standard countries must unfavourably influence the exchanges of countries having depreciated inconvertible currencies. But in the latter cases, the unfortunate consequences are far more marked. The credit mechanism in such countries is not only much more sensitive to disturbing events and to changes in public sentiment, both at home and abroad, but also recoils far more extensively from such influences. Moreover, a country which has allowed its currency to become heavily depreciated takes a far longer time to recuperate from a period of depression, and has to make far greater sacrifices to do so, than a country which is in the more fortunate position of having maintained a reasonably stable basis of internal and external exchange.

CHAPTER 30

THE BALANCING OF NATIONAL DEBITS AND CREDITS: CENTRAL BANKING POLICY.

It was an axiom among early exponents of the theory of foreign exchange that the rates of exchange between any two countries are determined mainly by the direction of trade in goods between those countries A large excess of imports over exports would, it was contended, inevitably cause the exchanges to become adverse or unfavourable, whereas an excess of exports over imports would have the contrary effect Hence, it was for many years a recognised policy of the Government in this and other countries to seek to bring about a favourable balance by influencing the flow of trade by various devices, as, for example, encouraging exports with bounties and discouraging imports with duties on foreign products

The spread of economic knowledge led gradually to the recognition that this conception of the influence of foreign trade on a nation's exchanges was deficient in the important respect that it ignored the effect on the rates of exchange of the money payments made between the countries of the world for things other than goods , as, for example, payments made in respect of services rendered in connection with the carriage, insurance and finance of commodity exports, or payments in respect of money invested, borrowed, and repaid, including sums transferred from one centre to another for temporary investment by banks and other institutions

Statistics of Foreign Trade.

One reason for this serious omission was the fact that payments for services and other immaterial items are never recorded in the statistics of imports and exports of *goods* which, in all civilised countries, are compiled from data supplied by the Customs and Excise These statistics set forth details of the nature, quantity and value of all goods imported and exported during the preceding month, quarter, half-year or year, as the case may be, and thus afford valuable information respecting the nature and direction of the country's trade They indicate whether its exports of goods exceed its imports, or *vice versa* , the main items comprising its exports and imports respectively , the

main sources of its foreign supplies and the chief foreign outlets for its products Records are also maintained of the movements of gold and silver bullion, those commodities which, by reason of their universal use as money, are of inestimable importance in the modern commercial world

"Invisible" Exports and Imports.

But the published statistics contain no record of payments made to or by a nation in respect of the miscellaneous non-commodity items to which reference has been made, and it was for this reason that the practice arose of referring to them as *invisible imports* and *invisible exports* Yet, long after the existence of such items had been grudgingly acknowledged, economists and others were very sceptical as to their actual influence on the exchanges, and not until the constant growth of international trade greatly accentuated their importance was it generally recognised that the so-called invisible items can influence the state of a nation's foreign indebtedness—and so the state of her foreign exchanges—quite as much as the movement of material goods

The term "invisible *exports*" is applied to those unrecorded items *for which payments have to be made to a country*, and which have therefore the same effect as exports of actual goods, *e g*, services rendered to other nationals by our shippers, bankers and financiers, and exports of British Treasury Bills purchased by foreigners Invisible exports create a foreign demand for the currency of the selling or supplying country, and must in the long run be paid for by the purchasing country either in money or in goods On the other hand, those unrecorded items *for which a country has to pay* are "invisible *imports*", since exports of money or of commodities have to be sent to other countries in payment therefor. Examples are services received from other countries, securities purchased abroad and loans raised at home on behalf of foreigners

Invisible Trade of the United Kingdom.

In the case of our own country, statistics or returns of *visible* imports and exports are published from time to time in the Board of Trade Journal, and they regularly disclose that, so far as goods and bullion are concerned, our imports largely exceed our exports Hence the question naturally arises. How is this heavy excess of imports paid for? The answer is to be found in the fact that such imports are more than offset by the highly valued *invisible exports* of services rendered to other nations by the United Kingdom in the capacity of international banker, shipper and financier In other words, a high proportion of our imports of goods represents the payments being made to us by other nations for our invisible exports of services and capital

Some of these payments represent accruing *income* or *revenue*, whereas others are *capital* items, *i e*, they represent movements or transfers of capital in the form of goods or of money, between this country and other countries If we apply an accounting analogy, we may say that the income or revenue items are those which pass into and out of Britain's *Revenue Account* with the rest of the world, whereas the capital items are those which affect her *Capital Account*

Every year, the experts at the Board of Trade make an exhaustive investigation with the object of estimating the *net* annual value of our invisible sources of revenue or income, which they group under the following heads —

Shipping Income —This item covers the *net* revenue estimated to be received by the United Kingdom in respect of the transport services of her mercantile marine and associated industries

Investment Income —The Board of Trade gives under this heading its estimate of the *net* income accruing to this country from overseas investments *of a joint stock character*, after allowing for deduction of income paid to foreigners in respect of their investments here

Income from Banking, Insurance and Similar Services —Under this heading are included the estimated *net* receipts in respect of (*a*) payments made to our bankers, brokers, merchants and accepting houses for commissions and brokerage in respect of services rendered in the financing of trade and the marketing of goods, (*b*) premiums paid to our insurance companies, brokers and underwriters in respect of the insurance of goods exported from this country, and in return for marine risks undertaken on foreign account, *i e*, for goods which never touch our shores; and (*c*) commissions paid to brokers and agents on the London Stock Market and the produce exchanges for business executed on foreign account

Miscellaneous Receipts on Revenue Account —Among other receipts of less importance for which one *net* estimate is given are payments made on account of the sale by Britain of second-hand ships; sums sent home by British settlers or emigrants abroad, sums remitted on account of profits by the overseas branches and agencies of British commercial houses, amounts paid by other countries in respect of tourists' expenditure in this country, and, finally, payments made to our Government on account of war debts and reparation payments, and contributions made by the Empire overseas for services rendered by the War Office, Admiralty and other Government Departments

Britain's Favourable Balance on Current Account.

In the Spring of each year, the Board of Trade combines its estimates of the nation's invisible income with the figures of the recorded receipts

and payments in respect of goods and bullion, and so obtains a kind of national balance sheet or, more strictly, a *National Payments and Receipts Account*, which gives a very clear indication of the results of our international business during the preceding year

The figures given in the Board of Trade's Statement for the year 1929 are as follows —

Statement of the United Kingdom's Estimated Net Balance of Payments for the Year 1929.

		£
Estimated net receipts for Invisible Exports —		
Net income from foreign investments		285,000,000
Net income from shipping services		130,000,000
Net receipts from banking and other services		65,000,000
Net miscellaneous receipts		15,000,000
Excess of Government receipts from Overseas		22,000,000
	Total	£517,000,000
Excess of imports of merchandise and bullion		366,000 000
Net Balance on Current Account in favour of this country		£151,000,000

Although the estimates vary considerably from one year to another, on the average they show a very considerable margin of net income or net receipts in our favour Every year, the net amounts estimated to be due to us from other countries in payment for our invisible services are much more than sufficient to pay for the excess of our imports of goods over our exports of goods Hence, if we looked no further than these figures, we should expect to find (*a*) that the foreign exchanges were usually very much in our favour and practically always at the gold import points, and (*b*) that we imported considerable quantities of gold from other countries

Actually, London rates of exchange on other centres are on the whole favourable, but they are not always at the gold import points On the contrary, they keep fairly near to the mint parities They move beyond the gold specie points only in very abnormal circumstances, and there is no great disparity between the total amount of gold imported and the total amount exported in any one year Clearly, therefore, Britain's exchange position is one of comparative equilibrium, indicating that the foreign demand for sterling keeps reasonably close to the supply How, then, can we account for this position in face of the large balance estimated to accrue each year in favour of this country ?

One possible explanation is that the payments made and received on the London Foreign Exchange Market during any day or during any week have not the slightest relationship to the annual balance which the United Kingdom is estimated to make out of international business But this fact, in itself, would not account for the relatively stable position of our foreign exchanges in the face of a consistently large balance of payments in our favour

The explanation lies deeper, and is to be found in the fact that Britain annually invests abroad at least as much as her estimated surplus of receipts over payments The annual excess of receipts on account of heavy invisible exports is counter-balanced by invisible imports of securities in respect of capital issues made in the City of London on foreign account, and by the invisible transfer of liquid funds between London and other centres The estimated surplus arising from our current account transactions never accumulates in the sense that other countries have to send us vast amounts of gold or have otherwise to effect payment of a large outstanding balance The surplus is depleted at least as rapidly as it is earned Almost before the income or revenue is due and received it is earmarked as a loan or capital export to some needy borrower.

Maintenance of the Gold Standard Implies Equilibrium.

This analysis of Britain's international financial position is important in that it leads to the conclusion that no country, and especially a gold standard country, can for long have a large annual *surplus* or balance of payments or of current indebtedness, either adverse or favourable A nation may have a consistently adverse or favourable balance of *trade*, *i e*, a balance between the total values of her exports and imports *of goods*, but no country can maintain a consistently heavy balance *of indebtedness*, favourable or otherwise, in respect of all international transactions.

The maintenance of the gold standard makes it absolutely essential that the exchanges shall be kept as close as possible to the mint parities with other gold standard countries, and that actual movements of gold shall be reduced to a minimum But neither of these objects can be achieved in face of a considerable balance one way or the other on the national current account Small adjustments can, of course, be effected without difficulty by imports or exports of gold, but it is quite another matter when it comes to the settlement of a heavy balance For, even if the available supplies of gold are adequate for the purpose, movements of considerable quantities of the metal cannot fail to have disturbing effects on the credit machine

So we conclude that a large balance on the national Current Account must be offset in some way The national accounts must balance, and the necessary equilibrium will be achieved either *automatically* because the prevailing conditions bring about a change in the direction of trade, or, *artificially* by the stimulation of transfers of capital, either in the form of long period loans or short period investments, and by inducing a change in the internal level of prices with consequent effect on the purchasing power parities with other gold standard currencies

We can verify the truth of this proposition by considering the two cases of (*a*) countries which have a large adverse balance of indebtedness on current account, and (*b*) countries with a large balance of indebtedness in their favour.

An Adverse Balance on Current Account.

Let us assume that the imports of an important gold standard country for some time exceed its exports, and that the difference between the values of goods imported and exported is not counter-balanced by invisible exports of services and other items What will be the result? Clearly, the demand for foreign currencies on the nation's exchange market will be in excess of the supply, while the supply of that nation's currency on foreign exchange markets will be in excess of the demand. The rates of exchange will be unfavourably influenced against the country concerned, and the value of her currency in terms of other currencies will tend to fall The external exchange will *undervalue* the currency Instead of being at the purchasing power parities with other gold currencies, *i e*, at the mint parities, the rates of exchange will be markedly adverse, and gold will tend to flow outwards

Now, the tendency is for this state of affairs automatically to adjust itself. The fall in the external value of the nation's currency discourages imports *to that country*, since foreign exporters, as sellers of its currency, realise less On the other hand, it encourages exports *from the country*, since foreign importers benefit from the relative cheapness of its currency in terms of their own money For similar reasons, exporters in the country itself are encouraged whereas importers are discouraged

Other forces act in the same direction The excess of imports over exports and the outflow of gold bring about a fall in internal prices and a rise in the value of money, which we have assumed to be gold or its equivalent The country becomes a poor market in which to sell but a good market in which to buy Thus imports are further discouraged while exports are further encouraged This position is accentuated because the producing classes and exporting interests curtail their expenditure, and lessen their demand for home and foreign commodities There is consequently a slackening in the demand for foreign currency, the home markets become less prosperous, credit contracts, the value of the currency rises and its external purchasing power improves Thus the general tendency is for the exchanges to return to the mint parities, for the adverse balance of trade to be corrected, and for a position of greater equilibrium to be established.

At times it happens that a young developing colony or a war impoverished state cannot possibly lessen her imports of essential goods yet cannot provide the exports necessary to pay for them. In such circumstances, other means must be adopted to permit of a continuance

of the disparity between imports and exports, while bringing about a position of equilibrium between the nation's debits and credits Generally speaking, the method adopted will consist in raising money abroad by long or short period borrowings

The Raising of Foreign Loans.

Although such expedients as borrowing abroad may bring about a more or less temporary equilibrium, they cannot be continued indefinitely The time comes when the credit of the borrowing country is exhausted and the other countries are disinclined to lend further Every loan raised abroad means that the borrowing country has to increase her exports of goods by the value necessary to pay the interest due to foreign lenders and to pay off the capital Hence, the total amount that the nation *can* borrow will be determined by the total annual amount of interest which she can offer to pay without still further upsetting the equilibrium between her payments and receipts

A Favourable Current Account Balance.

Similar forces operate in the reverse circumstances where the payments due to a nation for goods and services regularly exceed the payments she has to make on the same account In the absence of other correctives, the exchanges will be influenced in favour of the country concerned, and she will tend to receive considerable quantities of gold from other nations in settlement of the balance in her favour

But the inflow of gold will not continue indefinitely Apart from the fact that the available supplies of gold may not be adequate, forces will be set in motion which tend to bring into being a better equilibrium between payments and receipts The constant excess export of goods and the inflow of gold cause goods to be relatively scarce and money to be relatively plentiful Prices rise and the value of money (*i e*, of gold) falls The external exchanges with gold standard countries *overvalue* the currency They move so far from the purchasing power parities, *i e*, the mint parities, that foreigners defer purchases of the currency concerned, whereas holders of that currency are encouraged to exchange it for other gold currencies The country becomes a good market in which to sell but a poor market in which to buy. Hence imports are encouraged and exports are discouraged until the direction of trade is changed and greater equilibrium is established

All this presupposes the absence of other correctives, but just as a country with an adverse trade balance resorts ultimately to foreign borrowing in order to effect equilibrium between her payments and

receipts, so also a nation with a consistently favourable balance of trade, or a nation with a consistently favourable balance on current account, equilibrates the position by investing the surplus abroad.

If a nation has an excess of exports over imports, the producers of the exports (whether of goods or services) have relatively more to spend on commodities and on investment The wholesale and retail dealers sell more goods and they also find their incomes increased Hence they, in turn, spend more on commodities or on investment The additional amount spent on foreign-produced commodities tends to rectify the disparity between imports and exports, while more money is applied to investment in other countries

The process continues until the excess of exports is fully covered either by imports or by external investments If the standard of living is already high—as it is in Britain's case—the proportion spent on investment will be relatively greater than that spent on commodities The tendency is for the excess of exports to be invested abroad, and with each addition to the total of overseas investments, the annual income therefrom increases and so adds to the future surplus available for the purpose

Borrowing and Lending Effect Equilibrium.

Thus a nation whose annual transactions regularly involve a large deficiency of receipts as compared with payments is compelled to remedy the position by borrowing abroad, either for short or long periods If, on the other hand, the transactions of a country result in a consistently heavy surplus of receipts, the position tends to be equilibrated by the loaning of the surplus to other countries for development and other purposes Such a nation pays away the excess in return for securities which she imports, and, by so doing, achieves that balance between her payments and receipts which is so essential to the maintenance of stable exchanges and a stable price level

In the case of our own country, the international account is balanced by an increase or decrease of foreign investment in sterling bills and by the movement in and out of London of short-term funds When we are in deficit, as was the case in 1924 and 1926, we encourage foreign purchases of London bills and borrow short-term balances from other countries On the other hand, when we have a balance on the right side, we increase our short-term balances abroad, permit those already with us to be withdrawn, and lessen the attractiveness of sterling bills to the foreign investor Thus permanent equilibrium in our international balance of payments is achieved by modifications in the relative totals of our invisible imports and exports of capital securities and short-term investments, effected mainly by changing the rates of interest on loanable capital paid on the London Money Market

The Restless Process of Extinguishing Debt.

As a general rule, the adjustment of the debits and credits which go to make up a nation's international accounts is brought about almost automatically by various forces which come into play The interminable operation of debt settlement which goes on from day to day and from hour to hour between one nation and the rest of the world is a restless process of creating and extinguishing debt, tending constantly to square the totals of that nation's receipts and payments

But even automatic machinery requires special care and attention on occasion, and the same applies to the process of international debt settlement At times, the national balance of payments remains so consistently adverse or so consistently favourable that it becomes obvious that all ordinary means of remedying the position are doomed to failure Unless special measures are taken, gold movements will continue until the national basis of credit is severely reduced or increased to such an extent as to promote unhealthy financial conditions Radical action by those responsible for the nation's monetary affairs becomes necessary to correct the disturbance of equilibrium, and this implies action by the Government or by the central bank, and most usually by the latter, directed to modifying the relationship between the demand for and the supply of the national currency on the world's foreign exchange markets

CENTRAL BANKING POLICY

It was explained in Chapter 11 that one of the main functions of a modern central bank, as typified by the Bank of England, is to control the credit mechanism within the community in the interest of the nation as a whole by ensuring as great a steadiness as is possible in the level of internal prices

But the argument in the foregoing paragraphs will have indicated that this vital aim cannot be divorced from the highly important duty, now imposed on the central banks of all gold standard countries, of maintaining reasonable steadiness of the external exchanges in the neighbourhood of the mint parities And experience shows that these two aims are extremely difficult of parallel achievement At times they appear to be directly antagonistic, indeed, certain well-known authorities have gone so far as to declare that they are quite incompatible—that one may be achieved but that both cannot

In our own country, the Bank of England controls the volume of credit by manipulating its rate of discount, and, when necessary, resorting to its open market policy in order to increase or decrease the floating supplies of liquid funds on the London Money Market But in doing this, the Bank must also keep a most watchful eye on the course of the foreign exchanges, and, what is more fundamental, on the direction of

foreign trade, for, as we have seen, it is an important part of the Bank's business as our central bank to determine whether that temporary and permanent equilibrium of the national debits and credits, so essential to the maintenance of the gold standard, is in fact being attained.

Now, in this regard, most valuable information is afforded by the condition of the London rates of exchange on the principal gold standard countries, and particularly those on the United States, France, and Germany In ordinary circumstances, these exchanges tend to move in the neighbourhood of the mint parities, within the two limits imposed by the specie points But if, as sometimes happens, the trend of these exchanges is consistently unfavourable, and gold withdrawals from the London Bullion Market tend to exceed receipts of gold by the Bank, there is evidence of a serious disturbance of the equilibrium between the nation's current credits and debits, and action by the Bank may be called for to reinforce the normal factors which from day to day and from hour to hour tend to bring about that equilibrium And, of course, similar action in the reverse direction is required when the principal exchanges are unduly favourable, and the inflow of gold is of such dimensions as to threaten an uncomfortable expansion of credit

The Objects of the Bank's Foreign Exchange Policy.

In seeking to correct the disturbing influences, the Bank's object is, in brief, to modify the value of sterling in the world's foreign exchange markets, or, what comes in effect to the same thing, to modify the value of other important gold currencies on the London Foreign Exchange Market This it may achieve in two ways It may encourage the creation or extinguishment of debt between this country and the rest of the world, or it may bring about a change in the world purchasing power of sterling by modifying its internal purchasing power through a suitable adjustment of credit Both of these results the Bank can bring about by manipulating its rate of discount

By way of illustration, we will assume that the position of the principal gold exchanges has for some time been unfavourable to this country, and that the Bank of England decides that interference is called for In all probability, it will announce an increase in the Bank rate Speaking generally, the immediate effect of this announcement is to bring about an increase in the rates of interest on the London Money Market, to increase the attractiveness of that Market for the investment of foreign surplus balances, to increase the foreign investment demand for London bills and finally, to lessen the attractiveness of foreign centres for investment from this country In other words, the rise in the Bank rate encourages the purchase of sterling by foreigners and leads to a decrease in our current payments to the rest of the world. As a result, the world demand for sterling is increased, while the demand

for foreign currency in London is decreased The market rates of exchange are influenced in favour of London, the outflow of gold is stopped or reduced, and its inflow is encouraged

Such an immediate modification of the nation's financial position could be brought about in other ways For example, the British Government or the Bank of England could arrange a loan or establish a credit, in the United States or in another gold standard country, with the object of wiping off some or all of the excess debits outstanding against us But arrangements of this kind are not ordinarily resorted to if the position can be remedied by stimulating the usual machinery of debt settlement by manipulating the rates of discount

In addition to its immediate effect of bringing about *temporary* equilibrium between the national debits and credits, the raising of the Bank rate has the more fundamental, but less rapid, effect of inducing more *permanent* conditions of equilibrium on the Foreign Exchange Market by altering the existing basis of the rates of exchange As we have seen in Chapter 11, the rise in interest rates in this country forces up the internal value of sterling (*i e*, induces a fall in prices), modifies the purchasing power parity between sterling and other currencies, and ultimately promotes a closer equilibrium of international payments by causing a change in the direction of trade

But these changes in the internal value of a currency take time to operate They are brought about through the actions of traders and consumers and through the interplay of supply and demand,—processes far too slow in operation to save the situation in a country which is being denuded of its gold reserves and is suffering from other effects of consistently adverse exchanges They are equally unsuitable as a quick remedy in the case of a country which is being flooded with unwanted gold It is for this reason that the Bank of England, like other central banks, depends very largely for the success of its policy in stabilising the rates of exchange and maintaining the gold standard on the power of its rate to attract bankers' balances for quick investment And it is for these reasons, in turn, that the movement of bankers' surplus balances, constituting the *international short loan* fund, has attained a position of such vital significance in the international monetary situation, for relative money rates rather than relative price-levels are nowadays apt to exercise the more direct influence on the prevailing rates of exchange

The Bank's lead ineffective unless the Market follows it.

It should now be clear why the successful operation of the Bank's currency and credit policy depends so essentially on its lead being followed by the London Money Market In the first place, the foreign surplus balances which find their way to London for investment are mainly left in the hands of the joint stock banks, and such balances

will be specially attracted only if the rates offered by those banks follow the rise in the Bank rate Secondly, the first-class bills of exchange purchased by foreign banks for investment are discounted at market rates, and not at Bank rate, so that a rise in the latter which does not induce a corresponding rise in the market rates will not increase the attractiveness of the London bill to the foreign investor Finally, the Bank's ultimate object of raising the internal value of the currency will not be achieved unless money rates throughout the country rise with its rate, and so lead to the contraction of ordinary traders' loans and commitments

Fortunately, the position of the Bank of England as the arbiter of Britain's monetary policy is so well recognised that it experiences little difficulty in securing the effectiveness of its rate of discount and of its other measures directed to modifying the currency situation Both the London Money Market and financial interests throughout the country are usually both ready and willing to co-operate with the central institution and to follow its lead, while the trying experiences of the past few years have only too clearly demonstrated that the Bank well merits the confidence which it now enjoys

The Transfer of Capital Minimises Gold Movements.

Thus, we see that, under modern conditions, shipments of gold are largely replaced by the transfer of floating balances By the purchase of foreign currencies from traders and others, bankers accumulate large balances in foreign countries, and these balances are moved quickly and easily to those centres where they can be most remuneratively employed Such movements are the outward, tangible evidence of that restless process of debt settlement, of set off and cancellation, to which we have already referred, and their effect is to reduce to a minimum the international transfer of gold

But this does not imply that gold shipments never take place nowadays A central bank does not usually intervene to check gold exports unless the latter are of such magnitude as to constitute a threat to its reserves, nor, conversely, does it interfere with gold imports unless they are so large as to be likely to endanger the credit structure Changes in interest rates are seldom welcomed by trade and producing interests, for, as we have already seen, they tend to disturb that even basis which is a pre-requisite of profitable development and industrial progress

The Importance of Central Banking Co-operation.

Since the transfer of floating balances and the business of finance generally have thus achieved such vital importance in the international

monetary position, it is scarcely too much to say that the world's economic welfare is largely dependent on the manner in which its monetary affairs are handled by the leading central banks They have in their hands the power to raise or to lower internal prices, to influence the foreign exchanges favourably or unfavourably, to induce the inflow or prevent the outflow of gold, to stimulate or to restrain business activity and to bring about a change in the national balance of payments

It is only natural that the concentration of such power in the hands of these institutions should have occasioned much concern among those who are in a position to understand the full significance of the position And, in the years of reconstruction following the Great War, it became increasingly clear that such concern was warranted The world's central banks, anxious to fortify the basis of credit in their respective countries, engaged in what has been frequently described as a " scramble for gold " Those who already possessed strong reserves sought to increase them still further, while the newly-established central banks in the reconstructed countries were compelled to accumulate metallic reserves to form the basis of their reconstructed monetary systems

Such a world-wide demand for the precious metal was necessarily viewed with the gravest apprehension World supplies of gold are strictly limited, and the annual production adds an extremely small proportion to the existing stock Thus, gold in quantity, if it is to be obtained at all, must be obtained from the reserve of a leading central bank,—and especially from the Bank of England as the central bank of the world's principal gold bullion market It is scarcely to be wondered at, therefore, that the position of our own country in relation to the world wide demand for gold should have been described as " unstable and treacherous " Foreign banks, with large liquid balances in London, are not slow to withdraw those balances in gold whenever it suits them to do so They are not concerned with the fact that such withdrawals may occur at an inconvenient time, that they may increase the sensitiveness of our exchange position, disturb the basis of our internal credit mechanism and otherwise place the Bank of England—and so the country—in an awkward predicament

Fortunately, however, these facts have not gone unrecognised, and in recent years there has been growing evidence of the desire for closer co-operation between the world's central banks with a view to economising still further the movement and use of gold, and of minimising transfers of the metal which may prove embarrassing to one of the nations involved It may truly be said that, under present conditions, the successful operation of the gold standard depends on the material observance of its conventions This means that central banks must not abuse any position of temporary power which they may happen to enjoy, but must direct their policy with the far wider aim of promoting the stability of the international money market.

The Bank for International Settlements.

Tangible evidence of this is to be found in the institution of the Bank for International Settlements, the conception of which was the most prominent feature of the famous Young Plan, formulated in 1929 to supersede the Dawes Scheme The actual scope of the operations of the Bank, domiciled at Basle, must for a time be indefinite, but though its primary function is to be the conduct of all transfers and operations in connection with reparations, the Statutes clearly reveal the intention that the Bank shall become a central bank for central banks, promoting co-operation between them and co-ordinating their policy in financial matters of world importance.

Unlike the relations between a central bank and other banks in the same country, the relations between the International Bank and the world's leading central banks are reciprocal The International Bank may not only keep gold deposits on account of central banks but may also deposit gold with them It may rediscount bills held by central banks and it may have its own bills rediscounted by them It may open and maintain current or deposit accounts either *for* central banks or *with* central banks, and it may act as agent or correspondent for any central bank and appoint any central bank to act as its agent or correspondent

In addition, the Bank may buy and sell gold coin or bullion, exchange, or negotiable securities for its own account or for the account of central banks , it may lend to or borrow from central banks against gold, bills of exchange and other short term obligations of prime liquidity or other approved securities Subject to the consent of the central banks affected, it may deal with private individuals also; but, in practice, this concession is not likely to be very effective On the other hand, the Bank may not issue notes, accept bills of exchange, make advances to governments or open current accounts in their name, acquire a predominant interest in any business concern or remain the owner of any real property except in so far as it is required for its own business

Provisions as to the actual reserve to be maintained by the Bank are omitted from the Statutes, but the Bank must hold assets appropriate to the maturity and character of its liabilities

It is obvious from the provisions that the International Bank is not intended to interfere with the national independence and the influence of central banks in their own markets To obviate the possibility of competition with existing banks and the effect of such competition on national markets, the central banks may veto any operation in their currency or on their territory if it *may* involve the withdrawal of funds invested in the country. Central banks as a rule encourage the investment of funds in their own country, but this power of veto is likely to prevent the International Bank from investing funds in any way detrimental to a central bank

It is as yet early to indicate the possible effects on monetary conditions generally of the operation of the International Bank, but it is essential that the Bank should not become a competitor in the world's gold market and so intensify the world scramble for gold. An important prospect is that the establishment of the Bank will obviate, or at any rate considerably lessen, the need for the international movement of gold by substituting therefor transfers between the accounts of the central banks in its books. Current balances of the central banks concerned will indicate the state of international indebtedness, while depleted balances will be restored by the operation of rediscounting commercial bills and depositing approved securities. Thus the outcome of the institution of the International Bank should be greater stability of the world's credit structure, with ultimate advantage to the whole field of international trade and finance.

CHAPTER 31

THE SILVER EXCHANGES AND THE GOLD EXCHANGE STANDARD.

SINCE it is impossible to establish a mint par between a country on a gold standard and a country on a silver standard, the only numerical basis of the exchanges between two such countries is the value of silver in terms of gold, as that value is indicated from day to day by the price of silver on the world's leading bullion market, *i e*, that of London If a merchant in China has to pay money in London for goods imported, he must buy the right to sufficient gold or its equivalent—sterling—payable in London to satisfy the English exporter As a rule, he will buy the right to the necessary gold or sterling in the form of a draft or T T issued by an Eastern exchange bank and he will *pay for it with silver* On the other hand, Brown in London who buys China tea from a merchant in Shanghai must pay for the tea in silver, and he will obtain a right to this in the form of a draft or T T on Shanghai issued by an Eastern bank in London, *paying for it in sterling, i e*, gold

The Purchasing Power Parity between a Silver and a Gold Currency.

Clearly, then, an exchange of goods between a gold country and a silver country makes necessary an exchange of gold and silver And the same principles are involved whether an actual exchange of the two metals takes place, or whether all that happens is a transfer of book credits, as, for example, where Brown in London exchanges part of his sterling credit balance for Chinese goods, and that sterling amount is converted, through the intermediary of one of the Eastern banks, into a sum in silver currency placed to the credit of the Chinese exporter

Of course, the rate of exchange charged by the bank in making such a transfer depends not only on the price of silver in terms of gold, but also on *the expense to which the banker is put to move silver in or out of the silver-using country*, whenever necessary, to cover his sales or purchases of exchange

In general terms, therefore, the world price of silver in terms of gold tends to measure the purchasing power parity between the two metals, and the rate of exchange between a gold standard country and a silver-using country maintaining free mintage of silver will tend to be

determined by that purchasing power parity. The basis on which pounds will exchange for silver Hong-Kong dollars is the London market price of the latter considered as so much silver bullion, subject to an allowance for the cost of converting the bullion into coins and for transferring those coins to the place where payment must be made

The "Relative" Par between Silver and Gold.

Now, the price of silver on the bullion market may fluctuate without limit according to the vagaries of demand and supply, but the price of gold in most countries is confined within certain narrow limits of the mint price As a result, the exchange between a gold standard country and a silver country tends to rest at what is called the *silver parity* (or "*relative par*"), *i.e.*, the equation between gold at its mint or fixed price, and silver at its market price, due allowance being made for the cost of laying down the metal in the creditor country If, for any reason, the metal cannot be moved to a creditor centre, or if it cannot be moved thereto in sufficient quantity, then the exchange on that centre is likely to move in its favour above the silver parity

The Silver "Specie Points."

As is the case with remittances between gold-standard countries, the prices of remittances to and from silver countries are much influenced by market conditions of demand and supply, which in turn are influenced by the usual causes of exchange fluctuations, of which the chief is the state of trade between any two nations concerned

But just as the gold points between gold standard countries act as limits to the rates of exchange between them, so also the cost of buying silver and moving it to or from a silver standard country imposes on the prices of remittances fluctuating limits which are sometimes called "*silver specie points*" 100 silver dollars sent from Hong Kong to London will always realise in London their market price as silver *less* the cost of moving them from Hong Kong, hence a merchant in Hong Kong would not pay more for a remittance to London than the cost of buying and sending silver dollars Conversely, he would not accept less from a London debtor in the form of a draft or bill than he would obtain if silver was sent to him, and a London debtor would not pay more for a remittance to Hong Kong than it would cost him to send silver Hence, there is an upper and a lower limit to the price of remittances, and these limits fluctuate according to the changes in the market price of silver but they can neither rise higher nor fall lower than that price *plus* or *minus* the cost of transmission to the country concerned

There is also another price element A London banker who is under the necessity of remitting silver to Hong Kong to cover his commitments cares nothing where the silver comes from, so long as he can

keep down his costs He may ship it from London, but he can arrange to move it from India, or China, or Japan, whichever is the cheapest, and the nearer the source of supply of silver to the place where it is wanted, the cheaper the remittance rates to that place

Fluctuations in the Silver Exchanges.

Fluctuations in the silver exchanges are therefore dependent upon two groups of factors —

(*a*) The ordinary influences affecting the demand for and the supply of exchange

(*b*) Changes in the gold price of silver and changes in the cost of moving the metal from place to place

As a result, the silver exchanges fluctuate very considerably even in normal times Anything which affects the price of silver in terms of gold, or which affects the cost of moving silver to the places where it is required, must have its effect on the exchanges as, for example, the opening of new mines, the release of large quantities of hoarded coins, or the demand for extra silver for currency purposes Gold is required by practically all nations, and its value tends to adjust itself throughout the world, but silver is legal tender in only one or two countries and its value, unlike that of gold, is not subject to the stabilising influence of world-wide use and insatiable demand

The value of silver has, in fact, fluctuated most violently in recent years Before the War the price of English standard silver (*i e*, silver 37/40ths fine) was fairly steady around 2s 2d Conditions arising out of the War caused a world-wide demand for the metal for monetary and other purposes, and by February, 1920, the price had reached 89d per ounce Since that date there has been a gradual fall, and at the time of writing (January, 1930) the newspapers question the fact whether silver is still to be regarded as a " precious " metal in view of the continued decline in its value to the neighbourhood of 20d per ounce

Minimising Losses on Silver Exchanges.

For these reasons the majority of exchange transactions with Eastern countries have long been effected by cable or telegraphic transfer, which, being quickly acted upon, obviate the risks attendant upon transactions in bills payable days or months after date or sight Moreover, the prices of goods sold to silver-using countries by gold-standard countries are generally quoted in the currency of the latter, and payments must then be made according to the gold price of silver bullion

Frequently, exporters to silver countries protect themselves against exchange loss by drawing their bills on the Eastern importer in a gold currency, *e g*, sterling, and enfacing the bill with what is known as

an *exchange clause*, which fixes the rate of exchange at which the foreign drawee must pay The form and significance of such clauses are fully discussed in Chapter 33, but here it may be stated that the general effect is that the exporter is enabled to obtain cash advances against the bills from a bank, subject, of course, to the usual precautions as to security, etc , taken by banks in connection with the purchase of bills drawn on foreign centres On the other hand, the bank may undertake to *collect* the bill, in which event the exporter will, in due course, receive in his own currency payment in full, less collection charges In both cases, of course, the bank will take steps to see that the bill is paid by the foreign drawee according to any clause which the bill may contain

When a bill is drawn with an interest clause, the exporter can turn it into cash as if it were a sight draft, since the bank will be able to collect interest on the face value of the bill from the foreign drawee at the rate stipulated

Investment in Silver Countries.

Investors in gold standard countries who place money in silver countries must take similar precautions to obviate exchange loss They may do this by stipulating that dividends and coupons shall be paid, and loans repaid, in terms of a gold currency (frequently sterling), so that the onus of arranging the necessary exchange transactions is placed on the foreign government or corporation benefiting from the loan or investment If this were not done, dividends, etc , would be paid by the Eastern borrowers in silver currency, and the conversion thereof into gold currency might entail serious loss to the investors or lenders

Eastern Exchange Rates.

The rates of exchange between Britain and the Eastern silver-using countries are quoted in London as so many shillings and pence, or so many pence, to the dollar, tael or rupee, as the case may be *The rates are for T T 's from the East to London, whereby a certain amount of silver in the Eastern centre is paid for the right to a given sum in gold or its equivalent in London*

If Shanghai T T 's to London are quoted at 2/6d *per tael*, the rate indicates that 2/6d will be paid in London for each tael deposited with the bank in Shanghai If this rate moves from 2/6d to 2/3d it means that the tael has become less valuable in terms of gold (*i e* , sterling), and also that silver has fallen in value relative to gold Moreover, such a movement betokens a *rise* in sterling and is regarded by the Eastern banker as a *rise against him* of the rate of exchange on London Conversely, a movement in the rate from 2/- to 2/6 indicates

a *fall* in sterling and a *rise* in the value of silver To the Eastern banker, it is a *fall* in the London rate of exchange whereas ten taels must be given for a sovereign when the rate of exchange is 2/-, only *eight* must be given when the rate is 2/6d

Clearly, a movement like this must seriously affect the purchasing power of a silver unit such as the tael If the exchange moves from 2/6d to 2/3d, *silver falls in price in terms of gold*, the tael purchases less sterling and the Chinaman's purchasing power is correspondingly reduced Chinese imports are discouraged, whilst Chinese exports are encouraged On the other hand, if silver rises in price and the tael exchange consequently moves from 2/- to 2/6d, eight taels will purchase the same quantity of goods externally as previously cost ten taels Thus the Chinese will be stimulated to buy abroad their imports will be encouraged and their exports discouraged

China's Exchange and Currency.

Although movements are afoot to remedy matters, the exchange position with China is greatly complicated by the fact that no fixed currency system exists in that country, hence it is essential to know, in dealing with any rate quoted in terms of "pence per tael", whether the "tael" is that of Shanghai, Canton or other Chinese centre

The rates between Hong Kong and Shanghai and London are on a settled basis, as they are quoted in terms of pence to the local established dollar currency, and are settled satisfactorily by the Eastern exchange banks in those centres These banks base their T T rates to London on the gold price of silver in that centre, while any other rates quoted by them are based on the T T rates

China is an outstanding example of a country which depends primarily on sterling for her foreign trade settlements The Exchange banks draw on London for exports from China, and remit to London for her imports Thus the Chinese rates of exchange on London, like other Eastern rates, are fixed in China, and the European trader is saved much of the trouble and risk of exchange operations

The Gold Exchange Standard.

In order to avoid the difficulties with which they were faced by reason of the fluctuating gold price of silver, certain silver-using countries have adopted the *gold exchange standard*, the essential of which, as was explained in Chapter 3, is that the *gold* value of the silver currency unit is legally fixed at an arbitrary figure, *i e*, it is laid down that, for *external* exchange purposes, the currency unit shall be deemed to be equivalent to a given weight of fine gold Arrangements are made for the purchase or sale of gold bullion (or gold exchange) in exchange for

silver (or silver standard currency) by the central bank at the legally fixed ratio, with the result that the exchanges on gold standard centres are permitted to fluctuate only within certain narrow and definite limits which correspond to the specie points of a country having a full gold standard or a gold bullion standard

In some cases where the gold exchange standard has been put into operation, the value of the internal currency unit has been fixed, not in terms of *gold*, but in terms of the *gold currency unit* of a leading gold standard country In other words, the value of the gold exchange currency has been directly *linked* to the gold currency of a leading centre, *e g*, London or New York, at a legally fixed ratio, and that ratio has been maintained by the action of the government or central bank in selling or buying exchange on the gold centre whenever the exchange rate was forced away from the parity by the demands of traders for remittances to or from the gold exchange country

It is now recognised that a system of the latter kind is not strictly a *pure* gold exchange standard, and may be best described as a *currency exchange standard*, since the linking of a silver currency with a given gold standard *currency* is not the same thing as linking the silver currency with a given weight of gold In consequence of various restrictions and expedients, the so-called gold standard currency may have its value temporarily divorced from that of gold, with repercussive effects on the value of the silver currency based upon it

Such has been the experience of India, where such a system, based on the *silver rupee* linked to *sterling* on a fixed basis, (*i e*, a *sterling exchange standard*), functioned with considerable success under government control during the relatively undisturbed period from 1893 to 1914 During and after the War, however, sterling and gold were not synonymous, and India was faced with almost insuperable difficulties because the rupee was legally based on a foreign currency unit—sterling—whose gold value had markedly fallen, and was at that time subject to great variation Ultimately, the system collapsed, and recognition of the cause of the difficulties has led Indian administrators and business leaders to urge the replacement of the existing arrangements with a pure gold exchange standard, *i e*, a rupee whose value will be definitely fixed for external purposes as equivalent to a given weight of gold At the time of writing, nothing definite has been done

Similar systems to that existing in India prior to 1914 are in operation in other countries, notably Japan and the Philippines, the Straits Settlements and Java

The currency exchange standard may be applied with equal success where the internal currency consists of inconvertible paper, in which case the external value of the circulating paper currency is kept at a fixed par with the currency of a gold standard currency by central bank control of the exchanges Systems of this kind were adopted by several

countries which had to rehabilitate their currencies after the Great War, including Germany, Austria, Greece, Hungary and Belgium, in all of which cases the currency units were linked either to the American dollar or to the pound sterling

The Exchange Standard in Practice.

As a rule, an exchange standard system is controlled by the central bank of the exchange standard country working in close collaboration with the central bank of a gold centre with which it has close business or political ties The central bank in the exchange standard country holds itself open to purchase good class traders' bills on the gold centre at or near the fixed rate of exchange As a result, it ordinarily holds among its assets considerable quantities of maturing bills payable in the gold centre, and against the proceeds of these it is in a position to sell drafts on that centre at the fixed rate, as and when required If the central bank is unable to purchase sufficient bills on the gold centre, it arranges with the central bank therein to establish a credit in its favour, or it arranges to float a loan in the gold centre and draws and sells bills against the proceeds placed to its credit The constant aim is to maintain stability of the exchange at the fixed ratio, and the divergence of the current rate of exchange from this ratio is taken as an index of the demand for exchange

If there is a demand for remittances to other countries which tends to influence the exchange unfavourably and force it away from the parity, the central bank sells outward remittances drawn on its reserves in the foreign gold centre The remittances are paid for either in silver or in notes, as the case may be, thus contracting the internal circulation and sending up the value of the monetary unit The payment of the remittances in the foreign gold centre lessens the gold exchange reserve kept there and thus the general effect is as though gold had been exported from the country and the currency basis decreased

It is, of course, essential to the forcing up of the internal value of the monetary unit that the silver or notes received in payment for the remittances be kept out of circulation for a time, and that credit be suitably restricted, if necessary, by the maintenance of a sufficiently high interest rate, or possibly by an increase in that rate If this is not done, nothing will have been achieved towards forcing up the exchange value of the currency

On the other hand, if there is a demand in other countries for the exchange standard currency, its external value tends to move from the fixed parity, the exchange moves unfavourably, and the central bank intervenes by offering remittances on the country concerned in the foreign gold centre These will be paid for in that centre in gold or its equivalent, thus increasing the reserve held in the gold centre, while

they will be paid out in the country concerned either in silver or paper, thus increasing the circulation of currency and lowering its value The result is the same as if gold had been imported into the country and its currency basis accordingly increased

Essentials of the Gold Exchange System.

Quite apart from the question of the possession of adequate reserves in a gold centre, as well as resources at home, there are three conditions essential to the successful working of a gold exchange standard

In the first place, the home currency circulation must be subject to regulation by the Government or the central bank, and must be restricted to the needs of trade Clearly, if too much currency is issued, its value will at once tend to fall irrespective of the exchange position, while, if too little is issued, its value will be forced upwards in spite of any Government attempt at control

Secondly, the *intrinsic worth* of the home currency must be fixed *below* the face value; otherwise it would be possible to contract the circulation, but not to expand it This, of course, follows from the fact that increased issues decrease the value of each currency unit, and if this currency value falls below the intrinsic value, then currency will be withdrawn for use as bullion until the two values once more coincide

Thirdly, there must be a close and friendly relationship between the country operating the gold exchange standard and the centre where its reserves are kept But there is, of course, always the risk that the outbreak of war may cut off the two centres from each other, or that war may prevent the gold exchange country from obtaining possession of any reserves which it might hold abroad

It is not necessary for the working of a gold exchange standard based either on silver or paper that the country concerned should keep actual gold reserves either at home or abroad, provided that it can otherwise arrange either to sell or to buy exchange on a gold centre whenever the position of the gold standard exchange requires that it should do so

Advantages of the Gold Exchange Standard.

Whether the currency consists of silver or of paper, the adoption of the gold exchange standard provides the country concerned with a cheap, easily managed currency for internal use, and yet at the same time provides it with a steady external exchange operating on much the same basis as if it were on a full gold standard The system is specially suited to a country which is anxious to trade on a gold basis yet cannot afford to establish a full gold standard It enables the exchange position to

be adjusted quickly and easily according to the trade position, it permits reasonable control of the internal price level and it has at times proved very profitable to the country by which it is operated.

Disadvantages of the Gold Exchange Standard.

The exchange standard is not entirely free from disadvantages. First, it involves a complicated mechanism which is somewhat difficult to operate; although a paper currency is probably easier to " manage " than a silver currency. Secondly, a nation having a gold exchange standard, and therefore holding large balances abroad, sacrifices to a considerable degree its autonomy and absolute independence in financial affairs. This disadvantage, of course, applies equally to *any* standard which involves the holding of reserves either in gold in a foreign centre, or in saleable exchange on that centre, but it is one which is likely to be considerably minimised with the establishment and operation of the Bank for International Settlements. (See Chapter 30).

CHAPTER 32

POST-WAR CURRENCY PROBLEMS.

One important result of the financial upheaval caused by the World War was that the currency and exchange position in many countries became utterly demoralised in consequence of the issue of vast quantities of inconvertible paper money. In such countries, gold and silver coins entirely disappeared from circulation, prices rose to inordinate levels, while constant and violent movements in the prevailing rates of exchange produced an atmosphere of uncertainty and discredit in which trade could not possibly thrive.

When at last peace was declared and nations sought to resume a more normal course, statesmen, financiers and economists everywhere endeavoured to explain the causes of the widespread financial derangement, with the object of discovering and applying some remedy and of pointing some way out of the existing chaos.

It was soon realised that most of the world's financial difficulties were traceable to the unrestricted inflation resulting from deliberate or conscious currency manipulation, and that the post-war depression in trade owed its persistence largely to the uncertainty engendered by frequently changing currency values and the consequent instability in the foreign exchanges. The need of all peoples was for stability—stability of internal prices so that industry could thrive, and stability of the external exchanges so that international trade could proceed with certainty and confidence.

Deflation and Devaluation.

In many countries this need for stability could be met only by a programme of drastic financial adjustment and currency reform. Inflation had to be stopped, budgets had to be balanced and an end put to the orgy of extravagant spending and thriftless borrowing. But this was not all. Those countries whose currencies had become badly depreciated in terms of gold had to decide on some process of rehabilitation with the object of establishing their monetary systems once more on the tried and reliable basis of the gold standard. In the ten years following the Armistice, the French franc, for example, was subject to most violent fluctuations in value mainly because of the failure of successive French Governments to place the finances of their country on a sound footing.

From March, 1927, to June, 1928, the external value of the franc as indicated by the London-Paris rate of exchange was maintained or pegged in the neighbourhood of 124 francs per £1 sterling, only about one-fifth of the pre-war value of 25 2215 francs per £1 The currencies of Belgium, Germany, Austria, Greece, Rumania and Italy, amongst others, were similarly depreciated far below their nominal gold value, and it was obvious that drastic measures were necessary if these currencies were to be placed on a more reasonable foundation, and stability in their value once more ensured

To achieve these objects, such countries were faced with two alternatives They could either (*a*) resort to a policy of *deflation* with a view to restoring the pre-inflationary gold value of their monetary units, or (*b*) adopt the existing depreciated value by *devaluating*, *i e*, giving the monetary unit a lower statutory or legal value by reducing its legal gold content

The Objections to Deflation.

To certain countries the prospect of devaluating their monetary units involved a serious blow to the national pride, and, in some such cases, many valuable years were wasted and much economic harm was done in a hopeless struggle to restore the pre-war standard It cannot be denied that, on ethical and psychological grounds, there was much to be said for deflation to restore pre-war values Racial pride and the desire of a war-worn world for a return of the so-called "normal" conditions were factors not to be ignored Deflation was championed, too, because devaluation was considered to be a policy unworthy of any Government The State, it was argued, was morally bound to remedy those injustices between creditor and debtor, between borrower and lender, which inflation had caused But protagonists of the policy overlooked the fact that the persistence of inflation for so many years had very largely effaced the original injustices which must have followed its advent, while the other arguments carried little weight in face of the obvious and calamitous effects which were known to accompany conscious and deliberate deflation

Deflation, as we have seen in an earlier chapter, is a policy which causes widespread depression in trade, a diminution of industrial development and a reduction in the profits and wages accruing to the producing classes Those countries whose currencies were heavily depreciated soon realised that any question of the *immediate* return to the pre-war exchange value of their monetary units was completely impossible, for the result of any such action would be to place an intolerable burden on the tax-payer and upon industry, and to cause the currency to be hopelessly overvalued by the exchange, *i e*, to make its purchasing power abroad, converted into foreign currencies, greatly in

excess of its purchasing power at home Any such action could not but seriously disturb the course of trade, since no one would buy in the home country, while foreigners would hasten to sell their goods in so profitable a market Ultimately, the country would be drained of gold to pay for these goods This might continue until the influx of goods and the efflux of gold had raised the purchasing power of the currency at home to its pre-war value, but, in the process, widespread hardship would be caused

Although many countries soon realised that immediate deflation to pre-war values was impossible, the majority were slow to recognise that, except in one or two cases, notably those of Britain and Sweden, even a policy of *gradual* deflation was economically impossible because it would intensify rather than minimise the evils of post-war financial disorder Few people appeared to understand that the *gradual* appreciation in the value of a heavily depreciated currency induces almost as much uncertainty and instability in prices and in exchanges as the reverse movement of depreciation following conscious inflation

Ultimately, most countries whose currencies had suffered from marked inflation were compelled to face the far more practical, if unpleasant, alternative of *devaluation*

Stabilisation "De Facto" and "De Jure".

Devaluation implied the stabilisation of the value of the monetary unit as nearly as possible at its existing level as indicated by the prevailing gold exchanges This stabilisation proceeded by two stages First, there was a *stabilisation de facto*, *i e*, a maintenance of the value of the currency at a predetermined level by "pegging" the exchanges and controlling internal prices through a careful regulation of credit After some experience of the working of the exchanges and of the credit system on this temporary basis, legal effect was given to the arrangements by a *stabilisation de jure*, *i e*, legislative sanction was given to a decrease in the statutory gold equivalent of the monetary unit and to the measures necessary to maintain the new value of that unit

External or Internal Value?

In making a decision as to the gold value at which their respective monetary units should be stabilised, the countries concerned were faced with a problem of considerable difficulty The question arose as to whether that gold value should be the existing *internal* value of the currency, *i e*, its value as indicated by the general level of prices within the country, or its existing *external* value, as indicated by the rates of exchange with gold standard centres In practice, these values rarely

coincide with any degree of exactness, for although, in accordance with the purchasing power parity theory, forces are constantly working to bring the rates of exchange to the purchasing power parities, there are many factors, embodied in the generic term "economic friction" (*e g*, speculative influences, psychological factors, costs of transport and tariff barriers) which prevent the precise adjustment of the two values.

Overvaluation and Undervaluation.

In the absence of such adjustment, a currency is said to be either *overvalued* or *undervalued* by the external gold exchanges. *Overvaluation* implies that the value of the currency on the foreign exchange market is higher than its internal value as indicated by the level of home prices. In other words, home prices converted into gold at the prevailing rates of exchange are higher than world prices, and thus a stimulus is given to imports, whereas a handicap is placed on exports. *Undervaluation*, on the other hand, implies that the value of the currency in the foreign exchange market is lower than its internal value, in other words, home prices at the current rate of exchange are lower than world gold prices. As a result, exports are stimulated and imports discouraged.

Undervaluation may result from speculative selling of the currency concerned, as was the case in the "flight" from the franc and from the mark, when, owing to the fear of further inflation and lack of confidence in the future of these currencies, their external values fell below the levels justified by their internal valuations.

A currency whose internal value is depreciated is said to be *specifically* depreciated when it is undervalued in the foreign exchange market, and the extent of this specific depreciation is measured by the extent of the divergence of the prevailing exchange rate from the purchasing power parity.

Stabilisation and Adjustment Crises.

Clearly, then, a Government which embarks upon a stabilisation scheme is faced with two alternatives—the adoption of either the *internal* or the *external* value of the currency. But the effects of stabilisation depend, not on whether the internal or the external value of the currency is chosen, but on whether the choice falls on the *higher* or on the *lower* value of the currency.

If a currency is undervalued by the exchanges and the *external* value (*i e*, the *lower* value) is adopted, the internal value of the unit will have to be *forced down* to the lower external value. This implies that internal prices will have to rise until they reach a level at which they are in equilibrium with external prices at the rate adopted for stabilisation.

The choice of the lower external value of a currency means, therefore, that the change will be followed by a temporary boom owing to the continuance or resumption of inflation until parity of internal and external values is reached But when parity is reached, the hateful necessity for curbing expansion must be faced, and inflation must be stopped, otherwise the internal and external values will once more diverge This type of crisis has been distinguished as a *stabilisation crisis*, such as was experienced in Belgium and Germany, where the rates for stabilisation did not fully represent the internal purchasing power of the currencies

If, on the other hand, a currency is *overvalued* externally, and the *higher* value of the currency is adopted for stabilisation, the internal value will have to be *forced up* to the higher external value, in other words, home prices must fall This type of crisis is distinguished as an *adjustment crisis*, such as occurred in the case of England, whose export trade was very adversely affected by the overvaluation of sterling following our return to the gold standard in April, 1925

The important point to notice is that if there is a divergence between internal and external values, whatever the choice made by the Government, then, it will have to face a crisis of the one kind or the other, and the magnitude of that crisis will depend on the *degree* of the divergence from the purchasing power parity, on the elasticity of the various "factors of production", and on the skill with which those responsible for monetary policy carry out their task

Is the World on a Dollar Standard?

Every post-war stabilisation scheme has for its main object the fixing of the value of the monetary unit in terms of gold so as to establish a definite basis for the exchange of the unit against the currencies of other gold-standard countries

But the stabilisation of a monetary unit in terms of gold does not by any means imply that the unit is given an absolute and unfluctuating value On the contrary, the value of gold is itself not entirely stable, and, in terms of commodities, that value has varied considerably over a long period of years In practice, however, changes in the value of the standard on which several currencies are based do not affect the stability of the values of those currencies relative to one another, since the value of each currency moves in proportion as the value of the standard varies

But a matter of far greater moment to the world's stabilisation problems is the now widely accepted fact that the value of gold at the present time, as represented by the general level of world prices, is determined by the *value of the U'S dollar*, as that value is determined from time to time by the policy of the American Federal Reserve Board

For some time past that authority, anxious to maintain price stability in the United States in face of consistently large imports of gold, has adhered to the costly policy of *sterilisation*, *i e*, the excess imports of gold have been hoarded in the vaults of Washington and so prevented from exerting their usual influence of increasing the volume of credit and so raising internal prices Thus, the American price level or the internal value of the dollar has for some years past been stabilised independently of the gold holdings of the Federal Reserve Board and independently of gold movements to and from the country

Mr McKenna, speaking at the 1928 Annual General Meeting of the Midland Bank, explained this momentous fact in the following words "If", he said, "the price level outside America should rise in consequence of an increase in the supply of gold, America would absorb the surplus gold, if, on the other hand, the external price level should fall in consequence of a shortage of gold, America would supply the deficiency The movement of gold would continue until the price levels inside and outside America were brought once more into equilibrium"

Any country which nowadays adopts any form of gold standard, therefore, really links up the value of her currency with the value of the dollar, and "under such conditions, the standard selected by the Federal Reserve System for stabilisation of the dollar—which in any case must always be its aim—becomes a matter of extreme importance" [1]

In view of this position, it is scarcely to be wondered at that many well-known writers advocate the establishment of a standard which would free Britain and other countries from their monetary dependence on American policy But in spite of the weight of opinion behind this view, it is clear that America's control over the world price-level is not absolute While she may be able to enforce a lower price-level on Europe unless the European central banks are prepared to see their gold reserves seriously reduced, she cannot force Europe into inflation because the central banks of Europe, like the New York Federal Reserve Bank, would play the sterilisation game and adopt restrictive devices

These are fortunately only academic questions In practice, what is required, and what is actually being achieved, is greater co-operation between the leading Central Banks (and particularly between the Bank of England and the New York Federal Reserve Bank) with the object of deciding on a common policy directed to ensuring stability in the general price level and thus in the value of gold throughout the world

Currency Problems in the Principal Countries.

Most of those countries which suffered from currency mismanagement during and after the Great War have now stabilised their currencies and have restored, or are in the process of restoring, the gold standard.

[1] Professor Gustav Cassel, in the *Financial News*, January 21st, 1929

All have experienced, in varying degrees, the harmful effects of inflation, and have had either to devaluate their currencies or submit to the painful process of deflation In Scandinavia, in Holland, in Argentina and in Great Britain the inflation was comparatively slight, and all these countries have been able to return to gold at the pre-war parity

In Great Britain, the policy of restoring the pre-war parity was condemned in some quarters, but by most people it was considered to be the only policy which could be followed with safety and profit France and Italy were among those countries which retarded their economic recovery by entertaining the idea that their hopelessly depreciated currencies could be restored to their pre-war gold equivalents, ultimately, they, together with Rumania, Bulgaria, Greece and Czecho-Slovakia, were compelled to pocket their pride and stabilise their currencies at greatly reduced gold values In Denmark and Norway attempts were at first made to restore pre-war gold parities by *gradual* deflation, but consequent uncertainty so disturbed the economic life of those countries, and the problem of unemployment became so acute, that they were obliged to precipitate matters by forcing up the value of their currencies to that degree necessary to restore the old parities

Belgium, Finland, Germany, Austria and Hungary avoided many of the difficulties which faced other nations by instituting new units for external purposes with values approximating closely to those existing in the foreign exchange market

Much of the progress which has been made in the reconstruction of European currencies may be attributed to the ultimate, though gradual, recognition by statesmen that financial and economic questions should, as far as possible, be divorced from political considerations, and that the ultimate economic settlement and progress of Europe could be ensured only by a considerable abatement in the Allied claims for reparations from Germany and the other ex-enemy countries

Stabilisation in Britain.

The financial difficulties which affected most countries in consequence of the World War cannot be better illustrated than by reference to the conditions which existed in our own country For more than four years Britain was engaged in production, not for exchange, but for destruction The men withdrawn from industry to swell the fighting forces had to be clothed and fed, mainly from foreign sources, but there were few exports to pay for the imports And while our exports dwindled, our enormous imports of raw material, of munitions and of other war supplies, on behalf of ourselves and our Allies, increased by leaps and bounds Our balance of *trade*, which even in normal times is extremely unfavourable, became almost ruinously adverse, while our invisible exports

practically ceased by reason of the employment of our mercantile marine for war purposes and because the earnings of our bankers, underwriters, shippers and brokers were much reduced by the disorganisation of international business To add to these difficulties, the sterling exchanges were compelled to bear the strain of the vast payments made by Britain in her capacity of financier to the Allies

The vast sums due to non-belligerent nations supplying us with foodstuffs and materials had to be paid in gold, or by the sale of foreign securities, or by raising loans and establishing credits in the supplying countries Our gold currency was replaced by the emergency issues of Treasury notes, and these, owing to the increasing demands for Government disbursements, had to be issued in ever-increasing quantities The resultant inflation of the currency, together with a world shortage of raw material, due both to under-production and increased demand, caused a general rise in prices, bringing in its train further currency expansion, and a vicious circle of inflation, rising prices, further inflation and still higher prices

The high prices in this country naturally encouraged imports and discouraged exports, and so accentuated the adverse trade position Gradually, the purchasing power of our currency relative to the currencies of neutral countries declined and the rates of exchange between those countries and London remained for several years at markedly unfavourable levels

The Cunliffe Committee, 1918.

In 1918, with the cessation of hostilities, the Treasury appointed a committee of bankers and business men under Lord Cunliffe to investigate the condition of the currency and the foreign exchanges, and to consider the powers and functioning of the Bank of England The main recommendations of this committee were that the gold standard should be restored at the earliest possible moment as the surest means of promoting a return of our pre-war commercial and financial leadership, that Government borrowing should be curtailed, so as to lessen the expansion of credit and the issue of uncovered Treasury notes, that the volume of Government indebtedness should be reduced, that a free market for gold should be restored, that arrangements should be made whereby the Bank of England should be given cognisance of all exports of gold, be required to establish a minimum gold reserve of £150 millions and ultimately be given the complete control of the issue of notes in England and Wales, and that the maximum fiduciary issue of Treasury notes for any one year should be the legal fiduciary maximum for the following year.

The last recommendation was adopted in a Treasury Minute of 1919, with the result that currency inflation was definitely checked and a gradual process of deflation started.

The Gold Standard Act, 1925.

The improvement in the sterling exchanges in the following years and the endorsement of the recommendations of the Cunliffe Committee by the Committee on the Currency and Bank of England Note Issues in 1924 led to the restoration of the Gold Standard in April, 1925. By the Gold Standard Act of that year Great Britain abolished her restrictions on the export of gold, and adopted a *gold bullion standard*, the main principles of which are as follows —

1. Gold bullion can no longer be accepted by the Mint for conversion into coin from anyone except the Bank of England, but it may still be offered in unlimited quantities to the Bank, which is obliged to buy it at the rate of £3 17s. 9d. per standard ounce.

2. Both Bank of England notes and currency notes are inconvertible into gold *coin*.

3. Holders of "any legal tender" (*i.e.*, Bank of England notes and sovereigns) are entitled to demand in exchange from the Bank gold bars, which contain approximately 400 ounces of fine gold, at the price of £3 17s. 10½d. per standard ounce.

Both the Cunliffe Committee of 1918 and the Committee on the Currency and Bank of England Note Issues of 1924 were agreed on the principle of a fixed fiduciary issue of notes, centralised at the Bank of England, and on the internal use of inconvertible paper to economise the gold holdings of the Bank. The later Committee recommended, however, that the amalgamation of the Treasury and Bank of England Note issues should not be attempted until the country had had the experience of at least a full year's working of the gold standard, and the Bank of England had accumulated a normal minimum gold reserve of £150 millions. The experience of the first year's working of the exchanges after the return to gold proved satisfactory, but the disastrous general strike of 1926 delayed action in the direction indicated until 1928, when, in November, the amalgamation of the note issues was effected by the Currency and Bank Notes Act of that year. (*See* Chapter 5.)

PART V.

BANKING AND THE FINANCE OF TRADE AND INDUSTRY.

CHAPTER 33

THE FINANCE OF TRADE: MINIMISING EXCHANGE RISKS.

THERE is probably no direction in which banks throughout the world have in recent years more generously extended the manifold services placed at the disposal of their customers than in the facilities which they provide for the finance of foreign trade

Difficulties are inherent in international trade Initially they spring from the fact that the movement of goods over considerable distances, and usually by sea, necessarily involves great risk of loss or damage to the goods concerned, arising from a variety of circumstances and of perils unforeseen Then the completion of contracts between buyers and sellers of different nationality is obviously a matter which is brimful of complications resulting from distance and time, varying race and language, and from differences in business practice, law and morality Finally, there is the uncertainty that the fulfilment of obligations may be prevented by any of those multifarious happenings which disturb the even course of overseas trade,—political unrest, financial disasters, international conflicts and tariff difficulties

For our present purpose we may consider these risks which arise in international trade under three headings (*a*) *Exchange risks*, *i e*, the risks of loss attending the exchange of one currency for another, (*b*) *Credit risks*, *i e*, the risks of loss through the failure of the credit of one or other of the parties to the contract, and (*c*) *Transport risks*, *i e*, risks of loss of the goods or of damage thereto during transit from one country to another, which are covered by Marine Insurance Policies (page 468)

MINIMISING EXCHANGE RISKS

Every international transaction for the purchase and sale of goods necessarily implies an exchange of the currency of the buyer for that of

the seller, and, from what has been stated in the preceding chapters, it will be clear that any such exchange may contain serious possibilities of loss, especially where the value of one or both of the currencies concerned is uncertain or fluctuating In the absence of some safeguard against loss, an exporter who sells 30,000 pesetas worth of goods to Spain when the exchange stands at 28 pesetas per £1 will obviously lose heavily if, by the time payment is made to him, the exchange has moved to 30 pesetas per £1 he would actually receive only £1,000 as against a selling price of £1,071

This position was only too forcibly brought to the notice of traders, both in this country and abroad, during the uncertain years of the Great War and in the period immediately following the Armistice And, though the possibilities of loss have now been considerably reduced with the restoration of the gold standard in the more important countries, it has to be remembered that international business is often based on a very small margin of profit, and that even moderate fluctuations in the rates of exchange may reduce or entirely wipe out that margin unless safeguards are taken to cover the inevitable risks

The facilities now provided by the banks enable the trader to avail himself of such safeguards with little or no cost to himself, and if, for convenience, we look at the matter from the point of view of exporters and importers in this country, we find that there are three possible methods by which they can minimise (or indeed eliminate) the likelihood of loss from a change in the value of the currency of the foreign buyers and sellers with whom they are in business relationship, *viz*, (*a*) They may arrange *to receive or to make payment in sterling*. (*b*) They may contract to sell or to buy in terms of foreign currency, and may pass payments through a *Foreign Currency Account* opened with their bankers, or (*c*) They may contract in foreign currency, but protect themselves against fluctuations therein by entering into *forward contracts* with their bankers We will consider each of these methods first of all from the point of view of an exporter in this country, and then from the point of view of an importer

Arranging for payment in Sterling.

From the point of view of an exporter, the most obvious and most convenient method of obviating exchange loss on money due from abroad is to sell goods on the understanding that they shall be paid for in the exporter's own currency, sterling, so placing the seller in much the same position as if he had sold the goods to a buyer in this country There are a number of ways in which this can be arranged

It is possible, of course, that the foreign buyer of the goods may be a house of international reputation having an ordinary account with a bank in this country, in which case the English exporter may receive

payment of his invoice on shipment of the goods by a cheque, drawn on that account, which is sent for collection through the exporter's bank in the usual way It is more likely, however, that the foreign importer will not be a customer of a bank on this side, and he may accordingly arrange with his own bank to open in favour of the English exporter at a London bank what is known as a *London Banker's Acceptance Credit* The main features of such a credit are described on page 461, *infra*, but here it may be stated that its object is to enable the exporter to obtain payment of the sterling amount of his invoice from a London bank against his draft on that bank for the invoice value of the shipment, accompanied by the shipping documents, complete and in order

The third method, and one which has been widely adopted in this country, is that whereunder the exporter draws a bill of exchange on the foreign importer for the sterling value of the consignment, including any charges paid in connection with the shipment As a rule, the bill will be drawn at a fixed period after date or after sight, this period being determined either by agreement between the buyer and seller, or by the custom of the particular trade concerned Thus "three months after sight" may be the *usance* or customary period in some trades or between certain countries, whereas in other cases, the usance may be "at sixty days sight" or "90 days after date", and so on

Negotiation of Bills Drawn in Sterling.

Bills so drawn *in sterling* by an English exporter on a foreign importer may either be handed to a banker *for collection* and credit of the proceeds (less collection charges) to the account of the exporter, or, if the exporter requires the funds immediately, they may be negotiated at once with the banker The amount of sterling which the exporter receives for his bill depends on the manner in which the bill is drawn, *i e*, whether it is drawn (*a*) in the ordinary way, or (*b*) enfaced with an *exchange clause*, prescribing the mode of payment

If the bill is drawn in the ordinary way, the exporter may sell it to his banker (*i e*, discount it) and leave it to the banker to collect the sterling at maturity from the foreign drawee In this case, the exporter is relieved of all risks of loss through fluctuation in the exchange, and he receives the face amount of his draft *less* an allowance for stamp duty and discount for a period which, in the case of a bill drawn payable at some period after sight, will include (*a*) the time of the outward mail, (*b*) the time which the bill has to run, and (*c*) the time of the homeward mail All risk of loss through exchange fluctuations will be borne by the foreign drawee, who, if he has no sterling funds already, will either buy sterling forward or wait until the maturity of the draft, when he will buy the requisite amount in sterling, from his banker or another banker, at the best rate he is able to obtain

Exchange Clauses.

By the adoption of the second method, and the insertion in a bill of an exchange clause, the exporter on this side fixes the rate at which the bill will eventually be paid by the drawee There are a number of exchange clauses in daily use, some being more common than others and some being confined to bills on specific countries For example, bills on Brazil usually contain the clause —"*.Payable at the presenting banker's drawing rate for 90 days' sight drafts on London at date of payment,*" in which case the foreign drawee will be required to pay the collecting banker at the latter's current *selling* rate for a 90 days' draft on London

Many bills are claused "*Payable at the collecting banker's drawing* (*i e* , selling) *rate for sight drafts on London on the date of payment,*" in which case the drawee will pay the presenting bank a sufficient sum in the local currency to purchase a sight draft on London for the face amount of the bill, the collecting banker taking his profit in the rate at which he converts the face value of the bill into local currency

If the clause does not specifically state that the bill is payable at the *presenting* or *collecting* banker's rate, the drawee can exercise the option of buying the requisite draft on London from another bank, as where a bill is drawn "*Payable with approved banker's cheque on London for full face value*"

"*Payable without loss in exchange*" This clause has much the same effect as the last mentioned, since the collecting banker is compelled to accept in payment a bank draft in the original currency of the bill if the drawee chooses to tender one If the bank draft is not purchased through the collecting banker, he loses the "turn in exchange" which would otherwise accrue to him if he himself issued the draft or effected a transfer of funds at his own selling rate

Bills on India and the Far East are frequently drawn with the addition of an interest clause, thus "*Payable at the collecting bank's drawing rate for demand bills on London with interest at 6 per cent per annum from the date hereof to the approximate due date of the arrival of the proceeds in London*" By such a clause the exporter on this side not only ensures payment of the full amount of his invoice, but also ensures that the Eastern importer pays interest on the amount of the bill from the date of drawing (usually also the date of shipping the goods) until the date when payment is received in this country

Exchange as per Indorsement.

One of the best known of all exchange clauses is that embodying the words "*Exchange as per Indorsement*", meaning that the bill is to be paid by the drawee at a rate of exchange specified in an indorsement made by the negotiating banker

In pre-war days, this clause was often inserted in drafts of British exporters on their overseas customers, but nowadays the clause is used *only by special arrangement with the foreign drawee* This is because the negotiating banker, who pays the exporter in sterling the full face amount of the bill, adjusts the rate for conversion into foreign currency *to include interest on his money* until the funds reach him, so the foreign drawee has to pay, in addition to the face value of the bill, interest on that face value for the period that must elapse before the return remittance of the proceeds of the bill reaches the negotiating banker

Naturally, the drawee may object not only to having to pay the additional interest included in the rate but also to the fact that, since the rate of exchange is fixed in London, he is not given the chance of finding a cheaper alternative method of paying the amount due Indeed, foreign drawees have in recent years so frequently refused to pay at the indorsed rates that the method here discussed is by no means as popular as it has been in the past

At the same time, the method has great advantages from the point of view of the exporter on this side He draws his bill for the full amount of his invoice and converts it into cash immediately He is thereafter freed from all trouble in connection with obtaining payment of the bill and from all risk of exchange fluctuation Moreover, he receives more by this method than he would obtain if he were to forward his bill for collection and pay the collecting banker's charges, or if he were to discount an *unclaused* bill for the same amount with a banker

The Standpoint of the Importer.

Although many international transactions for the purchase and sale of goods are settled in the currency of the *seller*, it need scarcely be stated that it is always to the importer's advantage to arrange, whenever possible, to make payment in terms of his own currency By so doing, he knows precisely the extent of his commitments, he is freed from the trouble of arranging an exchange of his own currency for the currency of the seller, and he is relieved of all risk of loss on the exchange of two currencies An English importer, for example, may arrange to pay for goods received from the United States either by remittance of a London banker's sterling draft, or by meeting a sterling bill drawn by the exporter on him, or by the payment of an agreed sum in sterling to a London agent of the exporter against delivery of the documents of title to the goods concerned.

Transacting Business through Foreign Currency Accounts.

In certain special circumstances, merchants trading abroad who have to make or to receive payments in foreign currency find it to their

advantage to pass the transactions through a *Foreign Currency Account*, in the particular currency concerned, maintained with the Foreign Branch or Foreign Department of the bank with which they are accustomed to deal Generally speaking, an arrangement of this kind is of value only where the business of the customer concerned involves both payments and receipts in foreign currency, and its main object is to avoid the loss and trouble consequent on frequent conversions from one currency into another

Thus, an importer buying goods abroad may purchase the requisite amount of foreign currency from his banker as soon as each contract of sale is fixed up, and have it placed to the credit of his account in the relative foreign currency (*e g*, to a "Francs Account" or a "Dollar Account") When he wishes to make a payment, the importer issues a cheque against the balance, or instructs his bank either to issue a draft in favour of the exporter abroad or to pay the latter by T T or M T, as the case may be When the importer receives any payments in the foreign currency (as, for example, proceeds of bills or coupons sent for collection), he may have them placed to the credit of the foreign currency account to meet current withdrawals or for disposal afterwards as he may subsequently decide

In like manner, an exporter may have all sums in foreign currency due to him credited to a foreign currency account in his name, with the object either of utilising the balances for any payments which he may have to make in that currency, or of selling the foreign currency when he thinks it most opportune to do so Clearly, an arrangement of this kind is of considerable advantage to an exporter now that goods sent abroad are so frequently paid for in the currency of the importing country, and now that bills drawn in foreign currency are almost invariably paid in the currency in which they are drawn The proceeds of such bills can be placed direct to the exporter's foreign currency account, and there is no trouble or delay over the question of exchange into the exporter's home currency unless, of course, he wishes to have the exchange effected immediately.

Although the system here described possesses great advantages, it does not entirely eliminate exchange losses An importer who covers his exchange risks by spot purchases of the relative foreign currency, as soon as the debt is incurred, is in the position of paying *spot cash* for his purchases, and this is a method which *may* involve a considerable loss of interest on the funds, especially as it is more than likely that the interest allowed on the balance of a foreign currency account will be at a much lower rate than could be earned by funds invested in the importer's own business Similarly an exporter can avoid loss in exchange by this method only if he ultimately converts or sells the foreign currency at a rate at least as favourable as that prevailing when the debt to him was incurred, or if he can use the foreign funds at least as profitably

abroad, in the purchase of goods, services or securities, as he could have done at home, had the debt been paid in his own currency

An English merchant who opens a foreign currency account naturally deals with the Foreign Branch or Department of his bank, either direct or through the branch at which his ordinary account is kept But although the foreign currency account records are kept by the Foreign Branch, the foreign currency standing to the customer's credit is *actually held abroad as part of the bank's balances with its branch or agent* in the foreign country concerned

Forward Contracts in Exchange.

At the present time, by far the most important method of eliminating exchange loss is that which involves the making of a *forward contract* with a bank for the purchase or sale of the requisite sum in foreign currency on an agreed future date The essence of such a contract is that a customer arranges *now* with his banker the rate of exchange at which a given sum in foreign currency shall be delivered or taken up by the bank on a fixed future date In other words, a forward contract enables an importer or an exporter say, in this country, at the time he enters into an agreement to buy or to sell goods, definitely to fix the exact sterling equivalent of the total amount of foreign currency which must ultimately be paid or received by him A merchant enters into forward contracts in exchange so as to fix once and for all the rate of exchange at which he will pay for his imports or receive payment for his exports, as the case may be, but though the rate is fixed when the forward contract is made, *no money passes until the actual maturity date is reached*

Importers and Forward Exchange.

We may illustrate the advantage of forward exchange to an importer by considering the case where a London merchant has contracted to buy $50,000 of goods from an exporter in New York, subject to payment being made by a three months bill drawn in dollars on the London importer against the shipment when it is made Now, it is likely that the importer will require to dispose of all or part of the goods long before they arrive, but the question is How much will the goods cost him? What amount in sterling will he have to pay for the $50,000 required to meet the bill when it is presented for payment? To dispose of the uncertainty, he may, of course, buy the dollars at once, and have them held to his credit by his bankers until the bill falls due, but, by so doing, he will not only lose interest on the money for the term of the bill, but will also deprive his business of a good deal of capital which he can doubtless use far more profitably As an alternative, he may reckon

the cost of the goods at the current rate of exchange, and do nothing to obtain the dollars until the bill is presented, in the hope that he may then buy them at a rate at least as good But even now that the pound sterling and the dollar are functioning steadily together on the gold standard, the risk of loss on a $50,000 transaction through an adverse movement of the exchange is considerable The maximum possible loss is represented, as we have seen, by the " spread " between the export and import specie points, the extreme limits to the fluctuations of the daily rates of exchange, say, $ 04 per £1, or £400 on a $50,000 transaction,—quite sufficient to remove all likely profit and to involve the importer in a nasty loss

The wise importer in such circumstances therefore protects himself by a forward contract As soon as he has fixed up the purchase (or even before he finally settles it), he communicates with his banker and makes a written contract whereunder the banker agrees to provide $50,000 at a specified rate of exchange to meet the bill when it is presented No money passes between banker and importer until the bill is presented when the dollars are paid over by the banker to meet the bill, and the importer's account is debited with the sterling equivalent at the agreed rate By such an arrangement, which, thanks to the existence of a highly developed forward exchange market, costs the trader practically nothing, the importer is enabled to fix up the sterling equivalent of his foreign purchases without trouble or delay, frees himself from the trouble of studying or watching exchange movements, and protects himself from loss through adverse changes in the value of foreign currencies

By way of further illustration we may consider the case where a merchant is consigning goods to the Far East to an agent who has a ready market for them, and who can contract to reimburse his principal for them on an agreed date In order to effect payment, the agent will most likely choose a favourable moment to purchase from his banker a T T , to be effected on the agreed future date, against payment to the banker of an agreed number of taels or dollars or yen, as the case may be Though the T T is not made until the agreed future date, it is " booked " at once at the fixed rate of exchange, and the onus of executing the order at that rate devolves upon the banker provided he receives on that date the agreed equivalent in local currency

Exporters and Forward Exchange.

Forward exchange transactions are of just as much benefit to the exporter who has contracted to sell goods on the basis of future payment in foreign currency By consulting his banker as to the sterling equivalent which the latter will pay for foreign currency delivered to the bank on a fixed future date, the exporter can settle his contracts for the sale

of goods abroad on practically the same basis as if he were selling the goods for sterling in his own country It may be arranged, for example, that the exporter shall obtain payment by drawing bills on the foreign importer at three months after date for the invoice value of the goods in the importer's currency In such a case, the exporter, on entering into the contract, will arrange with his banker that the latter shall purchase the foreign currency represented by the bills at an agreed rate, and he will thus fix immediately the future sterling value of the buyer's payments This method, therefore, enables the exporter also to free himself of all worry and trouble connected with the value of the foreign currency concerned, and permits him to arrange contracts for the future delivery of goods without uncertainty as to the ultimate return therefrom.

Forward Contracts and the Banker.

It will be clear from what has been stated that the effect of a forward contract is to transfer the risk of exchange fluctuations from the shoulders of the merchant to those of the banker But it is no part of the latter's business to conduct speculative operations or to undertake undue risks Hence no reputable bank will accept forward exchange business unless it is amply covered against the various contingencies which may arise

From the banker's standpoint, the first risk to be guarded against arises from the fact that the customer concerned may not deliver or take up the foreign currency in accordance with the contract, or that he may not pay over or accept the agreed sterling equivalent, as the case may be Accordingly, it is the practice of bankers to enter into such contracts only with parties of whose credit and standing they are satisfied, and, in all cases, to embody the terms of the contract in a written agreement signed by the customer Wherever necessary, the deposit of ample security (in the form of a credit balance or otherwise) is required to cover any likelihood of loss through failure of the customer to carry out his part of the bargain

Finally, all reputable banks cover their forward exchange commitments in each currency in one of several ways which are open to them The majority of forward operations, and especially those whose amount is considerable, are covered by contra transactions of similar amount A banker who buys from a customer $100,000, three months forward, immediately sells the same amount in the Forward Exchange Market for delivery on the same day, and thus keeps his position in three months forward dollars all square In like manner, a banker who sells a large amount of francs for future delivery immediately buys a corresponding quantity in the Forward Exchange Market, which, in the most important currencies, is so highly developed that ample cover for all ordinary requirements is readily available

In all cases where forward transactions are covered by corresponding forward operations, and not by spot purchases or sales, no money passes, and, therefore, no profit or loss accrues, until the contract matures and is complete Suppose a London banker, A, sells to a customer, Brown, fcs 10,000 three months forward and that Banker A covers himself by a corresponding purchase in the Foreign Exchange Market, *e g* , from another London Bank, B At the time the deals are arranged, contract notes pass between the two banks and between Bank A and its customer, Brown, while Brown will be required to deposit security as a guarantee that he will faithfully discharge his obligations under the contract

No money passes between any of the parties until the contract matures in three months' time Then Bank A pays Bank B the agreed sterling equivalent for the forward francs purchased, and gets the francs in the form of a draft or mail transfer payable at Bank B's agency in Paris If a draft is issued, Bank A will send it to its agent in Paris for collection from Bank B's agent, and credit of the proceeds to Bank A's francs account If a mail transfer is issued, Bank B's agent will be instructed by mail to pay over the fcs 10,000 to Bank A's agent Alternatively, the transfer may be arranged by telegraph Whichever method is adopted, Bank A has fcs 10,000 placed at its disposal in Paris and it transfers these to Brown in the form of a draft or mail transfer payable at its Paris agency, while Brown pays over to Bank A in London the agreed sterling equivalent for the forward francs purchased by him

Bank A obtains its profit from the difference between the price at which it sells forward to Brown and the price at which it buys the forward cover from Bank B But this profit does not mature until the contracts are finally completed by all parties at the expiration of three months from the date when the arrangements are first made

How Forward Transactions are covered in Practice.

In actual practice, a London dealer's covering operations in respect of a forward currency transaction of any magnitude consist of two distinct steps As soon as the dealer has bought or sold forward, he proceeds to cover himself immediately, and before the Market can go against him, by a corresponding sale or purchase, not of *forward* currency, but of *spot* currency Subsequently, he makes his position all square by what is known as a " swap," *i e* , a sale or purchase of forward currency against spot at a *difference* between the two rates This may be illustrated as follows, if we assume the market spot quotation for dollars is \$4 85 $\frac{3}{16}$-$\frac{5}{16}$, and that three months forward dollars are quoted " $\frac{3}{16}$-$\frac{5}{16}$ over spot "

FIRST TRANSACTION

Customer Jones buys from Bank A \$50,000, *three months forward*, at, say, \$4 85$\frac{1}{4}$

Bank A buys from the Market $50,000 *spot*, at $4 85 3/16

Bank A is now in possession of $50,000 which it is not to deliver for three months, so to "square" his position, the dealer in Bank A gets rid of the spot currency and buys what he requires, *i e*, dollars for payment to the customer in three month's time

SECOND TRANSACTION

Bank A sells to the Market $50,000 *spot* at, say, $4 85 5/16

Bank A buys from the Market $50,000, three months forward, at $4 85 3/8

There are two important reasons for this seemingly complicated procedure First, the great majority of Market dealings in forward exchange take the form of combined spot and forward "swaps" *i e*, the purchase of spot currency and the sale of the same currency forward *at a difference in the rate*, either in favour of or against the buyer of the spot, and *vice versa* Hence, it is ordinarily far easier to effect a swap than to buy or sell forward *outright*, while the latter usually involves not only a certain amount of negotiation, but also less favourable rates The second reason is that the spot quotation is the more sensitive rate, and is therefore likely to move against the dealer unless he immediately buys or sells such currency as he requires to cover his forward commitments

The effect of the transactions is that Bank A transfers to some other member of the Exchange Market the obligation to deliver the $50,000 in three months' time to its customer Actually, the process of set-off and cancellation is so efficient, that few members of the Market have to keep an "uncovered" or "open" position One customer's requirements of dollars for forward delivery to him are actually provided by another customer of another institution who will have dollars for disposal at approximately the same time, and the Forward Exchange Market is the organisation through which the two transactions are brought into relationship and set-off one against the other.

A banker may cover forward transactions in other ways He may, for example, cover three months forward sales of pesetas by a corresponding purchase of three months bills on Spain maturing at approximately the same time, or by arranging with his correspondent in Spain to deliver to him the requisite quantity of pesetas in three months' time at a rate fixed immediately Finally, a banker who sells forward currency may, in exceptional circumstances, decide to cover immediately by the purchase of the equivalent amount of spot currency, which, for a variety of reasons, he may be content to hold in the foreign centre at interest until the forward contract falls due for completion But this is a method which will be adopted only if it is accompanied by some special advantage to the banker concerned.

Factors Governing Forward Exchange Rates.

The method of quoting the rates of exchange for forward transactions has been explained in Chapter 27, to which reference should be made at this point Now, the difference between the forward and spot quotations in the same currency at any particular time depends chiefly on the difference between the ruling interest rates in the two centres concerned A dealer who sells foreign currency forward may not always be able to get the forward currency necessary to square his position, in the manner described in the last paragraph Consequently, whenever the dealer fixes a forward rate, he usually does so on the basis that he *may* have to cover himself by buying or selling *spot* currency whether he actually has to do so or not

Now, suppose a dealer sells fcs 100,000, three months forward, and covers himself by buying spot fcs 100,000 By so doing he almost immediately pays out a given amount of sterling in London and has fcs 100,000 delivered to him in Paris, where they remain at his disposal for three months, *i e*, until the forward sale matures unless he sells them at a difference against forward If then, the rate of interest in London is 5% and in Paris only 3%, the dealer will lose three months' interest at 5% on his sterling, and gain three months' interest at 3% on the francs placed to his credit, *i e* he will suffer a net loss in interest of 2% per annum for three months

Hence, in fixing his forward rate in such circumstances, the dealer would sell to his customer *less* francs forward than he would spot, because he would expect the difference between the spot and forward rates at least to compensate him for the loss of interest incurred in the transfer of part of his funds to Paris

In practice, dealers work out the differences in interest rates as a certain addition to or deduction from the rate of exchange Thus, the Paris rate will be taken in round figures as 125 francs per £, and, on this, a difference of 1% per annum in interest rates would make a difference of approximately $10\frac{1}{2}$ cents per month between the spot and the forward quotations, thus —

$$125 \times \frac{1}{100} \times \frac{1}{12} = 1042 \text{ fcs} = 10\,42\text{c}$$

If the current T T rate is 125 francs per £ and interest in Paris is 4%, while interest in London is 5%, the dealer will prefer to hold money in London rather than in Paris He will prefer to sell spot francs rather than forward francs, and he will therefore give more francs per £1 spot than he will forward, *i e*, he will quote forward francs at a premium This premium will approximate to 1% per annum and if, for the moment, we ignore other factors which are dealt with hereafter, the dealer's various rates will *tend* to be as follows —

	fcs per £1	
Spot rate	125	
Less 1 month's interest @ 1% p a	105	(approx)
1 month's forward rate	124 895	,
2 months' interest @ 1% p a is	21	(approx)
2 months' forward rate	124 79	,
3 months' interest @ 1% p a is	315	(approx)
3 months' forward rate	124 685	,,

Again, if the spot rate on Paris is 124 and money is worth 5% in London and 9% in Paris, then a banker selling francs to a customer for three months delivery fixed, should be able to do so at 4% per annum (or 1% for three months), *better* than the spot rate, because a forward sale of francs can be covered by a purchase of spot francs to earn 4% per annum more interest than sterling would earn The forward rate would *tend* to be at a discount of 1% on spot, viz –

Spot rate	124 00
1% discount	1 24
Three months' forward rate	125 24

Thus, other things being equal, when interest rates are higher in Paris than in London, the dealer selling forward francs will show his preference for selling forward rather than for selling spot by giving his customer an increased number of francs per £ in the forward rate, and that increased number of francs will be determined by the difference between interest rates in the two centres The reverse is the case if interest rates are higher in London than in Paris

Relative Interest is Not the Only Factor.

But whilst differences in interest rates are the main basis of forward rates of exchange when conditions between the two countries concerned are stable, there are other important factors which may considerably affect the market The forward market in a currency may be so active that forward sales can *always* be covered by forward purchases, in which case differences in the prevailing interest rates will not seriously affect the forward quotations Moreover, if there are little or no forward operations in a currency, forward transactions therein, if they can be

entered into at all, can only be effected at whatever rates the bank concerned deems fit to charge. In such circumstances, the forward quotations are fixed at some arbitrary figure in relation to spot, and may be, for example, quoted in terms of a percentage discount or premium on the spot rates.

In brief, we may say that the influence of relative interest as the fundamental factor determining important forward rates may be obscured or entirely offset by other factors, of which the chief are the state of the forward market in the currency concerned, and the opinions of the foreign exchange dealers respecting the likely trend of money rates at home and abroad.

CHAPTER 34

THE FINANCE OF TRADE: MINIMISING CREDIT RISKS.

ALTHOUGH the facilities now provided by the bankers for the elimination of exchange risks have necessarily relieved the trader of a vast amount of anxiety and trouble, they afford him no protection against the refusal or inability of his correspondent abroad to give or to take delivery of the goods which form the subject of the contract Nor, of course, do the facilities referred to safeguard the trader against the risks of loss or damage to the goods during their transit from one country to another

But though it would be impossible entirely to eliminate the manifold credit risks inherent in international business, they are considerably minimised by the facilities now universally provided by the banks in the issue of *Letters of Credit*, and in the performance of a variety of other allied services connected with the finance of imports and exports

Letters of Credit.

The letters of credit issued by the banks in this and in other countries partake of such a great variety of forms and fulfil such a variety of functions, that it is almost impossible to form a definition which will cover all of them In general terms, however, it may be stated that a Letter of Credit is a document which enables the credit of the grantee (*i e*, the person in whose favour it is issued) to be reinforced or substituted by the superior credit of the issuer, usually a banker, with the object of enabling the grantee to obtain funds in a strange place on the strength of that reinforced or substituted credit

It is usual to divide all credits into two broad classes (*a*) those which are *bank* credits, and (*b*) those which are not The former group comprises all credits which embody an *undertaking* by the issuing bank to honour drafts drawn under the credit by the grantee or beneficiary, provided certain conditions are duly fulfilled Unfortunately, however, there is no agreement on this usage, and the term "bank" credit is frequently applied to documents which do not embody an undertaking of the type here mentioned

Letters of credit may be further classified as (*a*) *Commercial or Trade Credits*, which are intended to facilitate the movement of *goods*, and (*b*) *Non-commercial credits*, which are intended to facilitate the movement of *persons*, *i e*, to enable travellers abroad to obtain such funds as they require for business or pleasure on the strength of an instrument or authority issued under the signature of the bank granting the credit In the following paragraphs it is proposed to deal briefly with the main types of credit which are included in these two broad classes

NON-COMMERCIAL CREDITS

Travellers' Letters of Credit.

A Travellers' Letter of Credit is an irrevocable bank credit, issued in favour of a person who is about to make a journey abroad, containing a request addressed by the issuing bank to its correspondents and agents to cash on demand any drafts or cheques drawn by the holder of the credit on the issuing bank up to a stated amount

Since the issuing bank undertakes to honour the drafts when they are presented, it will issue such credits only to persons who are well known to the bank, or who are satisfactorily introduced, and only against payment of the full amount involved, or against the deposit of a guarantee or other security

The general object of these credits is to save a traveller the trouble of carrying unnecessarily large sums of money with him from place to place, and though they are used mainly by persons who travel for pleasure, they are equally useful to those who travel on business There are three principal kinds, of which the third is strictly a *commercial* credit

(*a*) *Circular Letters of Credit or World-wide Letters of Credit* These are available with *any* of the issuing bank's agents or branches abroad or at home A list of such agents is handed to the customer in the form of a "Letter of Indication", which bears the signature of the holder as a means of identification, and, for safety's sake, should always be carried by him separately from the letter of credit itself The object of the letter of indication, which the issuing banker requires the grantee-customer to sign in his presence, is to relieve the banker of the almost impossible task of advising the issue of the credit to all his agents and correspondents

(*b*) *Limited Letters of Credit* These are addressed to, and are only available with, certain agents and correspondents specified in the letter of credit which itself contains the specimen signature of the holder No letter of indication is issued in this case, because each one of the specified agents with whom the credit is available is advised of its issue,

and is furnished with a specimen signature of the holder for comparison with that signed on the draft in the presence of the cashing agent

(c) *Travellers' Commercial Letters of Credit* These are really a type of limited letter of credit issued to enable the holder to purchase produce at various points and funds are available thereunder only on presentation of drafts with specified shipping documents attached

If a credit of this kind is issued against deposit of the sterling amount involved, no charge for the facility will usually be made by the issuing banker, who, in such cases, will regard himself as adequately compensated for his trouble by the interest earned on the funds deposited A percentage charge on the amount involved is, however, usually made if the credit is issued against a guarantee, while some bankers always exact a commission for the facility

Encashment Credits.

Travellers who object to carrying a letter of credit about with them, and who propose to spend most of their time abroad in one place, are enabled to obtain funds from the foreign agents of their bank by the issue of an *Encashment Credit* This consists of a request or authority forwarded by the traveller's home bank to its correspondent abroad, either direct or through the intermediary of the foreign bank's head office, empowering the correspondent to cash the cheques of the traveller on the issuing bank up to a stated amount during a specified period Such a credit, is, of course, much the same in effect as a "limited" letter of credit, except that the traveller is relieved of the responsibility of carrying about with him a document which may fall into the wrong hands and be fraudulently used

Circular Notes.

Circular Notes are a modified form of Travellers' Letter of Credit Essentially, they take the form of sight drafts for various denominations in the currency of the issuing country, drawn on itself by the issuing bank, and are handed to the customer against payment of their full face value

Circular Notes were formerly payable abroad at fixed rates of conversion indorsed on them, such rates being calculated well below par so as to allow a certain profit for the agent, who debited their amount to the issuing bank at the rate ruling on the day of encashment Nowadays, however, circular notes are usually encashed abroad at the cashing bank's buying rate for sight drafts on the issuing centre on the date of encashment

Travellers' Cheques.

Travellers' Cheques are documents, very much like the ordinary cheque, requiring payment by the issuing bank of certain round sums, in this country usually £5 or £10, and are issued by the banks to known customers, in exchange for cash The customer is required to sign each cheque (as a drawer signs any ordinary cheque), when it is handed to him, in the presence of an official of the issuing bank, and he can thereafter cash the cheque at any agent of the issuing bank or elsewhere Frequently, the current value of these cheques in various important foreign currencies is clearly indicated on the face, and they are sometimes, though not always, accompanied by a Letter of Indication, giving a list of agents and correspondents of the issuing bank On encashment, the holder is required to sign the instrument in the presence of the payer, who compares the signature with that already on the cheque As a further safeguard, the holder may be asked to produce his passport If the holder desires to encash a traveller's cheque in a currency which is not indicated on its face, he will usually receive payment at the encashing agent's current *buying rate for sight drafts on the place of issue*

Circular Cheques.

Circular cheques, which must be clearly distinguished from the English Circular Notes described above, are issued by banks in certain countries to their agents or correspondents abroad so that the latter may sell them to customers who are about to visit the country of the issuing bank On issue, the cheques are similar in form to ordinary blank cheques and are bound in books of 10, 20, etc , in the same way They bear the name of the issuing bank and are printed in different colours according to the maximum amount for which they may be drawn For example, cheques printed in red must not be used for amounts in excess of 1,000 francs, and so on

When the cheques are sold to customers in exchange for cash, the selling bank signs the forms and fills in the amounts in the same way as a bank's customer draws an ordinary cheque The selling bank advises the issuing bank of the number and amount of the cheques sold and also the name of the person to whom they are issued The drawing bank gives the issuing bank credit for the amounts drawn, while the latter debits the drawing bank as soon as it receives advice of the sale of the cheques

The customer to whom the cheques are sold may cash them at any branch or agency of the issuing bank, a list of these being given on the back of each cheque form, as in the case of travellers' cheques No letter of indication is issued with circular cheques, and the holder has to establish his identity, if required, by producing his passport or other evidence

It should be observed that Circular cheques are drawn by a *bank abroad on the issuing bank*, whereas travellers' cheques are drawn *by the issuing bank's customers and are payable by the bank's agents and correspondents* in other countries Moreover, the issuing bank in the case of circular cheques is a bank in the country in which the customer is travelling, whereas the issuing bank in the case of travellers' cheques is the customer's own bank at home

COMMERCIAL CREDITS

Letters of credit issued by banks to facilitate trade in goods are of almost endless variety, and the tendency is for the number of different types to increase as the banks endeavour to provide for the special requirements of their customers It is therefore not possible within the space at our disposal to do more than briefly review the principal forms of commercial credits, and to notice the main characteristics of those most generally used

In this connection it may be observed, for the sake of clarity, that any credit whether a bank credit or otherwise, may have all or some of *five* different characteristics which will shortly be explained It may be (*a*) *confirmed* or *unconfirmed*, (*b*) *revocable* or *irrevocable*, (*c*) *clean* or *documentary*, (*d*) *sight* or *acceptance*, (*e*) *fixed* or *revolving*

Although practically all credits used for commercial purposes are now issued through the intermediary of the banks, it must be reiterated that no credit can be strictly regarded as a *bank* credit unless it embodies an *undertaking* by the issuing bank to honour drafts drawn thereunder At the same time, many credits are issued through the banks, both in this country and abroad, which contain no such undertaking Hence, it is likely that the complicated subject of credits can be best explained to the reader by first considering the form of so-called credit which imposes no obligation on the issuing banker, and by dealing subsequently with other forms in order according to the degree of liability which they respectively entail

Negotiation Credits or Authorities to Negotiate.

The so-called "negotiation credit" or "authority to negotiate" involves no undertaking by the issuing bank It is merely a form of authority, addressed by the issuing bank to a correspondent abroad, requesting the latter to negotiate certain drafts of the beneficiary on a named person (usually an importer in the issuing bank's country), provided they conform with specified requirements and are otherwise in order

The specimen reproduced herewith is typical of these credits, and,

Specimen Negotiation Credit

THE LOMBARD BANK LTD,
LONDON, E C 2
31st March, 19

TO THE NEW YORK CITY BANK,
NEW YORK

DEAR SIRS,

We shall be glad if you will kindly advise *Messrs Anderson & Company, 14, East Street, New York*, that we have authorised you to negotiate their drafts on *Mr James Brown, 12, Eastside Street, London, E C 2*, at *90 days after sight* for a sum not exceeding
£2,000 0 0 (two thousand pounds sterling)

To be accompanied by

Full set of Bills of Lading, made out to order and indorsed in blank, with policy of insurance and invoice

Relating to

Shipment of 200 bales cotton from Baltimore to Liverpool

This authority is valid for all drafts drawn in accordance with these provisions, so long as they are presented to you not later than *30th November, 19* , unless it is previously revoked or modified by notice to you

In reimbursement of any sums paid by you under this credit you are authorised to debit our account with you

Yours faithfully,
THE LOMBARD BANK LTD

on receipt of such an authority, the correspondent bank will immediately advise the beneficiary, taking care to point out that it undertakes no liability for the due honour of any drafts drawn under the credit.

Since a credit of this kind involves no undertaking on the part of the issuing bank, but is merely a form of *request* to the negotiating banker, the latter can never be certain that drafts drawn thereunder will be duly honoured on presentment, and may therefore refuse to negotiate. Hence, the beneficiary may find that a credit of this type is really of little use as a means of enabling him to obtain cash against his bills on a foreign importer.

Drawing "Without Recourse".

Exporters who draw bills under these credits sometimes endeavour to avoid liability for the non-payment of the bills by insisting that the credit shall permit them to draw the bills "without recourse". The effect of this is that the exporter is relieved of the responsibility for the payment of the bill if it is not met in due course by the banker who advises the credit, but, if he has shipped the goods he is not, of course, relieved of risk of loss in connection with them.

Unconfirmed Bankers' Credit.

The term "Unconfirmed Bankers' Credit" is usually applied to a credit under which the banker of the grantee (usually an importer) advises the beneficiary (usually an exporter abroad), either direct or through its agents or correspondents in the beneficiary's town, that a credit has been opened under which the exporter may draw drafts *on the*

grantee's bank in accordance with specified conditions, but on the express understanding that, while the bills *may* be honoured by the issuing banker, there is no *obligation* on his part to do so Unconfirmed credits are usually opened through an agent or correspondent of the issuing bank, and such agent or correspondent (called the *negotiating* bank) is generally empowered to negotiate (*i e*, discount) any bills drawn under the credit by the beneficiary, provided they are in order and otherwise comply with the terms of the credit

Some unconfirmed credits (as, for example, the specimen here reproduced) specifically state that they are subject to alteration or cancellation *at any time, without notice,* whereas others contain a clause to the

Advice to Beneficiary of Unconfirmed Documentary Credit

THE LOMBARD BANK, LTD,
LONDON, E C 2
31st March, 19

UNCONFIRMED CREDIT

TO MR JAMES BROWN,
14, EAST STREET,
LONDON, E C 2

DEAR SIR,

We have received advice by mail from *The Southern Bank, Ltd*, *Bangkok*, that they have opened their *unconfirmed* credit in your favour to the extent of *£2,000* (say *two thousand pounds sterling*)
available by your drafts at *90 days' sight drawn on them*
and accompanied by

Full set of Bills of Lading, made out to "order" and endorsed in blank
Marine Insurance Policy, covering transhipment risk, if any,
Invoices, duly signed in quadruplicate,

covering shipments of *40 cases of enamelled goods, July/August*

Your drafts are to be drawn to the order of *The Southern Bank, Ltd*, must be marked *D/P* (*Documents against payment*), and must bear the following clause

"*Payable at the drawing rate of The Southern Bank, Ltd, for demand drafts on London, plus interest at 6% from date hereof to approximate date of arrival of remittance in London*"

Kindly note that this credit is an *unconfirmed* one, and is therefore subject to alteration or cancellation at any time, without notice It is not to be considered as a *Bank* Credit and does not relieve you from the liability usually attaching to the drawer of a Bill of Exchange

We are requested by *The Southern Bank, Ltd*, for whom we act as agents, to negotiate your drafts drawn under this credit provided the conditions here specified are fully complied with

Yours faithfully,
THE LOMBARD BANK, LTD

effect that drafts drawn thereunder will be duly honoured by the issuing bank provided they are negotiated *before receipt* by the negotiating banker or the beneficiary of notice of cancellation Naturally, the value of the credit to the beneficiary is much increased by the inclusion of a clause of this kind (see below, page 464), and some banks refuse to negotiate bills under these credits unless they contain such an undertaking

In spite of the disadvantages of unconfirmed credits, they are widely used between firms who have mutual confidence in each other and feel

practically certain that their respective obligations will be faithfully carried out The opening of an unconfirmed bank credit often enables an exporter to sell his draft locally at a better price than he would obtain if he merely drew direct on his merchant debtor, as he might do, for instance, under a negotiation credit.

Confirmed Credits.

The most important of all forms of commercial letters of credit is that known as the '*confirmed credit*" Essentially, this consists of "a written or cabled authority addressed by a bank, either directly or through an intermediary, to a specified person abroad (frequently a shipper or exporter) permitting the accredited (or the *accreditee*) to draw bills of specified tenor on the issuing banker up to a stated limit, and embodying an undertaking on the part of the issuing bank to accept and, in due course, to pay those bills provided the stipulations of the credit are properly fulfilled" [1]

Confirmed credits issued in London are usually advised to the beneficiary through the issuing banker's agent or correspondent in the beneficiary's country, the agent being requested to negotiate the bills drawn under the credit In some cases, however, the credit is forwarded *direct* to the beneficiary, who may then discount his bills on the strength of the credit at his own bank or at whichever bank will offer him the best rate In the latter case, the amounts of any drafts negotiated must, for obvious reasons, be endorsed on the back of the Letter of Credit before it is handed back to the beneficiary

It must be stated, however, that there is no unanimity as to what a *confirmed* credit really is The definition here given embodies the view held in the London Money Market that a confirmed credit is one which implies an *absolute* undertaking by the issuing bank to honour drafts drawn thereunder, *i e* , an undertaking which cannot be recalled without the consent both of the beneficiary and of the bank to whom the credit is advised

Some authorities, however, consider that a banker's credit cannot be regarded as "confirmed" unless and until the *negotiating banker* himself confirms to the beneficiary that the bills drawn under the credit will be duly honoured In other words, it is considered by those who take this view that the essential of a confirmed credit is that the negotiating banker shall add his confirmation or guarantee to the undertaking already given by the issuing bank By way of illustrating this contention, we may suppose that an importer in New York desires his banker to issue a credit in favour of an exporter A in London The New York bank issues a confirmed credit which it advises to A through its London correspondent bank Now the New York bank may at the outset

[1] *The Principles, etc , of Foreign Exchange*, page 396

request the London correspondent itself to confirm the credit to A, in which event the latter will have every reason to be satisfied with the arrangements But let us assume that no such request is made and that A, on examining the credit, is not satisfied with the assurance of the New York bank (which is possibly quite unknown to him), that drafts under the credit will be duly met, and accordingly asks the London bank to " confirm " it The London bank, if it is willing to undertake this responsibility, will cable the New York bank for permission to do this On receiving the required authority, the London bank will add *its own* confirmation to its advice to A, and thereby assume responsibility for eventual payment of the drafts For this accommodation, the London bank will charge the New York bank a commission (the amount of which is a matter of arrangement), which will eventually be borne by the American importer

Irrevocable Credits.

An " irrevocable " credit is one which cannot be cancelled *without the consent of the beneficiary*, who is therefore sure that the drafts drawn under such a credit will be paid Members of the London Money Market had long regarded a confirmed credit as being irrevocable, but it was not absolutely certain that this was so, and, in order to be on safe ground, traders used to stipulate that a credit should be described as " confirmed and irrevocable " But the uncertainty on this matter was disposed of in the case of *Stein* v *Hambros Bank of Northern Commerce*, 1921, when it was settled that a credit described as " confirmed " is irrevocable

But it must be clearly understood that *any* credit can be cancelled *with the consent* in writing of all parties concerned, *i e*, the person at whose request the credit was opened, the bank or banks involved, and the ultimate beneficiary To this extent no credit is irrevocable, but a confirmed or irrevocable credit gives the beneficiary the sure knowledge that, unless he chooses to come to some other arrangement with the person at whose request the credit is opened and with whom presumably he is doing business, he can rely on the bank which issues a confirmed credit to honour that obligation provided that the terms of the credit are strictly complied with

Documentary Credits.

The term " Documentary Credit " is often used in a very loose manner Some writers endeavour to apply the term to specific forms of credits, but it is preferable to use the term in a general sense to cover all credits which stipulate that bills presented by the beneficiary for acceptance or negotiation under the credit must be accompanied by certain specified documents, complete and in order The documents

thus called for are usually documents of title to goods, but they may be documents such as bonds, share or scrip certificates, title deeds, mortgage deeds or bills of sale

As a rule, a documentary credit calls for a complete set of documentary bills accompanied by "a full set of shipping documents", which may consist of all or some of the following

(1) A full set of *Bills of Lading*
(2) *An Insurance Certificate or Insurance Policy*, issued by approved companies or brokers
(3) *The Invoice* (possibly certified) relating to the goods
(4) *A Consular* invoice
(5) *A Consular Certificate of Health*
(6) *A Weight Certificate*
(7) *A Letter of Hypothecation*

The documents tendered by the beneficiary with his draft must be precisely those asked for by the terms of the credit If a full set of bills of lading is required, it is not sufficient for the beneficiary to tender two copies and undertake to provide the remaining third copy at a later date If an insurance *policy* is called for, a *certificate* of insurance or a broker's cover note will not suffice, although, in certain cases, it may be customary to accept the former

The term "*Documentary* Credit" is sometimes applied in a restricted sense to a form of credit issued in the Eastern trade whereby an importer of goods instructs his bank to advise its branch or correspondent in the exporter's town to make advances to the exporter against bills drawn by him on the importer The importer undertakes to accept and pay the bills, but no liability or responsibility is assumed by the banks concerned, hence such a "credit" is really no more than an *Authority to Negotiate*, as explained above, and cannot in any sense be regarded as a *bank* credit

In the absence of arrangements to the contrary, the importer may cancel a credit of this kind at any time, and, for this reason, banks are not always ready to make advances against bills drawn under such credits As a rule, the exporter draws for the full amount of his invoice but, if the shipment contains *speculative* merchandise, the bank negotiating the bills will not advance more than a proportion of the invoice value

Illustration of the Procedure Under a Confirmed Documentary Credit.

In order to illustrate the procedure under a confirmed documentary credit, we will assume that a Parisian importer of American wheat is

requested by the American exporter to arrange for him to receive payment on shipment of the produce by drafts drawn in sterling at 60 days' sight on a London bank The Parisian importer will consult his own bank and give it written instructions to open a confirmed documentary credit at its London agents in favour of the American exporter The instructions will explain precisely what the credit is for, and will specify what documents are to be handed over by the exporter with his drafts,—matters on which the bank in Paris will probably be able to offer some useful advice to its customer The Parisian banker, having protected himself by obtaining the deposit of security or funds to ensure due fulfilment by the importer of his obligations under the credit, will open the credit with his London agent by a communication in form somewhat as follows

Request to open a London Banker's Confirmed Documentary Acceptance Credit.

NORTHERN BANK OF FRANCE,
PARIS
21st March, 19

GENTLEMEN,

On behalf and for account of our customer, *Jules Lazarre, of Rue de l'Argentine, Paris*, we hereby request you to establish a *Confirmed* Credit with your good selves to the extent of *£2,000 (two thousand pounds sterling)* to remain in force until *31st July, 19* , in favour of *Mr Henry White, 172, East Street, New York*, available by the beneficiary's draft at *60 days' sight* on your good selves, and accompanied by the following documents —

Full set of on-board B/L, insurance policy or certificate and invoice, covering shipment of wheat from Baltimore to Paris

Kindly confirm this credit to the beneficiary *by mail* through the intermediary of *your New York correspondents*, advising us by return of the name of your correspondents

Documents are to be forwarded *to us on acceptance*

Please accept the draft drawn under this credit to the debit of our "General Acceptance Account" under advice to us

Thanking you in anticipation and awaiting the favour of your acknowledgment,

Yours faithfully,

FOR NORTHERN BANK OF FRANCE,
JEAN ROUSSEAU,
Manager

TO THE LOMBARD BANK, LTD ,
LONDON, E C 2

NOTE —The italicised words are filled in as occasion demands.

On receipt of these instructions (the signature to which it will carefully authenticate), the Lombard Bank, Ltd , will at once advise its New York agents of the opening of the confirmed credit on the specified terms in favour of the American exporter, Henry White The New York agents will at once advise the opening of the credit to the beneficiary, White In due course, White will ship his produce to Paris, and will present his draft on the London Bank at 60 days' sight, together

Advice to Agents of Confirmed Documentary Credit.

THE LOMBARD BANK, LTD,
LONDON, E C 2
31st March, 19

THE NEW YORK CITY BANK,
LONDON

DEAR SIRS,

CONFIRMED CREDIT NO 1724

We have opened a confirmed credit No 1724 in favour of *Mr Henry White*, of *172, East Street, New York*

for account of *Jules Lazarre, of Rue de l'Argentine, Paris*

for £*2,000* (say, *two thousand pounds sterling*)

available by beneficiaries' drafts on us at *60 days* after sight, accompanied by —

Full set of on-board B/L, insurance policy or certificate, and invoice,

relating to shipment of

Wheat from Baltimore to Paris

Part shipments are *not allowed*

All drafts are to be marked as drawn under our Letter of Credit No *1724* and all documents are to be delivered to us against *acceptance*

We shall be greatly obliged if you will kindly inform your *New York* Office by *mail* of the opening of this credit, requesting them to advise beneficiaries accordingly, and, in consideration of your so doing, we hereby engage with you, as well as with the endorsers and bona fide holders of all drafts drawn in compliance with the foregoing terms, that such drafts shall be duly honoured on presentation at this office, provided they have been negotiated in *New York* on or before the *31st July*, 19

Yours faithfully,
THE LOMBARD BANK, LTD

If the confirmed credit is sent direct to the beneficiary, Henry White, by the Lombard Bank, it will take the following form:

Banker's Confirmed Acceptance Credit

THE LOMBARD BANK, LTD,
LONDON, E C 2
31st March, 19

LETTER OF CREDIT.
No 1724

MR HENRY WHITE,
172, EAST STREET,
NEW YORK

DEAR SIR(S),

At the request of *The Northern Bank of France, Paris*, and for account of *Jules Lazarre, of Rue de L'Argentine, Paris*, we have opened a confirmed credit in your favour to the extent of £*2,000* (say *two thousand pounds sterling*) available by your drafts on this Bank at *60 days' sight* against shipment(s) of

Wheat from Baltimore to Paris

Your drafts are to be marked as drawn under our Letter of Credit No *1724* dated London, *31st March, 19* , and they must be accompanied by the following documents

Full set of on-board B/L, insurance policy or certificate, and invoice which are to be surrendered to us upon *acceptance*

We hereby engage with you as well as with the endorsers and bona fide holders of drafts drawn upon this authority that such drafts shall be accepted on presentation and paid at maturity provided due compliance has been made with the above conditions

This credit remains in force in *New York* until *31st July, 19* , and is irrevocable until and including that date The negotiation of drafts will be considered a guarantee that the amounts thereof have been duly endorsed on this Letter of Credit

Yours faithfully,
THE LOMBARD BANK, LTD

with the documents called for by the credit, to the New York agents, who, if everything is in order, will *negotiate*, *i e*, purchase, the draft at the current buying rate for such drafts on London In this way, the beneficiary will receive cash for his goods as soon as they are shipped, and the onus of presenting and obtaining payment of the bill falls on the negotiating banker

The latter will forward the draft with the relative documents either to its own London office or London agents, or to the London bank with which the credit was opened On presentation, the accepting bank will carefully examine both the bill and documents, and if satisfied that everything is in order, will give its acceptance on the bill, which it will either retain in its own portfolio on behalf of the negotiating banker, or return to the agents by whom it was presented

It will be observed that the credit provides that the documents are to be forwarded to the Paris banker as soon as they are received by the accepting bank The drafts drawn under the credit will therefore be what is known as "*D/A Bills*", *i e*, bills which provide that the relative documents shall be handed over to the drawee against his acceptance of the instrument Bankers are always willing to negotiate bills so drawn because such an arrangement is made only when the drawee is known to be undoubted for his engagements For the same reason, bills of this type are discountable at much finer rates than "*D/P Bills*", *i e*, bills which stipulate that the documents attached thereto are to be delivered to the drawee only against actual payment

On receipt of the documents, the Parisian bank may either hold them until the necessary funds to meet the bill are provided at its maturity by the importer, or the latter may be permitted to have the documents, so that he can claim and realise the goods as soon as they arrive, under conditions as to security arranged between him and the bank For example, his signature may be taken to a document similar in function to the *Trust Receipt*, used for the purpose in this country and in the East (See page 245)

Two or three days before the bill falls due for payment, the Parisian bank, having been placed in funds by its customer the importer, will instruct the London accepting bank to pay the bill on presentation to the debit of the French bank's sterling account

This explanation has been given at length to demonstrate the manifold advantages of a confirmed credit By enabling the exporter to draw on a bank of established repute, it enables him to turn his bill into cash at a fine rate as soon as the goods are shipped and so avoid being out of capital in his business pending receipt of a remittance from the importer On the other hand, the importer is protected by the fact that acceptance of the bill will not be given until the accepting bank is satisfied that the documents are in order, while he is further

accommodated by being permitted on reasonable terms to obtain the documents and so dispose of the goods without delay The Parisian bank is protected not only by the security or cash deposit in consideration of which it opens the credit, but also by the fact that the documents are always under control of its agents or correspondents until the funds required to meet the bill are placed in its hands by the importer The negotiating bank incurs little, if any, risk in discounting the exporter's bill, because it can rely upon due acceptance and payment of the instrument by the London accepting bank, while the latter is fully protected by the documents and receives its commission for the use of its name without having to employ any of its capital in the transaction

Letters of Hypothecation.

Even when every reasonable precaution has been taken in dealing with the documents attached to bills, there is always a slight possibility that the banker has failed to cover every likely risk of loss As an additional safeguard, therefore, bankers in this country who negotiate documentary bills or open documentary credits almost invariably require the beneficiary to sign a Letter of Hypothecation (See Chapter 18)

Bankers' Acceptance Credits.

The confirmed credit described in the preceding paragraph would, if it were given its proper title, be properly referred to as a *London banker's confirmed documentary acceptance credit* The terms "confirmed" and "documentary" have already been explained The qualifications "London" and "acceptance" relate to the fact that the credit is opened by a London banker or accepting house, and that it involves *acceptance* (and not payment *at sight*) of bills drawn in accordance with specified conditions The credit is also properly described as an "acceptance" credit because it promises the acceptance of bills payable at a period after sight, in contradistinction to a "*sight* credit", which involves the issue and payment of drafts on demand, at sight or on presentation By virtue of London's position as the world's leading financial centre, London bankers' acceptance credits fulfil a function of extreme importance in the financing of international trade They are favoured the world over because of the ease and certainty with which bills drawn thereunder can be discounted or negotiated

The Finance of Outward Shipments of Goods.

Many of these credits are arranged with London banks by exporters *in this country* to finance outward shipments of goods The exporters,

instead of drawing their bills on importers abroad, draw by arrangement on well-known London banks or accepting houses as soon as the relative goods are shipped The bank usually confirms to the exporter that it will accept bills representing about 75% of the invoice value of goods exported, provided the bills are accompanied by certain specified documents, valid and in order After examination and verification of the documents, which are retained by the bank, the bill is accepted and returned to the exporter, who is thereby enabled to have it discounted immediately and the proceeds placed to his credit

This method is of considerable use in those cases where the foreign buyer is unable or unwilling to open a credit of any sort, or when goods are being sent out on consignment, as in the case of an attempt to develop a new market

The banker granting the acceptance credit does so on his knowledge of the standing of the exporter, and against the security either of the goods shipped or of some other form of collateral, and earns a reasonable commission without having to employ any of his own resources The exporter, by paying the banker for the use of his name as acceptor of the drafts, obtains an instrument which he can turn into ready cash at the lowest market rate of discount

As a rule, the exporter signs a Letter of Hypothecation in favour of the bank, and, if the proceeds of the goods do not cover the amount advanced, the exporter undertakes to make good the deficiency

It is obviously of first importance that the banker who has accepted the bill should retain complete control of the relative documents As a rule, these will be sent abroad to the bank's branch or correspondent with instructions that they are to be handed to the consignee only against payment of the full invoice value of the goods, and this payment must, of course, be received in London (either by T T or approved banker's cheque) in time to meet each bill accepted by the London bank when it is presented for payment at maturity

Although London bankers' acceptance credits are now frequently opened by exporters on this side, the great majority of them are opened with London bankers in favour of exporters, both here and abroad, by banks who are acting on *instructions of importers in other countries* Such credits relate not only to goods shipped abroad from this country, but to goods exported by one foreign country to another, as in the specimen confirmed credit described above And it may be stated that, in granting these acceptance facilities in favour of importers abroad, London banks rely, not upon the standing or responsibility of the exporters in this country, but upon security in the shape of current balances, deposits or other securities held by them on account of the banks by whose orders the credits are opened

Which is the Cheapest Method of Finance?

Which method of finance is adopted in any particular case depends, of course, partly on the relationship and the degree of confidence existing between the parties, and partly on the relative cost, for, other things being equal, the cheapest method of finance will naturally be employed

From the exporter's point of view, the method which offers him the most speedy return of his capital with the minimum of trouble and expense is that under which either he or the importer *opens a credit with a leading bank in the exporter's own country* The exporter can then draw his bill on the bank, obtain acceptance thereof as soon as shipment of the goods is made, and, by discounting the acceptance either with his own bank or with a discount house, obtain an immediate return of the capital represented by the shipment The costs of opening the credit will usually be borne by the importer, and the only deduction from the face value of the draft which the exporter must bear is the amount of the discount, which, on a first-class bank acceptance, will be at the lowest market rate

The next most speedy and inexpensive method is for *the importer to open a credit with a leading bank in his own country* In this case, the costs of opening the credit will doubtless fall on him, but the exporter may have to discount an acceptance on what is to him a foreign bank at a decidedly worse rate than that at which he could discount his home bank acceptance In addition, the exporter will have to bear the charge made by his bank for remitting the draft and relative documents to their agents in the importer's town for acceptance by the drawee bank, and for the return remittance of the proceeds

The third method is the one in which the *exporter draws his bill direct on the importer* If he does this, the exporter may be able to discount his draft with his own bank, in which case he would be charged discount at the rate ruling in the foreign centre for such trade acceptances, together with the bank's commission and eventual collecting charges Alternatively, he may take an advance from his bank against the security of the goods shipped, but, in this case, he will not obtain more than about 80% of the invoice value of the goods, and will be charged interest at a much higher rate than the home discount rate for first-class bank bills, together with his bank's charges and commission

Between countries such as Britain and U S A which have highly developed acceptance markets, the method of finance employed by exporters and importers will depend largely on the relative interest rates in the two centres When interest rates are markedly lower in New York than in London, the tendency is for the movement of goods between America and Europe to be financed by New York acceptance credits rather than by London acceptance credits, and *vice versa* Hence the great importance attached by London bankers to the maintenance of low discount rates in London We have seen that London makes a

vast annual income from acceptance commissions, but in New York London bankers have a wealthy and extremely keen competitor, only too ready to undertake any business which high interest rates may drive away from this side

Position of the Beneficiary under various types of Credit.

The position of the beneficiary differs considerably according to the particular type of credit which is opened in his favour

Under a Confirmed Bankers' Credit, his position may be said to be "gilt-edged", since he has the undertaking of the issuing bank, and possibly also of a well-known local bank, that his drawings will be duly honoured if they comply with the terms of the credit, while he is assured that the credit cannot be revoked even if notice is given to him unless he agrees to its revocation Technically, of course, he remains liable on his bill as drawer until it is paid (unless he is empowered to draw "without recourse", in the manner discussed below), but this risk is negligible under a confirmed credit

Under an Unconfirmed Credit, the position of the beneficiary depends on whether or not it embodies any undertaking on the part of the issuing bank If the credit is worded as in the specimen on page 454, it is of little use to the beneficiary, except in so far as it enables him to draw in payment for his goods a bank bill instead of a trade bill, and the negotiating banker will not be willing to negotiate bills drawn on the strength of such a credit unless he is satisfied as to the beneficiary's standing

If, on the other hand, the unconfirmed credit embodies the issuing bank's undertaking to honour bills negotiated under the credit before advice of its cancellation reaches the negotiating banker, the beneficiary is in a much better position, since both he and the negotiating banker are assured that they can rely upon the credit so far as it is acted upon before receipt of advice of cancellation

In neither case, however, is the position of the beneficiary very satisfactory In the former case there is the risk that bills he has discounted will be dishonoured, so that he will incur the expense of recompensing the negotiating banker for the amount of the bills plus the expenses incident upon dishonour, while in each case there is the risk that the credit may be cancelled *after the goods are shipped* in which event the exporter will be under the necessity of making a forced sale of the goods in the importer's country Though the latter risk is comparatively slight in the second case, it is nevertheless a real one

In the case of an Authority to Negotiate Bills or a Negotiation Credit, the beneficiary has no *assurance* from either the issuing banker or the negotiating banker that his drafts will be paid The only advantage of credits of this kind is that, so long as the credit is unrevoked,

the beneficiary can at once negotiate drafts which otherwise he might have to send abroad for collection, in which event he would be out of his money until the arrival of the return remittance

The position of the beneficiary under the last two credits is greatly improved if, as is sometimes the case, he is authorised to draw the bills "without recourse", or if the credit provides for payment to the exporter against the documents only and does not require the drawing of a bill In such cases the exporter has no fear of loss once the bill or documents have been negotiated, but there is, of course, always the risk that the credit may be cancelled between the date of shipment of the goods and the date when the documents are presented for negotiation Although in such circumstances the beneficiary may exercise his right of stoppage *in transitu* and thus recover the goods, he can look only *to the importer* for payment of freight and other charges

Under a Banker's Acceptance Credit the beneficiary is free from all trouble He obtains practically the exact amount of his invoice subject only to deduction of the appropriate rate of discount on his drafts

Omnibus, Fixed and Revolving Credits.

Bank credits used for commercial purposes frequently bear curious descriptions which have reference to the special conditions under which they are available We may note three of the most important

An OMNIBUS CREDIT is one granted to shippers of undoubted standing to enable them to draw *round amounts* on a bank against security of a *general lien* over their goods, the object being to enable the shippers to obtain capital for further operations and prompt payment for their produce as soon as it is placed on board ship

FIXED CREDITS are ordinary forms of credits which are available for a fixed total amount, either in one draft or several As a rule, their availability is limited to a stated period

REVOLVING CREDITS are those which are automatically renewed from time to time as certain conditions are fulfilled They are of four principal types (*a*) For a fixed amount *in one draft at any one time*, the credit being immediately re-available (*b*) For a fixed amount in one draft at any one time, the credit being re-available for the next draft *only when advice has been received of payment of the previous one drawn* (*c*) For *an unlimited amount in all, but with a limit to drafts current* at one time, so that the credit is re-available only when advice has been received that previous drafts have been paid, bringing the total amount of drafts current at any one time below the agreed limit (*d*) For a *limited amount in all during a specified period, e g*, up to a limit of £10,000 during any one month The credit is re-available during each period for the limited amount.

Clean Credits.

Clean credits are those available in drafts unaccompanied by shipping or other documents of value and are, in effect, much the same as the Travellers' Letters of Credit described earlier in this chapter, funds thereunder being obtained by the beneficiary merely by presenting his bill with the credit to the agents of the issuing bank They are frequently opened, not to finance the movement of goods, but purely for finance purposes connected with the transfer and loaning of funds by bankers in one centre to those in another When clean credits are opened to finance shipments, the bills of lading are usually sent direct to the consignee, instead of being handed to the bank together with the relative drafts for negotiation, and the funds are forthcoming, against drafts at sight or at term, without any charge over the relative goods

A banker naturally has to exercise great care in opening clean credits for anyone other than a bank or financial house of known repute, for, even if such a credit is opened to facilitate the movement of goods, there is no collateral security in the form of shipping documents, and there is always the likelihood that the credits are being utilised by persons who are merely speculating Unless, therefore, the parties are of the very highest standing, the issuing banker will usually insist on the deposit of security in the form either of a guarantee or of a cash deposit of the whole amount involved

THE NEGOTIATION AND ACCEPTANCE OF BILLS UNDER CREDITS

The negotiation and acceptance of drafts under credits is clearly a matter which requires extreme care, as the failure of the negotiating or issuing banker to observe the terms of the credit may involve him in serious loss Moreover, it must be remembered that the terms and effects of the numerous forms of credits are of great variety and extremely complicated, so that every case must be treated purely on its own merits

On receipt of a credit under which he is requested to act, a banker's first step is to ensure that it is authenticated either by the signature of the issuing bank, or, if advised by cable, by an arranged code He will then consider the exact purport of the credit, whether it is confirmed or unconfirmed, revocable or irrevocable, clean or documentary, and whether he is authorised to negotiate bills drawn thereunder or to give his acceptance on behalf of the advising correspondent Having satisfied himself on these points, he will carefully record the necessary particulars, advise the beneficiary, and await presentment of the relative drafts, or of the relative documents if the credit authorises advances against documents only

If drafts are presented for negotiation or acceptance, the banker's first step is to ensure that the credit is still in force, *i e*, that it has not

expired or been cancelled by the issuing bank He will then proceed to examine the draft with a view to satisfying himself that the signature is what it purports to be, and that the instrument is properly drawn as to amount, currency, etc , in accordance with the terms of the credit If everything is in order and the drafts are drawn under a clean credit, the banker will accept or negotiate the bill and, if necessary, he will indorse particulars of the draft on the credit, cancelling and retaining the latter for despatch to the issuing bank if it is exhausted or has expired

If the credit in question calls for delivery of documents of title to goods, the negotiating or accepting banker's task is much more onerous, since he must exercise every reasonable care to ensure that the documents received actually conform with the stipulations of the credit The invoice must detail the quantity and class of goods specified in the credit, and the bills of lading also should be precisely in accordance with its terms Usually, the credit will require the bills of lading to be made out to the shipper's order and indorsed in blank, and the banker should ensure that they specify the correct destination and indicate that freight is paid to that destination The insurance policy should be examined to ensure that it covers the relative goods, and delivery should be required of any other documents required by the credit, as, for example, a certificate of origin or consular invoice

Having satisfied himself that everything is in order, the banker will accept or negotiate the bill and, where necessary, indorse particulars thereof on the credit He will retain the documents and forward the duplicate sets by separate mail either to the issuing bank or to the importer, as the credit may direct , in the latter case, he will not fail to advise the issuing bank of what he has done

If he has negotiated a draft in his home currency, he will probably debit the amount to the account of the issuing bank If the bill is drawn in a foreign currency, the banker will purchase it from the beneficiary at a rate of exchange appropriate to the category in which such a bill would be placed in the drawee's centre, *i e* , whether first-class bank bill, trade bill, or otherwise

It will be observed that the responsibilities of the negotiating banker are towards his principal, the issuing banker, and not towards the beneficiary, *except in cases where the negotiating banker has added his confirmation of the credit to his advice to the beneficiary,* in which case he is, of course, liable for due payment of any draft drawn under the credit

The Bill of Lading.

Of the various documents with which the negotiating or accepting banker has to deal under Letters of Credit, the most important is the *Bill of Lading* The essential features of this document are described in Chapter 18, to which reference should be made at this point

The Mate's Receipt.

The terms of contract for the shipment of goods are usually arranged by the shipper with the shipowners or with the master, and an agreement is made whereby the shipper undertakes to send a definite quantity of goods and the agent undertakes to reserve space therefor When the goods are delivered on board by the shipper, he is given in exchange a document known as a "*Mate's Receipt*" This document is subsequently exchanged for the bill of lading, although the bill may be delivered without production of the mate's receipt if the master is satisfied that no other person than the one demanding the bill has any interest in it, and that the goods are actually on board It is possible, therefore, for the bills of lading to be issued to someone who does not hold the mate's receipt In such a case, the goods must be delivered at the port of discharge to the holder of the bill of lading

It will be clear to the reader that a banker must exercise the greatest care in dealing with these documents In particular, a banker who is asked to negotiate a bill of exchange to which a mate's receipt is attached should refuse to accept the latter document in place of the bill of lading unless he has obtained authority to do so

The Marine Insurance Policy: Covering Transport Risks.

Possession of this document is essential if the banker who makes advances against a shipment of goods is to be sure of the value of his security The policy covers all the principal maritime risks to which goods in transit by sea are subject, so that a banker who has full rights over the policy will not incur loss merely through loss of the goods It should be observed, however, that the policy may become void under certain conditions, and also that certain risks are not covered

The marine insurance policy covering the shipment of goods which are the subject of an advance should be made out in favour of the bank, or, if made out in favour of the exporter, should bear his indorsement in blank The policy must be properly stamped, otherwise it will be unenforceable

A CERTIFICATE OF INSURANCE is sometimes attached to a documentary bill in place of an insurance policy Such a document relates to a consignment of goods which is a part only of a larger shipment (or number of shipments) covered by a general policy, known as a "*floating*", "*declaration*" or "*open*" *policy* An insurance certificate is subject to certain disadvantages (*e g*, it is not a good delivery under a C I F contract), but, provided it is properly stamped, it may be safely used instead of the policy if it is accompanied by a letter of indemnity

A BROKER'S COVER NOTE (sometimes also loosely called a 'Certificate of Insurance") issued pending the issue of a policy, is not valid

evidence of the insurance of goods, and should never be accepted in place of the policy

Invoices for Goods Shipped.

AN INVOICE is a document which gives exact details of the goods, including a statement of their price, quantity and markings, together with particulars of the expenses of shipment A documentary bill should always be accompanied by an invoice, since the latter is *prima facie* evidence that the amount of the bill is not greater than the value of the goods shipped

A CERTIFIED INVOICE is used especially in connection with exports for entry under a preferential tariff, and consists of an invoice upon which is indorsed a certificate, signed by the exporter, giving the place of origin of the goods

A CONSULAR INVOICE is one which is signed by the Consul of the country to which goods are being sent, before they are shipped, in order to facilitate the assessment of Customs duties at the port of destination Such an invoice is in some cases required by the Customs regulations of the country to which goods are being consigned

Other Documents attached to Bills.

The customs regulations of certain foreign countries require proof of the origin (*i e*, place of manufacture or growth) of goods shipped thereto, and, for this purpose, a *Certificate of Origin* is demanded This is a document signed in the exporting country by the Consul of the importing country or by the exporter, or by the Secretary of a Chamber of Commerce, as the regulations may require

A WEIGHT CERTIFICATE (or Weight Note) is a document issued in the case of certain goods by dock companies or port authorities at the place of shipment, certifying the weight, both gross and net, of the goods concerned

No hard and fast rules can be laid down as to when these and other miscellaneous documents are required Each case must be considered on its merits, for, whether any or all of such documents are required will depend on (*a*) the Customs regulations of the country to which the goods are being sent or have been sent, and (*b*, the nature of the goods concerned All that can be said, therefore, is that the negotiating banker must acquaint himself with the requirements of these various regulations, and satisfy himself that they are complied with

Dock and Warehouse Warrants, Delivery Orders, etc.

The main characteristics of these documents, so frequently handled by bankers in connection with documentary bills are briefly described in Chapter 18

The Advantages of Bank Credits.

The perusal of the foregoing paragraphs should have convinced the reader of the manifold advantages of bank credits to the business community They permit shippers, merchants and manufacturers to reimburse themselves promptly for shipments, to turn their money over quickly, and so facilitate and cheapen production They often enable consignees to realise their imported goods before the maturity of the relative drafts They afford foreign buyers the satisfaction of transferring to a bank the task of seeing that documents are *prima facie* in order before they make payment for the relative goods

Furthermore, the bills drawn under credits on banks of international repute are negotiated more readily and on better terms than bills drawn on ordinary traders An exporter or other person who is owed money in another country prefers to draw on a bank, rather than on his business correspondent, because he can thereby get his money sooner and more easily, and, at the same time, get better terms, because a bill drawn on a bank commands a better price than an ordinary trade bill

EXPORT CREDIT INSURANCE

It should now be clear to the reader that service of incalculable utility is rendered by the banks to the trading community in the issue of letters of credit for the convenience of international trade It should be equally clear that the banks never undertake these services unless they are almost completely protected against loss, as for example, by the deposit of security or an acceptable guarantee, or unless they are acting on behalf of a customer or banking house of established repute Little objection can be taken to this attitude, since it is, of course, no part of a bank's business to undertake liability in connection with contracts which are likely to involve it in serious loss

It has become obvious during recent years, however, that there is a great deal of perfectly sound international business more or less "going begging" because it lacks that degree of security required by the banks, and because traders themselves are unable or unwilling to carry the inevitable risks The uncertainty engendered by the Great War vastly increased the proportion of international trading operations which fall within this category, and soon after the Armistice it was realised both in this country and in other countries that special provision would have to be made, with the help of the Central Government or otherwise, to relieve the ordinary trader of some of the risks which it was obviously impossible for him to accept

Credit Insurance.

In our own country, in the United States and in Germany, more especially, much valuable assistance in the direction indicated has been rendered by private organisations, called *Credit Insurance Companies*,

formed with the object of insuring exporters and bankers against loss from the failure of the credit of foreign importers These institutions—of which the Trade Indemnity Company and the General Trading and Finance Co , Ltd , are well-known examples in Britain—guarantee or undertake responsibility for the due fulfilment of purchase contracts by overseas importers, and so enable exporters to accept orders from buyers on whose credit they cannot otherwise rely

Though much useful work has already been done by these institutions, their development is still in its infancy, and there are indications that considerable further progress is possible if the requisite degree of co-operation can be achieved between the credit insurance agencies and the banking institutions which operate internationally

British Government Export Credit Schemes.

Still greater assistance in the form of credit insurance or credit guarantees has been rendered to traders in this country by the various *Export Credit schemes* inaugurated and put into operation by the Department of Overseas Trade The initial arrangements involved the Government in considerable loss, but the present scheme, implemented on 1st July, 1926, has proved extremely successful In return for a premium paid by the exporter, the *Export Credits Guarantee Department* is authorised, on behalf of the Government, to guarantee up to 75 % of the face value of accepted sterling bills of exchange drawn against shipments of goods wholly or partly produced in the United Kingdom The guarantees cover all risks of loss in respect of goods exported to any markets of the world except Russia, and except shipments of certain textiles to India and the Far East, and payment up to the limit of the guarantee is made immediately on default of the foreign importer

Since November, 1928, a new type of contract has been in operation, under which the exporter is covered in respect of any goods shipped to any members of a group of foreign importers whose names have been previously approved by the Department of Overseas Trade By this means, a great deal of unnecessary formality is avoided The exporter is enabled to transact his overseas business expeditiously, he is protected against loss through bad debts, and, without difficulty or delay, he can obtain advances from his own bank against shipments of goods as they are made

Since the premiums charged by the Department for guarantees under the latest scheme are fixed on an economic basis, the arrangements have proved to be self-supporting, and no burden has been imposed on the taxpayer Moreover, the Department has shown itself fully alive to the necessity for amending or extending the arrangements to meet new conditions as they arise, and its representatives accordingly visit the leading commercial centres of the country from time to time with the object of discussing the facilities with local bankers and trading interests

CHAPTER 35

BANKS AND THE FINANCE OF INDUSTRY.

THE years 1929 and 1930 will be memorable in the history of banking in this country for the attention focussed on the question of the degree to which our banking and monetary policy has contributed to the unprecedented conditions of depression which have prevailed since the post-war boom of 1920 in our basic industries, and notably in those connected with coal, iron, steel, cotton, wool, shipbuilding and engineering, all of which were at one time supreme in the world's markets

It is only to be expected that the situation in those industries should have invoked a vast amount of speculation as to the underlying cause or causes, but it is truly surprising to find to what extent blame has been attached to, and criticism directed against, our general monetary policy and against the methods of business and the organisation of our banking institutions Much of the criticism, as is well known, has been inspired by political motives, especially that section of it emanating from Socialist or Communist circles, which regard our prosperous banking industry as the nucleus and essential basis of what is, to them, a much hated capitalist system.

But in quite a different category is that highly influential and expert body of authority, unquestionably above political or selfish motives, which has zealously attacked our cherished banking traditions, and has had the satisfaction of seeing its criticisms lead to various improvements in our banking and currency systems.

Some important points of controversy have already been touched upon in the preceding pages Reference has been made to the criticisms which have centred round the structure and policy of the Bank of England, and to the steps which have been taken to meet some of the more general objections Brief mention has also been made of the objections to the process of amalgamation among English banks,- now practically vetoed so far as the large joint-stock banks are concerned We have discussed, too, the arguments that the Government issue of Treasury notes, and the dual control of our paper currency during the period 1914–1928, contributed largely to the nation's post-war financial difficulties, and we have observed that a cure for some of the ills was found in the amalgamation of the two note issues and by certain modifications in the Bank of England's system of note issue

Finally, we have noticed the suggestions that Britain's return to the gold standard in 1925 served but to accentuate her post-war industrial troubles, and the counter proposals that the institution of a managed currency would do much to relieve this country of the burden some yoke implicit in the maintenance of the gold standard, and free our currency system from its apparent dependence on American monetary policy

Generally speaking, the alterations and improvements mentioned owe their inception to agitation by leading economists and industrialists, but the body of criticism with which we propose to deal in this chapter has far more widespread approval We refer to the contention that industry and employment in this country have suffered severely, first as a result of our general monetary policy and, secondly, as a result of the action of our banks in restricting credit facilities

Criticisms of our General Monetary Policy and of its Control.

Criticisms of our general monetary policy are mainly concerned with the question of the desirability or otherwise of maintaining the gold standard in this country, with its implications of having to protect our central gold reserve by high rates of discount, and having to secure stability of the foreign exchanges by manipulating the volume of credit and the level of internal prices Apart from the fact that changes in the ruling rates of interest are in themselves harmful by reason of the uncertainty which they engender, the prevalence of high rates imposed in order to safeguard the nation's gold reserves against foreign drains, must have a depressing effect on industry by increasing the charges which producers have to pay for accommodation Hence a vast amount has been written and spoken in the attempt to demonstrate that the nation's industrial progress is being stifled by the monetary policy of the Bank of England and of the British Government in slavishly adhering to the gold standard —described by one well-known authority and fearless critic as "a barbarous relic"

The attack on the Bank's policy came from all directions and even from inside the great joint stock banks Mr McKenna joined forces with certain prominent industrialists and leading economists in ascribing the industrial depression and unemployment prevalent from 1921 onwards to the stringent policy pursued by the Bank and the Treasury in their determination to restore the gold standard and safeguard the nation's gold reserves The cry was echoed in the political camps and by industrial associations throughout the country In April, 1928, the Conference on Industrial Reorganisation and Relationships, comprising leading industrialists, representatives of Employers' Federations and of the General Council of the Trades Union Congress, addressed a Memorandum to the Chancellor of the Exchequer

expressing strong doubts on our then existing monetary arrangements, and suggesting that our currency and banking policy, as directed by the Treasury and the Bank of England, ought to be framed so as to safeguard and further the special interests of industry The views of the Conference were succinctly summarised in the statement "that it is impossible to restore prosperity to industry and trade, or to re ive or maintain stability of trading conditions, unless the elasticity of currency and credit is so arranged to meet the requirements of industry and commerce that industrial recovery will not be arrested by the lack of credit facilities, as soon as increased production becomes effective"

This statement quite frankly suggests, as had in fact been previously suggested by Mr McKenna, that there are times when industry cannot but benefit from a reasonable expansion or inflation of credit, whereas the policy of the Bank of England and the Treasury has for some years been deliberately deflationist, and, if the signatories to the Memorandum are to be believed, so restrictive as to paralyse business incentive and industrial progress

One of the many organisations which did not mince matters in their criticism of the Bank of England's policy was the British Electrical and Allied Manufacturers' Association, which, in its Survey of the General Economic Position, published in December, 1928, distinctly asserted that our general financial policy "has been an ever powerful factor interfering with the normal growth of business, and has undoubtedly contributed to the state of depression which has ruled in this country The result of the campaign to reduce wholesale prices, which has been going on steadily since 1920, has been to drive the basic industries practically into bankruptcy, while other industries have remained untouched" In the same article, the Bank of England was accused of having made its policy "dependent on movements in the United States and of having made sterling entirely subordinate to the dollar, to such effect that the industrial and economic position of the United States has more importance for the Bank of England than the industrial and economic position of Great Britain"

These extracts are quoted to indicate the extent to which the general monetary policy in this country has been blamed for the virtual collapse of our leading industries During 1929, fuel was added to the already heaped-up fires when the Bank of England, in order to protect its reserves against constant gold withdrawals to the Continent and elsewhere, raised its rate of discount by stages to 6½ per cent The Bank's action was roundly denounced by industrialists and employers, who insisted that the high rates of interest would still further cripple our halting industrial life It was pointed out that, again and again since the crisis of 1920, our internal trade had no sooner begun to show signs of recuperation and renewed activity, than all hopes were

blighted by the raising of the Bank rate, so restricting credit and adding to the weight of the charges borne by employers for that financial assistance without which progress is impossible "Every time the underlying conditions have been favourable to trade revival, every time signs have appeared that recovery was actually taking place, on every such occasion, without exception, industry has been held back, on the one hand by insufficient credit supplies for productive purposes, on the other by the closely connected insufficiency of public purchasing power to take off the market the goods actually produced" (*Midland Bank Review*, August, 1928)

Hence, it is contended, credit supplies to industry have been cut off at the crucial point They have been granted long enough to give a temporary stimulus to production, but have been stopped before the distribution of the additional credit through the channels of wages and profits has had time to take effect Hence the ups and downs and incipient revivals of British trade

Whether the arguments mentioned are sound or otherwise, they do unquestionably demonstrate, on the one hand, the growing realisation of the vast power for good or for evil which now lies in the hands of those responsible for the control of the credit and currency mechanism, and, on the other hand, the imperative need for an unselfish, non-political monetary policy framed in the interests of the nation as a whole

Difficulties of the Position.

Unfortunately, there is not a vestige of agreement, among those best qualified to judge, as to what monetary policy is best suited to the peculiar interests of this country For, in considering any question of credit control or manipulation, the fact has to be faced that Britain's position is peculiar A variety of factors—notably the pioneer spirit of her traders, the possession of vast resources of important materials such as iron and coal, and an early lead in the manufacturing industries—enabled Britain to build up an international business of enviable proportions The nation of shopkeepers became also a nation of bankers, and, on the certain foundation of an unrivalled industrial predominance, erected for itself a financial leadership of unquestioned strength, and one which has been maintained even in face of the difficulties of recent years London's position as the world's leading monetary and banking centre, the acknowledged prestige of her money, discount and foreign exchange markets, the universal recognition of the sterling bill as a form of international currency, the unchallenged reputation of London banks and financial houses, the establishment under banking auspices of the British Trading Corporation and the British Italian Banking Corporation, to promote our trade with the near East and Italy, respectively,

the extension of our banks throughout the Empire and in foreign countries,—all these are matters which prove beyond all shadow of doubt that British banks have been well to the fore in promoting foreign trade and in providing those financial facilities which have contributed so materially to the growth of our international commerce So far as our foreign trade is concerned, the banks certainly cannot be accused of having been apathetic, negligent or unmindful of opportunity

But in the industrial field, the British lead has been rapidly diminished by other progressive nations The products of certain of our basic industries have been subjected to severe competition in overseas markets where once they were supreme In many directions our goods have been entirely ousted, and other outlets have had to be sought Moreover, other countries which have fostered the growth of competitive industries behind the shelter of protective barriers, have not only shut out British products from their markets, but have successfully attacked those products in home markets

Small wonder, then, that those who seek to defend our general monetary policy point to other reasons for the decay of our great industries They insist that the decline is the inevitable result of intensified competition and of the headway made by other countries which at one time relied upon us for their supplies Some ascribe the unfortunate position of these industries to our rigid adherence to the policy of free imports, while others blame our employers for not reducing production costs by scrapping antiquated methods and plant which, in more progressive countries, have long been superseded

Those who take these views maintain that, if Britain's industrial leadership in certain directions is gradually passing away from her, then every effort should be made to strengthen and consolidate her still profitable business as an international banker and financier For this, they contend, the maintenance of the gold standard and of stability in the foreign exchanges is imperative, while strong gold reserves are as essential to us as a nation of bankers as they are to a private banking institution

Protagonists of what we may call the *Banking School* in this controversy are often faced with the argument that the monetary policy of this country should be framed, first and foremost, to assist our depressed industries because of the valuable contribution made by the products of those industries to the total of our exports, and so to the credit side of our balance sheet of international payments The question is constantly asked whether the retention of London's financial leadership and all that it implies is really worth the sacrifices which industrialists and others have to make by way of higher charges for credit and capital

To such arguments the Banking School reply that, though our industrial exports are of immense value and though it is tragic to see them

fall away, yet it must not be forgotten that Britain's services as banker, insurer, and financier are also an export, though invisible, of the huge annual value of from £60 to £70 millions Such exports do just as much to "square" our international balance sheet as do exports of manufactured goods, while there is little doubt that, but for the profits made by the banks out of their international business, they would be compelled to charge considerably higher rates for credit accommodation to domestic industry

Can our Internal and External Monetary Policies be Divorced?

Holding opinions midway between those of what we choose to call the Banking School and the Industrial School are a number of expert economists, like Mr J M Keynes, who contend that, under our present method of conducting the gold standard, it is impossible to achieve what, to them, are the two conflicting aims of internal price stability and low interest rates, and external exchange stability and relatively high gold reserves These two aims, they contend, are incompatible, one may be achieved, but to achieve both contemporaneously is extremely difficult, if not impossible

To meet the difficulty, various proposals have been made In brief, their essence is that we should have two distinct monetary policies one directed to the control of internal conditions of currency and credit, and the other occupied essentially with the maintenance of exchange stability and with the balancing of our international account Probably the most practical suggestion is that, for internal purposes, we should have a managed paper currency (see page 43), controlled without reference to our gold reserves and without immediate reference to the exchange position, and that we should utilise our gold holdings solely for the purpose of our international balance of payments In other words, it is proposed that the internal credit and currency structure should be regulated independently of gold movements to and from the country

There is little doubt that the solution of our present monetary difficulties lies in this direction Nowadays, many gold movements in and out of the Bank of England reserve have no reference whatsoever to the nation's credit and currency position A large addition to the Bank's stocks of the metal may represent the deposit for safe keeping of part of a foreign central bank's metallic reserves, while a large decrease may be due to the withdrawal of part of the London balances of foreign banking institutions Is it unreasonable, therefore, to suggest that such movements should not be allowed to influence rates of interest in this country, and so impose on an already burdened industrial machine extra difficulties in the form of fluctuating interest rates and marked uncertainty?

The Controversy assumes a New Phase.

During 1929, the controversy between the Banking School and the Industrial School assumed an entirely new phase Now criticism was focussed, not so much on matters of general credit and currency policy as on the degree of practical financial assistance rendered by the banks towards the development and rehabilitation of industry in this country This new aspect of the problem has been hotly debated On the one side, we have had a number of prominent industrialists, supported by a leading member of the Government, declaring that British banks have lagged far behind those of other nations in the degree of financial assistance which they place at the disposal of industry, and, in particular, those branches of industry which have had to reconstitute themselves to meet the changed conditions consequent on the War, and to face constantly increasing competition from overseas On the other side, of course, we find our leading bankers, ranged in almost solid formation to resist this fresh onslaught on their time-honoured traditions, and, quite reasonably, pointing to the world-wide reputation of our banking system as a self-evident proof of the success of their methods and policy

The Need for Industrial Reorganisation and Rationalisation.

The suggestion that our banks do not afford as much assistance to industry as they might, or as much as is afforded by the banks in other countries, is not by any means recent For years past the banks have been accused of being more zealous of their international business than of the needs of their domestic customers, with the result that Britain's internal trade suffers through an undue accumulation in the City of London of funds gathered from the provinces to finance international banking Others have long suggested that the small trader experiences the greatest difficulty in obtaining adequate financial assistance from the banks, whereas the large capitalist, or the company with prospects, has no difficulty in satisfying his or its capital needs through the London Capital Market Then there are those who charge our banks with being ultra-conservative and ultra-cautious, in as much as they are ready at all times to grant short period loans against undoubted security, whereas they are rarely willing to accept what appears to be reasonable business risks or to assist industry by the provision of long-term capital

The British Banking Tradition of Non-interference.

Charges of the latter kind call into question those vital principles of joint stock banking which have operated so successfully in this country for nearly a century We may best explain the meaning of this statement by briefly comparing the essential features of English banking with

those of the leading continental systems, which, it may be stated, have received pæans of praise from those who have been foremost in condemning the inadequacy of our own institutions

It has been observed earlier in this book that the fundamental principles of English banking are, first, the acceptance of deposits (largely withdrawable on demand by cheque), and, secondly, the granting of short period loans at interest The second of these two principles is, of course, linked up with the other Banks who promise to repay on demand millions of their customers' money cannot—indeed dare not—lock those millions away in long-dated loans The funds must be kept as liquid as is possible, and, for this reason, English banks have made no secret of their preference for short term loans of small amount, widely distributed and regularly maturing under agreed terms of repayment Much of these funds they invest in first-class bills, maturing within a period of not more than three months, while a further proportion is invested in gilt-edged securities which, in normal circumstances, are realisable without difficulty In like manner, the banks endeavour to keep their loans to trade and industry as liquid as possible They aim at supplying *circulating* rather than *investment* capital, at financing the production and sale of goods rather than the purchase of plant and equipment Their object is to ensure that their loans are being constantly turned over, so that while some are being repaid other fresh loans are in process of arrangement Hence, the English banks prefer to lend money in relatively small amounts to small traders on the understanding that the loans shall be regularly reduced out of profits, or to private individuals, on the understanding that regular repayments shall be made out of earnings or income, than to tie up capital for several years in mortgages on property or in loans to limited companies against debentures

The bedrock principles of British banking are thus still the same as those laid down 100 years ago by Gilbart in his famous "History and Principles of Banking" Gilbart gave three important propositions in relation to advance banking First, that it is not the business of banks to supply their customers with capital to carry on their trade, second, that it is contrary to all sound principles of banking for a banker to advance money in the form of permanent loans on dead securities such as collieries, mills and manufactories, and third, that it is bad policy for a bank to make a very large permanent advance to any one customer

But it must not be thought that our banks never grant long term advances It is merely intended to imply that they *prefer* the short term liquid type of loan, and, as a result, employ most of their funds in loans of that type Moreover, the banks are now probably more conservative in this regard than they were previously, since the depressed industrial conditions which have followed the Great War have caused

many of the loans made to industry to become *immobilised*, or *frozen*, that is to say, many advances made on the basis of early repayment became long period loans with no certainty as to eventual repayment This has been especially the case in the cotton, woollen, iron, steel, shipbuilding and engineering industries, so much so, indeed, that in a number of cases the banks have themselves had to take in hand the financial reconstruction of the enterprises, and have had to make considerable monetary sacrifices in order to permit of some degree of rehabilitation

But whether the English banker lends for short or for long periods, he always maintains the position of *creditor* in relation to his borrowing customers He never assumes any responsibility for the conduct or management of a customer's business, in the capacity of partner, director or otherwise Just as our banks have adhered to their traditions of short term loaning, so the business man in this country has jealously guarded the complementary tradition of freedom from interference, and it is more than likely that he would strongly resent any departure from this custom The keynote of the British system of banking credit is that both debtor and creditor shall function with a maximum degree of independence and freedom from restraint It is in this respect that we find the greatest contrast between the English system and that prevailing on the Continent, especially in Germany

The Continental System : Interference in Industry.

In Germany, the cheque system is not greatly developed, and so the need for maintaining an essentially liquid position is not as imperative as it is in this country The banks finance industry not only through the medium of short term loans for current needs, but also by providing much of the investment capital which, in this country, is furnished by the proprietors, *i e*, directors, shareholders, and debenture holders Moreover, bankers and industrialists in Germany are closely associated as partners or directors of concerns in which they are both financially interested Directors of the banks serve on the boards of industrial companies, and so apply their experience and special knowledge for the benefit of the business in all that affects its financial position and commitments

Capital for industry is provided by the German banks in two ways (1) by utilising funds obtained through the issue of bonds for public subscription to grant long-term loans secured on the assets of the borrowing concerns, and (2) by investing funds subscribed by the proprietors in shares of industrial concerns, and in many cases actually obtaining control Each of the four large banks (Deutsche Bank und Disconto-Gesellschaft, Dresdner Bank, Darmstadter und Nationalbank and Commerz und Privatbank) has large industrial participations

German industry is especially fostered by a number of banks which each specialise in the finance of a particular industry, *e g*, Bank fur Textilindustrie, Bank fur Brauindustrie, these institutions may be described as fulfilling a rôle half-way between that of a bank (as we know it) and that of an investment trust The intimate association between German banks and industry is largely due to the fact that many of the usual banking functions are concentrated in the hands of specialised institutions Mortgage business is almost monopolised by *Pfandbrief* and *Hypotheken* banks, municipal finance is attended to by *Stadt* banks, small savings and loans are arranged by *Spar*, *Raiffeisen* and *Genossenschaft* banks, and so on

The result of this specialisation is that the German banking system as a whole has been, and continues to be, of the greatest assistance to the nation's industrial development The banks undertake every kind of credit operation, including advances on personal security, and the assistance of company flotation So important have the banks become that they tend to control the general policy of industry to a greater degree than is usual in other countries Germany's closely knit kartell movement was partly a result of the identification of the interests of banks with certain industries, and while, in some cases, the kartells have become powerful enough to be largely independent of the banks, in most cases the banks have retained control Thus the general position is that German bankers participate in the risks and responsibilities of their clients to an extent which British banking tradition, especially, would not tolerate

In France, also, the banks are closely attached to industry The large French banks may be classified as *Etablissements de Crédit* and *Banques d'Affaires* Members of the former class carry on a business similar to that of English banks, whilst members of the latter class (such as the Banque de l'Union Parisienne) are more closely interested in industry, to which they lend their aid partly by participating in the capital of industrial enterprises and partly by placing their bonds and shares with the public There exist also a number of purely industrial banks (such as l'Union des Mines) whose functions are to finance each a particular industry, while various agricultural credit banks meet the requirements of the farming community by granting loans for both long and short periods And there is, of course, the *Crédit Foncier*, the great French mortgage bank, under the control of the Government which loans funds to private individuals, to municipalities, and to industrialists (including agriculturalists), on a large scale, and for long periods against mortgages of property

In perhaps no other country is the connection between banking and industry so close as in Switzerland There the *Trust Banks* (such as the Union Financière de Genève) specialise in the issue of their own bonds and utilise the proceeds partly by granting long-term loans and

partly by taking participations in the capital of industrial enterprises Here again are to be found specialised undertakings (such as the Banque pour Entreprises Electriques) which interest themselves in one industry only

Belgium, too, owes an inestimable debt to her banks for their services to industry Thanks to the part played by her two leading banks, the Société Générale de Belgique and the Banque de Bruxelles, post-war industrial reconstruction has been carried out on co-ordinated lines with the minimum of economic waste, and without confusion, over-capitalisation or over-production The Société Générale, through its controlling interest in the leading concerns in the Belgian coal industry, has done much to introduce into that industry co-operative marketing, systematised restriction of output and economical centralisation of coking and by-product plants In like manner, the Banque de Bruxelles, operating through a subsidiary holding company, the Compagnie Belge pour l'Industrie, has done yeoman service in connection with the rationalisation and re-organisation of Belgian manufacturing industry

British v. Continental Practice.

There is undoubtedly much to be said for the Continental system It is logically sound that the banks should have intimate first-hand knowledge of the financial position of businesses in which their funds are invested Moreover, there are occasions when the banker's special knowledge and advice must be of the greatest benefit to a concern when important questions of policy are being discussed by the Board Supporters of the system frequently contend that it has done much to maintain the elasticity and responsiveness of the industrial fabric and that it has been largely responsible for the rapid rehabilitation of Continental industry since the War The case for financial initiative, as has been well stated by the *Economist*, is that an outsider can weigh up the situation as a whole better than those in the business, who often cannot see the wood for the trees , that frequently heads of firms and directors of companies have a vested interest in preserving their situations , that if nothing is done the banks, in common with the rest of the community, suffer , and, finally, that the financiers have the indispensable means of smoothing the way

But such arguments do not prove that British banks should operate on the lines of those in other countries On the contrary, British bankers contend that a high proportion of the funds invested by the German banks in industry is subscribed by the proprietors, whereas the proprietors of English banks subscribe but a very small proportion of their funds Most of such funds represent customers' deposits, and since these are largely repayable on demand, it would be obviously unwise and unsound to lock up a high proportion of them in long period loans

to industrial enterprises An English banker is the custodian of vast sums of other people's money which may be withdrawn on demand or at short notice, and on the basis of which he builds up a vast superstructure of credit Unless the disposition of his funds is most carefully administered, the whole structure may be gravely imperilled Hence, an English banker cannot lock up his funds in a factory, since a factory, whether closed or working, is useless for the purpose of cashing a customer's cheques

There is another important point of difference English bank loans are widely distributed, in relatively small amounts, over many industries, whereas, in the German system, the tendency is rather to relatively large investments in particular businesses and particular industries, wherein the banker concerned is specially interested and of which he has special knowledge and experience The greater security of the English method can scarcely be questioned, whilst it has the added advantage of providing financial facilities to every branch and grade of industry without rigid selection, so that no one industry can be said to be unduly favoured

Then, it is pointed out that, in this country, with its pre-eminent Capital Market, there is no dearth of facilities whereby industry may satisfy its needs for long period capital In no other country are there organisations which surpass in efficiency and experience the London Stock Exchange, the London issuing houses, investment houses, finance companies, and underwriting agencies, and, in no other country is there to be found a more varied and enterprising band of company promoters than is to be found within the boundaries of the City of London

Finally, our bankers point out with perfect truth that the rates of interest charged in this country for loans are no greater than is received, or ought to be received, on fully secured preference shares or debentures, and that such rates are not as high as should be obtained on ordinary shares Hence, for the rates which are now charged, it is unreasonable to expect the banks to undertake the greater risks involved in actually becoming proprietors of businesses in which they are financially interested If industrialists insist that the banks shall take greater risks, then they must be prepared to pay higher charges for the accommodation

The standpoint of the British banks must be admitted to be sound Their organisation and tradition are unique Their obligations to millions of depositors in every walk of life cannot and must not be in the slightest degree impaired by the desire to cater for the special needs of a relatively small number of industries And their reputation for stability and security is now so essentially the life blood of a nation whose international position depends on her standing as the world's banker and financier, that the banks cannot be expected to embark on new experiments or to change the nature of their business to meet a situation which has arisen out of emergency conditions In actual

fact, our banks already render inestimable service in providing working capital for the distribution and marketing of goods as well as for production, while a high proportion of their advances to customers is undoubtedly applied in the purchase of goods for consumption

The Need for Rationalisation and Re-equipment.

But, since the collapse of the great boom of 1920, it has become increasingly obvious that our rapidly changing industrial economy demands vast supplies of new financial resources which the joint stock banks are unwilling or unable to provide A number of our leading industries are gradually undergoing a process of which there is dire need if foreign competition is to be adequately met, and this may be summed up in the frequently misused term *rationalisation*, which in spite of its apparent terrors, simply means the re-organisation, and if necessary, the amalgamation, of industrial concerns on the most modern and most scientific lines so as to secure greater economy and greater profit in relation to the capital outlay This implies the writing off of existing superfluous assets, the elimination of inefficient productive units and weak selling agencies, the reduction of over-head costs through the economies of large scale manufacture and co-operative buying and selling In brief, rationalisation means the application of the most modern and scientific methods both of production and distribution with a view to selling the product at the lowest possible price and at the highest possible profit.

Unfortunately, there is every evidence that such a process has been long overdue in several of our leading manufacturing industries The inbred conservatism of British employers, who adhere tenaciously to methods which have served them well in the past, and have an insufficient first-hand acquaintance with either methods or markets overseas, has been and remains the greatest obstacle to necessary change The report of the Balfour Committee on Industry and Trade, published in 1928, left no room for doubt that a great modernisation effort was necessary in this country It is incontestable that in the iron and steel trade, for example, a great many of our plants are entirely obsolete and inefficient as judged by foreign standards The majority of our iron furnaces are small and costly to operate, our coking and by-product plants are in urgent need of wholesale replacement, while few British steel works can be said to be absolutely modern in their general lay-out and arrangement of processes This is in distinct contrast to the conditions in similar industries in Germany, America and Belgium, where comprehensive schemes of rationalisation and modernisation have placed the majority of their plants far in advance of those in this country And apart from the modernisation of plant and equipment, a great deal has been done in the countries mentioned to reduce production costs

through the amalgamation or consolidation of small individual concerns into large units, with a consequent saving of productive, administrative and selling expenses

How is Rationalisation to be Implemented and Financed?

Schemes of amalgamation and rationalisation obviously necessitate not only an immense amount of painstaking and skilled investigation, but also considerable outlay of long-period capital. So far as the former requisite is concerned, our bankers have shown themselves most willing and ready to render whatever help lies within their power But as has been quite rightly pointed out by Mr J Beaumont Pease[1] and other equally prominent bankers, "it is not the function of individual banks, or even of banks as a whole, if that were a practical possibility, to initiate the re-organisation of industry, or to try to dictate the steps which should be taken in this direction Bankers have not the necessary detailed knowledge of the condition of an industry as a whole, or a sufficient acquaintance with its technicality, to be in a position to say what particular reforms are advisable, what flaws there may be in its technical procedure, or what units are redundant These points should be left to the industry itself, or to technical experts called in for the purpose, to determine"

Leading bankers have been equally pertinent in their contentions that the nature of their business does not permit them to supply the immense amount of capital required for the rationalisation and re-equipment of our basic industries They contend that the necessary capital should be obtained from the Capital Market and from the investor, who seeks to put away his savings for a period of time, and not from the banks, whose business is essentially that of short term loaning

Moreover, there is not wanting evidence that, even were the banks willing to provide the necessary funds, their existing position and resources scarcely permit them to do so Facts and figures given by bank chairmen at the end of 1928 showed that the proportion of advances made by banks had already reached the accepted limits, and that the banks had already rendered so much financial help in connection with rehabilitation and rationalisation, that it would be unwise to extend their commitments in this direction Mr F C Goodenough, Chairman of Barclays Bank, for example, has stated that the British banks have granted to industry "assistance beyond anything which in normal times would have been regarded as justifiable" While, in some cases, the help so given has been justified by results, many bank loans to industry have become "frozen" or immobilised through the inability of the concerns accommodated to improve their position, while several banks have suffered exceptionally heavy losses through having granted financial

[1] Speech at Lloyds Bank Annual General Meeting, 31st Jan 1930

assistance to concerns which were already so inefficient that it would have been better to have allowed them to "go under" altogether rather than attempt to assist them to continue on uncompetitive and uneconomical lines

The banks do not altogether blame industry for this position They recognise that, in some cases, they have lent too easily and too freely, and that their policy of granting accommodation in certain directions has been proved to have been short sighted But it is clear that the banks are now convinced that the real problem of our distressed industries is not the lack of adequate financial assistance, but the urgent necessity of securing greater efficiency, of lowering costs of production and selling prices, of securing new outlets for our products, and of consolidating our existing markets

Bankers are insistent that industry is in dire need of re-organisation and that that re-organisation must come from industry itself before the banks can advance further capital As was rightly pointed out by Mr F C Goodenough, the banks are merely throwing good money after bad if they provide financial assistance for an industry which continues to produce inefficiently in spite of a change in basic conditions, or in spite of some artificial interference with economic laws And they emphatically deny that any enterprise which is inherently sound and progressive has ever experienced difficulty in raising capital necessary for expansion and development

They are equally insistent that the encouragement of production is likely to be of little permanent value unless it is accompanied by a thorough-going improvement in existing methods of selling and distribution They have rightly pointed out that rationalisation, re-equipment and re-organisation would not cure all the troubles from which industry in this country is at present suffering Much of the trouble with which our manufacturers are faced is undeniably due to the difficulty of finding adequate outlets for their products Several overseas markets wherein the British trader was once supreme are now partly or wholly closed to him In addition, there is the fact that the consumption of many commodities, both at home and abroad is still on a restricted scale Hence the need for the development of consumption as well as of production It is obviously useless to spend millions on industrial reorganisation unless the most painstaking attention is at the same time being directed to sales promotion, the fostering of existing markets and the opening of new ones The price at which we can produce, and the markets for our products, are the two essential elements of our present industrial problem, and both of these are quite outside the province or functions of the banks

Finally, there are the more general objections that "the powerful weapon of financial pressure must be used with great discrimination The building up of great business units is a process which has often,

unfortunately, been attempted for quite improper financial motives, which have ended in disaster And, even when designed with the best of motives, a financial reconstruction may come to grief, if it is not based on a sound technical foundation While it is undoubtedly the case that waiting for the industrialists themselves to move has involved undue delay, it is none the less essential that industrial considerations alone must determine the size, form and character of the new organisations, and that the necessary experience and knowledge must be supplied from the ranks of industry " [1]

The Need for New Facilities.

This, then, was the position in the latter half of 1929 The banks were fully alive to the need for rationalisation, and for the necessary accompaniment of expert financial advice and adequate financial support, but they were unwilling to undertake the task as part of their ordinary business of joint stock deposit bankers While they were willing to recognise the justice of the demand that adequate financial facilities should be available for industrial re-construction, they were equally insistent that such re-construction should come from within, that industrialists themselves should initiate the re-organisation, and come to the banks with their proposals and requests for monetary aid The orthodox theory in this regard has been convincingly stated by Mr Tennant[2]- " Credit can help at the psychological moment and those who control credit must always be ready and watching for the opportunity to help But the initial impetus must come from the side of trade and industry The function of banking is to be always ready to cater for an increased demand for commodities and an enhanced manufacturing activity by expanding the supply of credit *pari passu* with such developments If the expansion takes place before the signs of an approaching increase in demand herald the need for an increase in production, the well-known evils of inflation are let loose . "

It became fairly obvious, therefore, that the situation could be met only by the creation of some new form of organisation in which both the banks and industrialists could co-operate to achieve the desired end And it was here that the Bank of England, so frequently accused of antiquated principles and obsolete methods, took the country by surprise by giving a lead in the right direction and by acting with quite obvious but most unusual directness of purpose

Assisting Production : The Securities Management Trust.

By the end of 1929 it was clear that the Bank of England intended to leave no stone unturned in its efforts to assist the depressed industries of the nation The Bank had already taken a leading part in the

1 *The Economist*, "Banks and Business", 18th January, 1930.
2 Westminster Bank, Annual General Meeting, January, 1930

re-construction of the well-known concerns Armstrong Whitworth and Co , Ltd , and William Beardmore and Co , Ltd , and had established a precedent by affording direct financial assistance to the Lancashire Cotton Corporation, an undertaking which is charged with the important problem of rationalising the American spinning section of the Lancashire cotton industry

Apparently, however, the Bank directors had arrived at the conclusion that work of this nature could best be undertaken by a special organisation, and in November, 1929, it became known that such an organisation had come into being as the *Securities Management Trust*, formed under the Bank's auspices, and with the Bank Governor as the chairman of an expert Board of Directors, to assist in formulating plans for industrial re-organisation The Trust is not intended to be an industrial bank, and will not compete with the joint stock banks in the financing of industry Its functions are to encourage and assist the process of rationalisation by investigating the position of concerns, valuing their assets, considering their suitability for amalgamation, and possibly granting them temporary financial assistance pending the raising of permanent new capital In arranging for the issue of such new capital, the Trust will act through and in conjunction with the existing institutions which undertake such business, but the strength of its credit will necessarily ensure success for any issues which it is known to sponsor

In brief, the object of the organisation is to bring finance and industry more closely together, to provide expert financial advice and assistance, and to ensure, by thorough investigation, that any new capital introduced into industry shall be effectively employed and be of enduring benefit

To this end, the Trust has taken a leading part in the formation of a new company, the Bankers Industrial Development Company, which was registered in April, 1930, with a capital of £6,000,000 Of this, the £1,500,000 " B " shares subscribed by the Securities Management Trust, Ltd , retain for that organisation a 50% control, while the remainder of the capital is being found by leading banking and financial institutions in the City The new company is thus, in effect, a partnership between the Bank of England and the City with the avowed object of receiving and considering schemes for the rationalisation of industry and of ensuring that satisfactory schemes shall obtain the necessary financial assistance, and that they shall not be held up by competition or rivalry between various banks and finance houses The close connection of the new organisation with the Bank of England is indicated by the fact that its directorate, composed of members of the chief financial concerns in the City, has the Governor of the Bank as its Chairman, while the intermediary character of the company is illustrated by the facts that it is not intended that profits shall be made, and that the

directors are giving their services without fee. Clearly, the new institution will fulfil a rôle of the utmost national importance if, by smoothing away financial difficulties, it can bring greater prosperity and more profitable production to our great industries.

Fostering Consumption: The United Dominions Trust.

That the Bank of England is keenly alive to the fact that industrial prosperity depends as much on the fostering of consumption as it does on the furtherance of production was clearly revealed in January, 1930, when it became known that the Bank had itself arranged to supply further capital for the development of an organisation known as the United Dominions Trust

This organisation was formed in 1922 with the object of providing credit for consumers of useful and necessary articles (as distinct from luxuries) produced in this country, and so with the aim of encouraging the sale of British goods Its operations have been eminently successful, and much useful work has been done in financing the distribution and purchase, under long term credits, of such things as electrical equipment for industrial and domestic use, and farm tractors for agricultural use Manufacturers and distributors to whom the Trust grants long term credit facilities are able, in turn, to grant long term credit to their customers, with the result that the Trust is now financing sales of millions of pounds' worth of British goods through its branches in the leading industrial centres of the country And it may be added that, though its turnover is extremely large, its loss ratio through bad and doubtful debts is almost negligible The institution thus acts as a link between consumers and producers, and, though the business is mainly conducted by means of funds received from depositors (including the banks) and is, in fact, officially described as being that of "bankers", it actually bears little resemblance to the business of banking as we are prone to regard it in this country

At the time of writing there are no indications that the principles underlying the formation of the United Dominions Trust are being extended, although it is quite obvious that the organisation fulfils a function of the greatest importance, as is only too clearly indicated by the Bank of England's active participation in its fortunes The encouragement of instalment buying and of hire purchase trading cannot fail to benefit industry and employment It should enable small traders whose activities are restricted by lack of capital both to improve their equipment and to enlarge their activities. But it is obvious that the encouragement of consumption can only be beneficial if the goods concerned are being produced at economical and competitive prices, so that any efforts such as those which are being made by the United Dominions Trust must be complementary to rationalisation and increased efficiency on the industrial or producing side.

The City shows its Readiness to Assist.

It will be clear from the foregoing paragraphs that, in spite of suggestions to the contrary, British bankers, led by the Bank of England, are only too willing and ready to do everything in their power to assist industry during the present exceptionally difficult period. And, if further evidence were needed, it was unmistakably supplied by Mr J. H. Thomas, the "Minister of Unemployment", in an important speech at Manchester on the 15th January, 1930. In the course of his remarks, Mr Thomas stated that the City of London stood ready to support any plans that, in its opinion, would lead to the necessary re-organisation and re-equipment of industry. But the Minister was careful to emphasise that the City "was convinced that a number of our important industries must be fundamentally re-organised and re-modernised in order to be able to produce at prices which will enable them to compete with the world", but that any "industry which proposes schemes which, in the opinion of those advising the City, conform to those requirements, will receive the most sympathetic consideration and co-operation of the City in working out the plans and finding the necessary finance. In short", he said, "the whole forces of British finance are, for the first time, prepared to stand behind industry."

If the promise implied in this pronouncement is fulfilled, it is clear that there is considerable hope for the future. But the fact cannot be hidden that there is an immense amount of spade work to be done before industry and finance can be brought into that close co-operation necessary to attain the object which they are both anxious to achieve. There is much leeway to be made up on both sides, but it is reasonably clear that, although the industrialists have so far been most prominent in their criticism of the banks, the banks have been perfectly reasonable in their insistence that British industry must itself awaken to the sense of its responsibility in this new economic age.

On the other hand, it is obvious that the banks, by the institution of economic and industrial research departments or otherwise, must perfect their knowledge, not only of the particular undertakings with which they are in close business relationship, but also of industrial groups as a whole. Our large banks are now so much centralised in London that they cannot possibly have that intimate knowledge of important localised industries which was possessed by the private bankers of the last century. And the banks cannot but gain, and cannot fail to avoid some at least of the costly mistakes of the past, by obtaining direct representation on the boards of the large organisations wherein they are financially interested. Such arrangements would not only place the advice of our financiers directly at the disposal of leading industrialists, but would also enable the banks to obtain first-hand knowledge of the measure of risk implied in their more important short term industrial commitments.

Then there is the important fact, that only by actively grappling with the problems briefly discussed in this chapter can the banks ever hope to ward off what, to them, are extremely unpalatable proposed remedies for the present industrial situation Britain's international banking and financial business thrives largely by reason of her open door policy of freedom of trade with all nations, and that business, with which our bankers are, of course, so intimately concerned, is likely to be seriously imperilled through the adoption of such suggested palliatives as protection and increased Empire preference Hence, by unstintingly giving industry the full measure of their assistance experience and skill, our bankers stand to gain, not only from the greater prosperity of their own domestic customers, but also from the fact that the prosperity of their international business will not be jeopardised if, by their efforts, they are able to ward off fiscal experiments likely to damage London's position as a leading monetary centre

British Banks and Agriculture.

It has been stated that much of the criticism directed against British banks arises from the suggestion that, while larger capitalists are able to satisfy their monetary needs without trouble, either from banks or from the London Capital Market, many small traders experience considerable difficulty in raising new capital Criticism of the banks on this ground has been specially marked among agriculturists, who complain strongly that the assistance rendered by the banks to the farming industry is quite inadequate to meet its requirements, and that the lack of satisfactory financial support has been an important cause of the existing serious depression in the industry

Nevertheless in 1926, a Royal Commission instituted to investigate the financial requirements of agriculture reported that, in spite of suggestions to the contrary the modern joint-stock banks offered quite as much assistance to the farmer as did the private bankers of the last century, but that there undoubtedly was room for a considerable extension of the available credit facilities It was pointed out that, although farmers with security to offer have little difficulty in obtaining loans, the needs of the small tenant farmer, whose only assets are his stocks and his crops, were not being adequately met Hence the legislature found it necessary to reinforce the existing facilities, and, to this end, passed the *Agricultural Credits Act*, 1928, which deals with the provision for agricultural purposes of both long and short term credit

Long Term Credit — One result of the findings of the Commission and of the passing of the Act was the foundation of the Agricultural Mortgage Corporation which grants long term loans against mortgages of agricultural land or in respect of agricultural improvements under the Land Improvements Acts It has a capital fixed at the nominal sum of £650,000 contributed by the joint-stock banks

Loans on land granted by this Corporation may not exceed two-thirds of the value of the mortgaged property, and are repayable, including interest, over a period of not more than sixty years Since the debentures of the Corporation are a trustee security, it obtains all its resources as cheaply as possible, and is therefore in a position to lend cheaply

SHORT TERM CREDIT —The Act encourages the farmer to go to the banks for short term credit instead of relying on trade credit It introduces a new form of charge, known as an "agricultural charge," which a farmer may create in favour of a bank over all or any of his ordinary assets Such charges may be fixed or floating, and may secure a defined or a fluctuating amount They give a first claim to the property charged subject only to claims for rent, rates and taxes Bankers are thus provided with an acceptable security, while the disadvantages of undue publicity have been overcome by the provision that, though all such charges must be registered and the register kept open to inspection by any person, publication of agricultural charges is to be unlawful and persons responsible therefor are liable to a fine not exceeding £20

The advantages claimed for the scheme are that it establishes a uniform standard of long term mortgage credit for agriculture, and gives new facilities to farmers who wish to purchase their holdings, by providing the necessary credit at a reasonable rate of interest, in a universally applicable form and free from the risk of unexpected foreclosure

The Government and the Industrial Situation.

Although in this chapter the intention has been to deal more especially with the present policy of our banks in relation to industry, our survey would not be complete without some reference to the steps which have been taken by the British Government to examine, and, if possible, to deal with the general economic position of the country

It has been explained in preceding chapters that since 1918 various Government committees have been set up with the special object of investigating questions connected with our currency and banking structure In addition, a considerable amount of highly important and constructive investigation has been instituted on the industrial side. Probably the most important step was the appointment by Mr Ramsay MacDonald, in 1924, of a Committee, consisting of well-known economists, bankers and business men, under the chairmanship of Sir Arthur Balfour, charged with the task of investigating the conditions and prospects of British industry and commerce After five years of exhaustive enquiry, this Committee (usually referred to as the Balfour Committee on Industry and Trade) in its final report, dated March, 1929, made a number of

important recommendations dealing with the necessity for economy in State expenditure the need for rationalisation in industry, the desirability for stability and continuity in the matter of tariff policy, and the importance of relieving industry of the burden of taxation In regard to the provision of banking and financial facilities for industrial purposes, the Committee reported that the requirements were, for the most part, being adequately met by our existing banking system, and gave their opinion that, though the restoration of the gold standard was bound to involve some degree of transitory dislocation, it was unquestionably necessary and must prove ultimately beneficial.

The Committee on Finance and Industry, 1929.

In spite of the fact that this report was favourable to the banks, the Government during 1929 was obviously much influenced by the weight of criticism to which we have referred in this chapter, and in November, 1929, the Chancellor of the Exchequer announced the appointment of a Committee "To enquire into banking, finance, and credit, paying regard to the factors, both internal and international, which govern their operation, and to make recommendations primarily for the relief of industries, and calculated to enable these agencies to promote the development of trade and commerce and the employment of labour"

The members of the Committee are drawn from various sources and include representatives of the banks and of industry, together with members of the Government and well-known economists The Report of this group will be awaited with the greatest interest, and without doubt any suggestions which may serve to relieve the present financial and economic difficulties will be welcomed as much by bankers as by other members of the community.

The Economic Advisory Council.

The Balfour Committee and other committees set up since the War have undoubtedly rendered valuable service in their respective spheres, but it has been gradually recognised that economic and monetary problems are now so intricate, and so vital in their effect on national welfare, that some permanent expert organisation is required to advise the Government on such matters Accordingly, Mr Stanley Baldwin's Government set up what became known as the *Committee of Civil Research*, consisting of expert economists and business men, charged with the task of advising the Government on monetary and economic subjects

In January, 1930, the arrangements were taken considerably further when Mr Ramsay MacDonald announced that the work of the Committee

of Civil Research was forthwith to be taken over by an *Economic Advisory Council*, consisting of the Chancellor of the Exchequer, the Lord Privy Seal, the President of the Board of Trade, and the Minister of Agriculture and Fisheries, together with several well-known economists and business men, and a permanent staff of experts, under the chairmanship of the Prime Minister The Council was formed as a standing body constituted to advise the Government on economic matters and to make a continuous study of developments in trade and industry It will examine the use of national and imperial resources, advise on the effect of legislation and of fiscal policy, both at home and abroad, and report on all aspects of national, imperial, and international economy which have any bearing on the prosperity of the country

It is as yet too early to express any opinion as to the results which are likely to follow the establishment of this Council, but there can be little doubt that the formation of some such organisation has been only too long delayed It is to be hoped that the Council will deal, not only with the problems which have been discussed in this book, but also with the equally important suggestion, now so frequently made, that the policy of our central Government is itself largely responsible for the present depression in industry and trade It is almost generally admitted that British industry cannot possibly revive unless national expenditure is drastically curtailed with a view to relieving the productive organisation of at least some part of the present crushing burden of taxation Sir Harry Goschen[1] has rightly pointed out that we appear to be inclined to dissipate our potential capital in unprofitable directions, and that a continuation of this policy can only result in encroachment on our national wealth Spending and saving are complementary, and, unless Government expenditure on unproductive lines is curtailed, our national savings are likely to prove inadequate for the constantly increasing demands of industry

Therefore we cannot but hope that the Economic Advisory Council with its representation from the three great groups, -bankers, industrialists and politicians – which have been respectively blamed for the present conditions of industrial gloom, will be able to reach agreement on some line of policy and joint co-operation, which will promote the so eagerly awaited return of the nation's erstwhile prosperity

[1] National Provincial Bank, Annual General Meeting, January, 1930

INDEX.

A

PAGE

Abrasion 13
Acceptance—
  For Honour 278
  Supra Protest 278
  General 275
  Presentment for 276
  Qualified 275
Accepting Houses 101
Acceptor for Honour 278
Accommodation Bill *See* Bill of Exchange
Account, Stock Exchange 121
Account Payee 319, 333
Adjustment Cases 428
Administrators 184
Advances to Customers 93, 143
Adverse Balance of Trade 406
Advising upon Investments, Banker's Liability 255
Agricultural Credits Act, 1928 488
Agricultural Mortgage Corporation 488
Agriculture and Banking 488
Akrokerri (Ashanti) Mines, Ltd v *Economic Bank*, 1904 333
Allonge 293
Amalgamation in English Banking 70
Answers on Returned Cheques 174
Appropriation of Payments 165
Arbitrage 391
  Compound 392
  Simple 392
  Two point 392
Arbitration on the Stock Exchange 117
Articles of Association 189, 194
Assignment of Balance 175
Assignment of Debt 224
Associations, Accounts of 199
Attorney General v *National Provincial Bank*, 1928 167
Auchterlonie & Co v *Midland Bank Ltd*, 1928 326
Authority to Negotiate 452, 457
Authority to Sign 177
Aval 298

B

Backwardation 125
Bailee—
  Banker as 209, 250
  For Hire 250
Bailee (*continued*)— PAGE
  For Reward 250
  Gratuitous 250
  Negligence of 250
Bailor 250
Balance of Indebtedness 369 405
Balance of Trade 369 388, 403, 431
Balfour Committee on Industry and Trade 492
Banbury v *Bank of Montreal*, 1918 168
Bank Act, 1826 60
Bank Act, 1833 61
Bank Advances, Quality of 203
Bank Amalgamations 70
Bank Balance Sheet 86
Bank Cash 143
Bank Charter Act, 1844 62, 355
  Suspension of 64, 65
Bank Credits—
  Effects on Exchanges 391
  Advantages of 470
Bank, Definition of 76
Bank for International Settlements 414, 424
Bank Money 9
Bank of England 58, 132
  Foreign Exchange Policy of 410
  and Industry 487
  Notes 49
  Reserve 135
  Return 132
Bank of England Book 129
Bank Paper 377
Bank Premises 93
Bank Rate 108, 137, 410
Bank Return—
  Bankers' Accounts 134
  Banking Department 133
  Gold Coin and Bullion 133
  Government Debt 133
  Government Securities 135
  Issue Department 133
  Movements in 137
  Notes Issued 133
  Other Deposits 134
  Other Government Securities 133
  Other Securities 133, 135
  Proprietors' Capital 133
  Public Deposits 134
  Rest 134
  Seven Day and Other Bills 134
  Silver Coin 133
Banker, Nature of Obligations 87, 163
Bankers' Acceptance Credit 461

	PAGE
Bankers' Assets	89
Bankers' Books Evidence Act, 1879	167
Bankers' Call Rate	108
Bankers' Deposit Rate	108
Bankers' Deposits	138
Bankers' Drafts	355
Bankers' Funds	86
Bankers' Industrial Development Company	488
Bankers' Investment Demand for Bills	393
Bankers' Payments	356
Bankers' Seven-Day Rate	108
Banking	57
Functions of British	76
Utility of	79
Banking Concentration	83
Banking School	476
Banking Theory	61
Bankrupt, Undischarged	180
Bankruptcy	313
Bankruptcy Act, 1914	181, 313
Bankruptcy (Amendment) Act, 1926	314
Bankruptcy Rules, 1915	183
Bank's Loans and Investments	96
Bank's Profits	97
Bank's Proportion of Cash	96
Banks—	
Classification of	80
and Creation of Credit	84
of Deposit	61
Dominion and Colonial	81
Eastern	81
Foreign	82
as Intermediaries	361
Irish	81
of Issue	61
Joint Stock	81
Merchant	82
Private	81
Scotch	81
Trustee Savings	81
Barter	1
Bavins, Junr., and Sims v *London & South Western Bank*, 1900	332
"Bears"	121, 396
Belgian Banking	482
Beneficiary	464
Bill Broker	110
Bill Discounting	109
Bill of Exchange	257
Acceptance	275
Acceptance for Honour	278
Acceptor	273
Accommodation	268
Accommodation Party	268
Alteration	269, 279
Bearer	266
Cancellation	279
Capacity to Contract by	272
Collection	327
Consideration	261
Bill of Exchange (*continued*) —	PAGE
Copy	293
Date	262
Days of Grace	263
Delivery	271
Discharge	279
Dishonour	274, 276
Drawer	274
Due date	263, 276
Estoppel of Parties	273
Fictitious or Non-Existent Payee	264, 268
Foreign	263
Form of	258
Holder	266
Holder for Value	267
Holder in Due Course	266
Inchoate	269
Indorsement	272
Indorser	274, 297
Inland	263
Liability of Parties	272
Negotiability	257
Negotiation	270, 272
Overdue	274
Payment	308
Time for	261
Payment for Honour	279
Requisite as to Form	259
Retired	326
as Security	224
in a Set	270
Signature	264
Signature by Agent	265
Sum Payable	261
Title	265
Defect of	267
Transferor by Delivery	274
must be Unconditional	260
Unpaid	340
Use of	362
Bill of Lading	241
"Received for Shipment"	242
"Through"	243
Bill of Sale	246
Bills Discounted	91
Bills of Exchange Act, 1882	Chapters 20–25
Bills of Exchange (Crossed Cheques) Act, 1906	330, 335, 352
Bills of Exchange (Time of Noting) Act, 1917	277
Bills of Sale Act, 1882	246
Bimetallism	13, 35
Blank Transfers	230
Bondholder's Register	254, 353
Bonds	120, 353
Bourse	384
Bradford Banking Company v *Briggs*, 1887	231
Bradford Old Bank v. *Sutcliffe* 1918	221
Branch Banking	72, 83
Brandao v. *Barnett*, 1846	208

	PAGE
Brassage	11
Breach of Trust	314
British Banking	57
Policy	478, 482
Brokers	383
Brokers' Cover Note	468
Broker's Deposit Rate	108
Building Societies Act, 1874	198
Building Society—	
Account of	197
Permanent	198
Terminating	198
Bullion	378
Certificates	6
Points *See* Specie Points	
Report, 1810	59
Returns	105
"Bulls"	121, 396
"Bundles of Charges"	124

C

Cable Transfers	377
Cannan, Prof	27
Capital & Counties Bank v Gordon, 1903	309, 330
Capital Paid Up	88
Cassel, Prof	33
Central Bank Equipment	147
Central Banking	132, 146
Co-operation	412, 430
Official Rate of Discount	147
Open Market Policy	147
Policy	409
Progress	412
Central Banks, and Exchange Standards	422
Central Reserve System	70 74
Certificate of Incorporation	189
Certificate of Insurance	468
Certificate of Origin	469
Cheque System	58
Cheques	280
Alteration	288, 310
Assignment of Funds	314
Cancellation	290
Clearing	324
Collection of	128, 327, 329
Country	324
Crossed *See* Crossed Cheques	
Defect of Title to	315
Dishonour	323
Drawer's Liability	283
Duplicate	291
Form of	280
Holder for Value	315
Inchoate	288
Indorsement *See* Indorsements	
Indorsers' Liability	283
Lost	290
Marking of	321
Metropolitan	324
Not Transferable	286, 319, 337
Notice of Dishonour	323
Out of Date	283
Payment by	291
Payment excused	311
Payment in Due Course	318
Payment of	308, 316
Post dated	315
Returned Unpaid	324
Signature	309
Stale	283
Stamp-duty on	282
Stopped	315
Stopping Payment	312
Time allowed for Collection of	131
Unpaid	340
China, Exchange and Currency	420
Circular Notes	450
Circular Cheques	451
Clayton's Case 1816	166
Clean Credits	466
Clearing System	324
Clearing—	
Branch	128
Cheques and Bills	126
on Irish and Scotch Offices	129
Country	126, 127
House	125
Local	124
Metropolitan	125, 127
Settlement	127
Summary Sheet	128
Town	125, 126
Clipping	12
Close Price	371
Closing an Account	174
Clubs, Accounts of	199
Coinage	10
Free	11
Gratuitous	11
Coins	10, 48
Collateral Security	204
Bills of Sale	246
Fully Negotiable Securities	226
Inscribed Stocks	227
Land and Goods	235
Life Policies	232
Mortgage Deeds	239
Non Negotiable Securities	227
Produce and Goods	240
Registered Stocks and Shares	227
Requisites of	225
Collecting Banker	327
Liability of	328, 337
Negligence	332
and "per procuration" Signatures	333
Protection of	330, 337, 352
Trust Account	181
Collection of Bills	338

PAGE

Collection of Cheques 128
for a Customer 330
for Private account of official 333
Time allowed for 131
Commercial Crises 150
Committee (Lunacy) 179
Committee of Civil Research 493
Committee on the Currency and Bank of England Note Issues 66, 433
Committee on Finance and Industry, 1929 493
Committees, Accounts of 199
Companies Act, 1923 192, 195, 231, 304
Compensated Dollar 45
Conditional Orders 320, 347
Confidential Opinions 168
Confirmed Credits 455
Confirmed Documentary Credit 457
Consideration *See* Bill of Exchange
Consumption, Assisting 488
Contango 121
Continental Bankers' Investment Demand 393
Continental Banking 480
Contract Note 121, 385
Conversion 321 328
Convertible Paper Money 6
Corporation of Sheffield v *Barclay*, 1905 229
Countermand of Payment 311
County Court Garnishee Summons 172
Coupons 193, 353
Due Date 354
Credit 50
and Bank Cash 144
Banks and Creation of 84
and Capital 55
Control of 142
and Currency 145
Dangers of 53
effect on Exchanges 399
Facilities 487
Functions 52
and Gold 145
Instruments 51, 360
Insurance 470
Money 9, 10
and Prices 56
Risks 434
Utility of 52
Volume of 54
Crises 148
in Great Britain 151
Crossed Cheques—
Account Payee 333
Cashing 318
Definition 284
Effect of Crossing 286
General Crossing 284
Not Negotiable 285, 334
Opening a Crossing 287
Payment of 317

Crossed Cheques (*continued*)— PAGE
Protection of Collecting Banker 337
Special Crossing 284
Specimen Crossings 285
"Cum Dividend" 120
Cunliffe Committee, 1918 66, 432
Cunliffe Limit 145
Currency 10
Accounts 393
and Credit 145
Metallic 48
Systems 36
Theory 61
Currency & Bank Notes Act, 1914 49
Currency & Bank Notes Act, 1928 49, 66 433
Currency Exchange Standard 40, 421
Current Accounts 77, 89
Customer—
Account of 163
and Statute of Limitations 164
Banker's Obligation of Secrecy towards 167
Obligation of Banker to pay cheques of 166
Relation between Banker and 163

D

D/A 460
D/P 460
"Day to Day Money" 99
Days of Grace 263
Dealers 383
Dealer's Position Sheet 386
Debasement 12
Debentures 193
Bearer 193
Mortgage 193
Naked 193
Registered 193
as Security 192
Declaration Policy 468
Deficiency Bills 134
Deflation 33, 425, 431
Gradual 427
Objections to 426
Delivery *See* Bill of Exchange
Delivery Order 244
Deposit Accounts 77, 89
Deposit Receipts 356
Assignment of 357
Garnishee Order, effect of 357
Loss of 358
Depreciation 12
Devaluation 425, 431
Diamond Alkali Export Co v *Bourgeois*, 1921 243
Direction of Trade 363, 388
Discharge of Bill 279

	PAGE
Discount	373
Houses	100
Market	100
Rates	139
Discounting	109
Dishonour of Bill—	
Consequences	277
Due Date	276
Measure of Damages	278
Right of Action on	278
Distringas, Notice in lieu of	231
Dividend Warrants	351
Indorsement of	307
Dock Warrants	244
Documentary Credit	456
Documents against Acceptance	460
Documents against Payment	460
Documents attached to Bills	456
Documents in the Form of Receipts	350
Dollar, Value of	429
Dollar Exchange Standard	41
Dollar Standard	429
Domiciles	325, 329
Dominion Exchange Rates	372
Double Quotation	370
Drawer of a Cheque—	
Bankrupt	313
Death	312
Insanity	313
Due Date	263

E

"Earmarked" Sovereigns	106
Eastern Exchange Rates	419
Economic Advisory Council	493
Economic Friction	428
"*Economist*"	370
Eckstein v *Midland Bank Ltd*, 1926	227
"Effects not cleared"	309
Embiricos v *Anglo Austrian Bank*, 1905	265
Encashment Credits	450
Engagements	89
The English Capital Market	112
Equation of Exchange	25
Equitable charges	230
Estoppel	273, 334, 356
Etalon Boiteux	37
Ex-dividend	120
Exchange as per Indorsement	437
Exchange Clause	419, 437
Exchange Standard	422
Exchange Risks	434
Minimising	434
Exchanges, Theory of	359
Executor-Trustees, Accounts with	185
Executors, Accounts with	184
Export Credit Insurance	470
Export Credits Guarantee Department	471
External Value of Currency	397, 420, 427

F

Favourable Balance of Trade	403, 407
Federal Reserve Board	69
Fiat Money	42
Fictitious or Non Existent Payee *See* Bill of Exchange	
Fiduciary Issue	32, 67, 133
Finance Act, 1918	282
Finance Companies	114
Financial Crises	150
Fineness	10
Fisher, Irving	25 43
Fixed Credit	465
"Fixtures"	99
"Flat" Prices	120
Fleming v *Bank of New Zealand*, 1900	167
Floaters	99
Floating Charge	193
Crystallised	193
as Security	195
Floating Policy	468
Fluctuations in Exchanges—	
Arbitrage	391
Bank Credits	391
Banking operations	391
Issue of Loans	389
Overseas Investment	388
Payment of Interest	390
Speculation	388, 396
Stock Exchange Influences	388
Trade Influences	387
Transfer of Funds	392
Foreign Banking	73
Foreign Bills	263
Collection	378
Negotiation	378
Foreign Currencies Exchange of	362
Foreign Currency Accounts	435, 438
Foreign Exchange—	
Basis of	360
Dealings	385
Definition	359
Markets	381
Mechanism of	383
Maxims	375
Purchasing Power Parity Theory	364
Quotations	370
Terminology	370
Foreign Exchange Quotations—	
Certain	362, 372
Direct	364
Fixed	362
Indirect	363
Moveable	363
Uncertain	363, 373

	PAGE
Foreign Loans	389, 407, 408
Foreign Quotations	372
Foreign Trade, Statistics	401
Formal Security	206
Forward Contracts	373, 435, 440
Forward Exchange—	
Bankers and	442
Covering	443
Exporters and	441
Importers and	440
Rates	445
Transfer of Funds by	395
Forward Price of Silver	106
France and Deflation	425
Free Coinage	11
French Banking	481
Friendly Societies Acts, 1896 and 1908	198
Friendly Society, Account of	197

G

Gambling Act, 1774	233
Garnett v *McKewan*, 1872	169
Garnishee Order	170, 357
General Estates Co, *In re*, 1868	227
German Banking	480
Giblin v *M'Mullan*, 1868	251
Gold—	
and Credit	145
Mint Price of	12
Price of	12, 103
Scramble for	413
World Movements of	104
Gold Bullion Standard	39, 397
in England	49
Gold Deflation	34
Gold Exchange Standard	40, 397, 420
Advantages	423
Disadvantages	424
Essentials of	423
Gold Inflation	34
Gold Points *See* Specie Points	
Gold Specie Standard	39, 397
Gold Standard	39, 405
and the Export Trade	44
Gold Standard Act, 1925	48, 49, 433
Goldsmiths	57
Goldsmith's Book	129
Good Faith	317, 331
Goods as Security	241
Gordon Case *See Capital & Counties Bank* v *Gordon*, 1903	
Gratuitous Coinage	11
Great Western Railway Co v *London & County Bank*, 1901	163, 336
Gresham's Law	13
Griffin, *In re*, 1899	357
Guarantee—	
Bankruptcy of Debtor	220
Bankruptcy of Surety	220
Guarantee (*continued*)—	PAGE
by Company	214
Continuing	215, 216
Death of Principal Debtor	220
Death of Surety	219
Definition	212
Demand for Repayment	219
Determination of	219
Form of	212
Giving Time	223
Joint	218
Determination of	221
Joint and Several	218
Determination of	221
Lunacy of Guarantor	221
by Partnership	215
Rule in Clayton's Case, and	215
Specific	217
Validity of—	
Misrepresentation	214
Signature	214
Value of	213
Guaranteed Mail Transfers	377
Guaranteed Payments	377
Guarantor	212
Discharge of	222
Liability of	218
Rights and Obligations	222

H

Hannan's Lake View Central Ltd, v *Armstrong*, 1900	332
Hawtrey, R. G.	22
Hayman, Christy & Lilly, Ltd, *In re*, 1917	195
"Here and there"	385
Hilton v *Westminster Bank Ltd*, 1926	312
Holder *See* Bill of Exchange	
Holder for Value *See* Bill of Exchange	
Holder in Due Course *See* Bill of Exchange	
Holidays	263
Householder's Protest	277
Hypothecation	208

I

Importers Co, *Ltd*, v *Westminster Bank, Ltd*, 1927	334, 336
"In the Bank"	100, 135
"In-clearing"	126
Inchoate Bills	288
Inchoate Instruments	269
Inconvertible Currencies	400
Inconvertible Paper Money	6
Inconvertible Paper Standard	42

	PAGE
Independent Unit Banking	83
Industrial School	476
Industry and Banking	472
Indorsements	293
of Administrators	303
of Agents	302
Blank	294
Cancellation of	299
Classes of	294
Conditional	295
Courtesy Titles	301
Dividend and Interest Warrants	307
Effect of	297
of Executors	303
Facultative	298
Fiduciary Payees	305
Foreign	306
Forged	329
Impersonal Payees	306
Limited Companies	304
Limiting	298
by Mark	305
Negativing	298
Official Payees	305
Partial	294
Partnerships	304
Restrictive	296
Sans frais	298
Sans recours	298
Special	294
of Trustees	303
Indorser, *See* Bill of Exchange	
Infants	
Accounts with	177
as Agents	177
Inflation	33 431
Informal Security	208
Inner Capital Market	113
Insanity of Customer	178
Inscribed Stock	228
Insurance Policy, Marine	468
Interest rates	393 395
Interest Warrants	351
Indorsement of	307
Intermediate Day	122
Internal Value of Currency	397, 427
International Debts, Settlement of	360
Interplea	175
Intrinsic Value	423
Investment Demand	393
Investment Trust	113
Investments	92
Invisible Exports	402
Banking and Insurance Revenue	403
Great Britain	402
Investment Income	403
Shipping Income	403
Invisible Imports	402
Invoice	469
Certified	469
Consular	469
Irrevocable Credits	456
Isometric Standard	43
Issuing Houses	114

J

Joachimson v *Swiss Bank Corporation*, 1921	164, 170
Jobbers	117
Joint Accounts	179
Authority to Sign	180
Bankruptcy	180
Husband and Wife	180
Joint and Several Liability	180
Joint Liability	180
Joint Stock Banks	63
Joint Stock Companies—	
Accounts of	189
Borrowing by	190
Winding up	196
R E Jones Ltd v *Waring and Gillow Ltd*, 1926	267

K

Keynes, J M	26, 43
Kirkwood v *Carroll*, 1903	342
Knapp, G F	21

L

Ladbroke v *Todd*, 1914	333, 336
Land Charges—	
by Joint Stock Companies	238
Register	237
Land Registration Act	338
Latin Union	35
Law of Property Act 1925	224 239
Legal Tender	15
Lehfeldt's Scheme	46
Letter of Hypothecation	245, 461
Letters of Credit	448
Circular	449
Commercial	452
Confirmed	455
Confirmed Documentary	457
Documentary	456
Finance of Shipments by	461
Irrevocable	456
Limited	449
London Bankers	461
Negotiation	253
Negotiation of Bills under	460
Non-Commercial	449
Travellers'	449
Travellers' Commercial	450
Unconfirmed Bankers'	453
World-Wide	449
Liabilities for Acceptances, etc	89

PAGE

Liabilities of Customers for Acceptances, etc 93
Lien 170
Bankers' 208
Circumstances Inconsistent with 209
Conveyances and Leases, on 210
General 208
Particular 208
Securities Deposited for Safe Custody, on 255
Statutes of Limitation 211
Stocks and Shares 210
Life Policies as Security—
Charge over 234
Disadvantages 233
Precautions 232
Limitation Act, 1623 164
Limited Legal Tender 15
Limited Liability and Banks 63
Limping Standard 37
Linking 421
Liquidators, Accounts with 183
Lloyds Bank, Ltd v *Chartered Bank of India, Australia, & China*, 1928 333, 334, 336
Loans and Deposits 143
Local Authorities—
Accounts of 199, 200
Advances to 201
Orders of 349
Treasurer 200
Local Authorities (Financial Provisions) Act, 1921 201
London Acceptances 382
London & Montrose Shipbuilding Company, Ltd v *Barclays Bank, Ltd*, 1926 332
London and Provincial Bank v *Golding*, 1918 355
London Banker's Acceptance Credit 436
London Bills, Preference for 394
London Bullion Market 103
London Clearing House 125
London Foreign Exchange Market 102, 363
London Joint Stock Bank v *Mac Millan and Arthur*, 1918 310
London Money Market 99, 381
London Rates 109
"London Reimbursement" 102
London Silver Market 106
London Stock Exchange 116
London's International Position 140
Long Bills 377
Lord Tenterden's Act 1828 168, 255
Lost Notes 345

M

Mail Transfers 377
Maker of a Promissory Note 342
Liabilities of 343

PAGE

Managed Currency 43
Marked Cheques 321
Market Borrowers 100
Market Conditions and Government Borrowings 141
Market Lenders 99
Market Rates of Discount 107, 108
Market Supplies of Money 138
Married Women—
Accounts with 178
as Agents 178
Mate's Receipt 468
In re Mead, 1880 357
Mechanical Book-keeping 173
Medium of Exchange 2, 3
Medium of Exchange Theories of Money 22
Memorandum of Association 189, 194
Memorandum of Charge 207
Memorandum of Deposit 195, 207, 226, 230, 346
Memorandum of Transfer 236
Mercantile Law Amendment Act, 1856 165
Middle Price 372
Mint Par of Exchange 366
Mintage 11
Misrepresentation by Banker 168
Monetary Policy 477
Criticisms of 473
Monetary Standards 35
Monetary System of Britain 47
Monetary Theory of Trade Cycle 158
Money 2, 4
Bank 9
Cannan's Theory of 27
Credit 9
Credit Instruments as 24
Definition 2
Equation of Exchange 25
Fiat 42
Fluctuations in demand for 29
Fluctuations in supply of 30
Functions 3
Keynes's Theory of 26
Legal Tender 15
Medium of Exchange Theories 22
Paper 5
Qualities of 4
Quantity Theory of 23, 28
Rapidity of Circulation 24
Theory of 16
Token 15
Unit of Account Theory 21
Value of 16, 25
Money at Call and Short Notice 90, 99
"Money at the Bank of England" 136
"Money Lad and Received" 328
Money Market 132
Money Orders 354
Monometallism 35
Morison v *London County and Westminster Bank, Ltd*, 1914 332, 333, 335

	PAGE
Mortgages	236
Equitable	206, 238
Legal	206, 236
of Registered Land	238
Second	239
as Security	236
Valuation of	237
Multiple Legal Tender System	35

N

Nathan v Ogdens, 1905	347
National Provincial Bank v Charnley, 1924	193
Negligence	331
Drawer of cheque, of	310
Negotiability	349
by Estoppel	227
Meaning of	257
of Stale Cheque	283
Negotiable Instruments	257
Negotiation	279
Bearer Bill, of	271
Bill, of	270
Bill to Order, of	272
Negotiation Credits	452
Non trading Corporations	197
"Not-Negotiable" Crossing	319
Note Issue—	
Elastic	68
France	68
Germany	68
Great Britain	64
Maximum Issue Principle	68
Partial Deposit System	67
Proportional Reserve System	68
Simple Deposit System	67
Systems of	67
United States	69
Notice in Lieu of Distringas	231, 232
Notice of Dishonour	323
Waived	298
Notice of Lien	231
Noting	277
Novation	215

O

"Official Minimum"	137
Omnibus Credit	465
"Open Market Policy"	140, 147
Open Policy	468
Opening Accounts	176
Ordinary Course of Business	317
Other Accounts	83
Other Deposits	139
"Out clearing"	126
Out-Clearing Book	126
Outside Capital Market	112
"Outside" Brokers	118
Overnight Money	99
Overvaluation	428

P

Paper Currency, British	48
Paper Money	5
Par	373
Par of Exchange, Mint	366
Parallel Standard	38
Parr's Bank v Yates, 1898	165
Partnerships—	
Accounts of	185
Bankruptcy of Firm	188
Bankruptcy of Partner	187
Death of Partner	186
Dissolution	186
Lunacy of Partner	187
Non-Trading	186
Trading	185
Pass-Book	172
Effect of entry in	172
Paying Banker—	
Liability of	320
Protection of 290, 299, 316, 349, 352	
Payment—	
for Honour	279
in Due Course	279, 316
Presentment for	276
"Per Procuration" signatures	265
Personal Security	204
Plaint	172
Pledge	207
Implied	209
Policies of Assurance Act, 1867	254
Position Sheet	386
Possessory Title	238
Post Office Act, 1908, Section 25	354
Post War Crisis	155
Post-War Problems	425
Postal Orders	354
Preferential Creditors	196
Premium	373
Presentment for Acceptance	275
Price Index Numbers	17
Board of Trade	19
Cost of Living	20
Economist	19
Prices—	
Effects on Distribution of Changing	31, 32
Effects on Production of Changing	29
Fluctuations in	29
Theory of	16
Production, Assisting	487
Promissory Notes	341
Alteration of	345
Due Date	344

Promissory Notes (*continued*)— PAGE
Form of 341
Joint 342
Joint and Several 342
Lost 345
Maker 342
Presentment of 343
as Security 224, 345
Signatures on 342
and Statute of Limitations 346
Proportion of Advances to Liabilities 96
Prosperity Ltd v *Lloyds Bank Ltd*, 1923 174
Protest 277
Householder's 277
Psychological Theory of Trade Cycle 159
Public Deposits 138
Purchasing Power 364, 397
Purchasing Power Parity 364, 367
Deviations from 368
Importance of 369
Silver and Gold 416
Pure Limping Standard 47

Q

Quantity Theory of Money 23, 28

R

Rapidity of Circulation 24
Rates of Exchange 360
Appreciation 376
Causes of Fluctuations *See* Fluctuations in Exchanges
China 420
Depreciation 376
Discount 376
Dominion 372
Eastern 419
Falling 376
Favourable 375
Firm 376
Foreign Quotations 372
Forward 373
High 375
How determined 363
Low 375
Official 372
Premium 376
Rise 376
Unfavourable 375
Weak 376
Rating and Valuation Act, 1925 201
Rationalisation 478, 484
Real Property Limitation Act, 1874 211
Ready Price for Silver 106
Rebate 336
Rebate on Bills not Due 14
Receipts, Documents in the form of 250
Receiver (Lunacy) 179
Receiving Order 313
Reckitt v *Nunburnholme*, 1928 266
Reckitt v *Barnett, Pembroke and Slater*, 1928 263
Rediscounts 395
Referee in case of need 278
References 33, 3
Register of Mortgages and Charges 192, 194 195
Registered Stock 223
Registration of Mortgages and Charges 192
Reichsbank 68
Relation Back 313
Relative Par, Gold and Silver 417
Released Sovereigns 106
Remedy Allowance 10
Reserve 94
Reserve Accounts 89
Reserve Fund 88
Reserve Liability 64
Retiring Bills 326
Returns 324
For Clearing Purposes 127
Revenue Act, 1883, Sect 17 320, 329, 337 349 350 353
Revolving Credit 465
Royal British Bank v *Turquand* 1856 191
Rule in Clayton's Case 166 206, 213 215
"Running" Brokers 111

S

Safe Custody 248
Authority to Third Parties 253
Bankruptcy of Depositor 249
Conversion 329
Coupons and Bonds 253
Death of Depositor 249
Lien 253
Presentment of Bonds and Coupons 254
Receipt Book 248
Return of Goods 252
Scramble for Gold 413
Searches 238
Security—
for Advances 203
Assignment of Debt 224
Bills of Exchange 224
Collateral *See* Collateral Security
Continuing 213 226
Debentures as 194
Floating Charge as 195
Formal 206
Personal 212
Promissory Notes 223, 345
Securities, Stock Exchange 378
Securities Management Trust 487
Seigniorage 11
Set-off, Banker's Right of 169

	PAGE
Settlement	121
Settling Day	122
Seven-Day and Other Bills	134
Shares	119
Shipping Income	403
Short Bills	340, 377
Short Term Capital	113
Signatures—	
Forged or Unauthorised	264
"Per Procuration"	265
Specimen	177
Silver, Price of	418, 420
Silver Exchanges	416
Fluctuations in	418
Investments	419
Minimising Losses	418
Silver Parity	417
Single Legal Tender System	35
Specie Points	366
Silver	417
Specific Depreciation	428
Speculative Dealings	396
Spot	374
"Spot and Forward"	395
Spot Price for Silver	106
Stabilisation	429
in Britain	431
Crises	428
De facto	427
De jure	427
Stale Cheques	283
Stamp Duties—	
Cheques of Friendly Societies	198
Cheques of Trade Unions	199
Stamp Act, 1853, Section 19	261, 320, 329, 349, 350, 353, 355
Statute of Frauds Amendment Act, 1828	165, 168
Statute of Limitations	164, 211
Stein v *Hambros Bank of Northern Commerce*, 1921	456
Sterilisation	430
Sterling Bills	436
Sterling Exchange Standard	40, 421
Stewart v *Westminster Bank, Ltd.*, 1926	265, 332
Stock	119
Stock Arbitrage	389
Stock Exchange—	
Dealings on	121
Official List	120
Securities	119
Transactions, Banker's Obligations	255
Stock Markets	116
Stockbrokers	117
Stop Order	244
Store of Value	2, 3
Stamp Act, 1891	282
Subrogation	191, 197
Supra Protest	278, 279
Surety *See* Guarantor	
Sutters v *Briggs*, 1922	330
Swap and Deposit	395
Sweating	13
Swiss Banking	481
Symmetallism	38
Synchronism	149
Tabular Standard	42
Talon	354
Tap Rates	141
Telegraphic Transfers	377
Thairlwall v *Great Northern Railway*, 1910	348
Ticket Day	122
"Times" Middle Rate of the Day	372
Token Money	15
Tournier v *National Provincial Bank*, 1924	167
Trade Cycles	148
Periodicity	157
Synchronism	149
Theories of	157
Trade Paper	377
Trade Unions	198
Trading Certificate	189
Transfer of Capital	412
Transfer of Funds	377, 392
Forward Exchange, by	395
Transfer of Shares	229
Transferor by Delivery *See* Bill of Exchange	
Transport Risks	434, 468
Travellers' Cheques	451
Treasury Notes	144, 432
Treasury Bills	141
"Trial of the Pyx"	10
True Value of Securities	120
Trust Deed	193
Trust Property	182
Trust Receipt	240, 460
Trustee—	
Account with	181
Advance to	182
Bankruptcy	183
Death of	182
Safe custody for	249
Trustee Act, 1925	182, 183
Trustee in Bankruptcy, Account with	183
Turner v *London & Provincial Bank*, 1903	333
Turquand Case *See Royal British Bank* v *Turquand*	
U	
Uberrimæ fidei	233
Ultra Vires	191, 197, 214

	PAGE
Unconfirmed Bankers' Credit	453
Undervaluation	428
Unit Banking	83
Underwood v *Bank of Liverpool and Martins*, 1924	332, 334
Underwood v *Barclays Bank*, 192	309, 335
"Undisclosed Buyer"	105
Unit of Account Theory of Money	21
United Dominions Trust	488
Unsound Mind, Persons of	178
Usance	436
Usual Course of Business	170

V

Vagliano Bros v *Bank of England*, 1891	269 325
Valeur Compensée	385
Value Date	385
Vinden and Rogers v *Hughes*, 1905	269
Visible Imports and Exports	492

W

Waiver	270
"Walks"	195
Warehouse-keepers' Certificates	244
Warehouse keepers' Receipts	244
Warehouse Warrants	244
Ways and Means Advances	134
Weekly Money	99
Weight Certificate	69
Weight Note	460
Weighting	18
Wide Quotation	372
Wigzell, In Re, 1921	314
Window Dressing	138
Without Recourse	453
Workmen's Compensation Act, 1925	196

Printed in England by
Waterlow and Sons Limited, London, Dunstable and Watford

OTHER VOLUMES IN THIS SERIES

The works specified below have been written to provide that concise, up-to-date and authentic information which is required by those preparing for professional examinations They will also be found of great practical assistance as works of reference to professional Accountants, Secretaries, and others Each book is handsomely bound in heavy, gold lettered, cloth covers, and contains a copious index Postage in each case is 9d extra

Banker and Customer. By S EVELYN THOMAS, B Com , Cert A I B., A C I S Second Edition 736 pp. Price 12s 6d net

Principles and Practice of Book-keeping and Accounts By B G VICKERY, F C A. Fifth Edition 570 pp Price 12s 6d. net

Elementary Book-keeping. By R. G WILLIAMS, A C A 455 pp. Price 6s. 6d net

Principles and Practice of Auditing. By J. LANCASTER, A C A 378 pp Price 10s 6d net

Partnership Law By E. WESTBY-NUNN, B A., LL B 160 pp Price 7s 6d net

Principles of Mercantile Law. By E W CHANCE, O B E , LL B , Barrister-at-Law Fourth Edition Revised by T OTTAWAY, Solicitor 480 pp Price 12s 6d net.

Principles and Practice of Income Tax and Sur-Tax By REDDISH and TEVERSON, Chartered Accountants Fifth Edition 293 pp Price 11s 6d net

Elements of Economics By S EVELYN THOMAS, B Com., Cert A I B., A C I S Fourth Edition 676 pp Price 10s 6d net

Economic Geography By D E WILLINGTON, B Com , F R G S 330 pp Price 7s 6d net

English Grammar, Composition and Correspondence. By M ALDERTON PINK, M A (Lond), and S EVELYN THOMAS, B Com , Cert A I B , A C I S Third Edition 450 pp Price 8s 6d net

Company Law By HARRY FARRAR, M A , LL B , Barrister-at-Law 660 pp Price 12s 6d net

Elements of Company Law. By HARRY FARRAR, M A , LL B , Barrister-at-Law 340 pp Price 7s 6d net

The Law and Accounts of Executors, Administrators, and Trustees. By E WESTBY-NUNN, B A , LL B , and B G VICKERY, F C A Second Edition 300 pp Price 12s 6d net

Arithmetic. By D A YOUNG, B A , Hons (Lond) 440 pp Price 7s 6d net

All these volumes are obtainable through any bookseller or direct from

THE GREGG PUBLISHING CO , L D 36-38 KINGSWAY, LONDON W C 2