THE DESIRABILITY OF COMMERCIAL PAPER AS A BANK INVESTMENT

AN ANALYSIS

By

J. HERBERT CASE

Vice-President Franklin Trust Company, Brooklyn, N. Y.

COMPLIMENTS OF

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To Miss Mildred Adams
With the Compliments
of the Author
J. H. Case

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Mr. President and Gentlemen:

In banking as in politics, it is a mighty fortunate thing that all the people of this country are not each and every one of the same mind at the same time—our business is conducted upon the theory that they never will be—and this is sound, because when the Smiths need funds in their business the Browns require a safe place to put their surplus. The 25,000 banks in this country have in their keeping billions of this "surplus" and it is our business to so handle this that we not only can take care of the Smiths when they need working funds today, but also return the Browns their money whenever they may want it. Upon the face of it this is a grave responsibility and what we want to know is not only how we may do this today when business is going on quietly and undisturbed, but how we may do it equally well tomorrow when markets and men are out of balance and the conditions extraordinary. In other words, we want something more than a theoretically well balanced arrangement that works out well most of the time. We want, rather, that practical method which will withstand the strain of unusual conditions arising during commercial depressions and financial crises.

While perhaps no two bankers agree precisely upon just what constitutes the ideal investment for any given sum, say ten million dollars, I am strongly of the opinion that the one who employs the major part of this in short term loans to our merchants and manufacturers upon their notes, whose issuance is based upon those live and moving inventories of products in the course of manufacture—or current assets—rather than upon the instruments used in manufacture—or fixed assets—is and always will be upon a much more sound or liquid basis than he who largely invests in bonds and stocks which simply represent a participation in the fixed or immovable properties that cannot be liquidated at all, though the securities themselves may be subject to transfer. The proof of my contention may be found in the enviable record of our so-called purely commercial banks, which in the time of every disturbance and in the time of every crisis have best withstood the strains. What does the commercial bank do in the matter of investments? It puts practically all its funds into these short term notes, notes backed by the credit of the maker and secured by everything he has, but specifically and particularly by his always marketable products which are constantly passing through his hands on their way from producer to consumer, being continuously and automatically converted into cash. In other words, the commercial bank invests largely in what we term commercial paper. While I may have in some degree indicated what commercial paper is I would briefly define it in one concise paragraph, as "Notes of hand issued by merchants and manufacturers to yield funds with which to finance current business." Let me repeat, commercial paper may be best defined as "Notes of hand issued by merchants and manufacturers to yield funds with which to finance current business." Notes issued to finance any but strictly current business do not properly fall within this classification.

In this connection it is not at all amiss to constantly remember that we have a wonderful and tremendous country, with a population now of nearly ninety-five millions of people and constantly increasing, possessing the greatest amount of wealth per capita of any people on the globe. They constantly require things to eat and drink and wear, and things that will save them labor, and will always go on eating, drinking and buying clothes and merchandise, even though in periods of business depresson or financial unrest their purchases may be somewhat restricted in amount. This enormous daily consumption of commodities to which I have just alluded constitutes then the real justification for the issuance of notes by the merchant and manufacturer, the individual firm or corporation, through whose hands these commodities are steadily passing on the way to the ultimate consumer. The annual value of our farm products alone in 1911 is said to have exceeded nine billion dollars. Think of it, an amount equal to the entire resources of all our 7,200 national banks; does not this in itself explain in some measure the legitimate need of temporary capital, to plant, to cultivate, to harvest, to transport and to market this enormous annual yield of our farms, and does it not also constitute a fairly sound basis for the issuance of such notes?

As to the manner in which these notes are paid, a prominent and reliable firm of note brokers of whom I recently made inquiry, informed me that during the first twelve days of the money panic of 1907 — at its very peak — they had maturing through their office something more than ten million dollars worth of bought paper, every single dollar of which was promptly paid without renewal. It does not require any wild flight of the imagination to believe that the money so received by the holding banks looked mighty good to them at that particular time. Can you imagine ten million dollars worth of securities, or in fact any other form of loans or investments, being so readily converted into cash in the same period with so little trouble and upon so favorable a basis? One of the old line Trust companies in New York, whose reputation for conservatism is proverbial, show in their recent published statement a deposit liability of about thirty-five million dollars. Their assets, a most interesting exhibit, show over six million dollars in cash and something more than sixteen million dollars in Bills Purchased, an amount approaching 50% of their total deposits. The officers of this company have, I am told, expressed themselves as believing this to be the best and most liquid asset they possess. Moreover, during certain months of the year they undertake to have maturing each business day about two hundred and fifty thousand dollars of bought paper. A comfortable situation surely whether unusual business conditions obtain or not. The advantage of having one's investments "turn over" so frequently is self-evident, in that fresh funds are constantly being supplied, thus enabling one to meet either an extraordinary demand for money, or if no such demand exists, to again re-employ it in short term loans.

Only a short time since a director of a prominent Wall Street bank, a large purchaser of commercial paper, personally told me that the President of his Bank had recently tabulated the amount of its purchases of outside paper made during the past ten years. What do you think they found? The paper so purchased aggregated the enormous sum of seventy million dollars, every single dollar of which had been promptly paid when due, with the exception of one five thousand dollar note which was temporarily "hung up" owing to the business being liquidated, although fully 50% had been received on this. Think of it. Seventy million dollars in outside paper purchased in a period running over ten years, with a loss so small that it is scarcely worth speaking of. Let me cite another instance nearer home. In the institution where your effiicent President is today the Active Executive Officer, there has been purchased to my certain intimate knowledge during the past ten years upwards of ten million dollars of commercial paper, the whole representing a multitude of small units, as the purchase of any one name is ordinarily limited to $5,000 or $10,000. The actual loss sustained during this period has been something less than $4,000 occurring on two endorsed Bills Receivable, not a single dollar having ever been lost on straight notes issued for money. Need stronger arguments than these be advanced to emphasize the desirability of such notes for temporary investment when discretion and good judgment is exercised in the purchase of them?

A feature which strongly appeals to me is that purchased paper may be timed to mature just when you anticipate large withdrawals or foresee the desirability of having additional money for new commitments. In the selection of paper great care should be used in taking on only such notes as will stand the numerous tests for soundness which should be applied in every instance. Has its maker character, capacity and capital—the three essentials? Is the management absolutely efficient and honest? Is its record that of a money-maker? Is a proper amount of insurance carried? Is its past history of caring for its obligations absolutely beyond criticism? Does it take advantage of all discounts? If these and other tests be answered in the affirmative you may be sure you have a good note.

Safety in making investments is the all important thing. It matters little how successful we may be in other directions, in rearing a promising financial structure, say by rapid growth or in making large profits, safety should be the one controlling factor that governs our actions, and to my mind safety and the ability to convert our assets are twin sisters.

After all is said and done, about the best asset in existence is the honor and integrity of our great merchants, individuals and firms, together with those large corporations whose management regards highly their contracts, and the strong position which they occupy in the commercial and industrial world. A single note going to protest may mean bankruptcy and business death. Here, too, as in the physical world, self-preservation is the first law of nature.

To revert, if I may, to the 1907 disturbance. An officer of one of the embarrassed companies that was obliged to seek and did receive help from the Associated Trust Companies during that unfortunate period told me that the *first* thing the committee of bankers asked for was a list of their maturing commercial paper. This is significant; they wanted then, that which would provide current funds, that which would quickly and naturally convert itself into cash, thus automatically reimbursing them for the advances made. If it occupies so prominent a place in the minds of our leading bank officials who have in hand such important business as the lending of aid to institutions in distress, is it not a strong indication that it must constitute a mighty good banking asset?

Early in 1910 Mr. James G. Cannon delivered an address before the Finance Forum of New York on the subject of "Clearing House Loan Certificates and Substitutes for Money Used During the Panic of 1907." In this address he says, "You will remember that during the last panic, the mercantile interests of this country stood like a rock, and there were very few failures. Of the collateral held against Clearing

House Loan Certificates issued in this City during that period, including substitutions, the total of which was $453,000,000, $330,000,000, or 72.92% consisted of Commercial Paper, and $123,000,000 or 27.08% was made up of stocks, bonds and short time railroad and other similar notes. This being the case, an *Emergency Currency* of the character I have mentioned would certainly seem to meet the requirements of the mercantile community."

If we would but remember that money is merely a medium of exchange, all important but lifeless, performing only a mechanical function in the production and distribution of food and clothing—creature comforts so essential to life and happiness—and if we would further remember that this commercial paper is on the one hand issued by the great merchants and manufacturers for money to pay for these live, moving commodities, and on the other hand subsequently liquidated and retired from the proceeds of these same commodities as they are sold, it would certainly appear that Mr. Cannon's view as here expressed is entirely sound.

National Banks, both in theory and in practice, are usually considered as strictly commercial institutions, their ordinary business being the loaning of money to their customers on notes secured by endorsement or otherwise not infrequently supplemented by the purchase of outside paper. The National Bank Act contains a distinct prohibition against the purchase of real estate other than land for the bank's own use; also a further prohibition against the loaning of money to be specifically secured by bond and mortgage. The framers of this act apparently believed that investments and loans of this sort, even though well secured, were of too fixed and immobile a character. I maintain, however, that whether or not this prohibition is sound it is not strictly interpreted when a National Bank may enter the security market and buy to an unlimited extent an obligation commonly termed a "Bond," which is usually nothing more nor less than a participation in a mortgage, often one for a large amount, which of course represents assets just as fixed and immobile as the smaller mortgage loan on the real property of an individual. When such bonds are not listed on the exchange their sale is not one mite less difficult at any time than is the ordinary straight mortgage.

May I remark right here that a large gold medal and all the other just desserts due a benefactor of mankind, awaits the clever mind that will devise a method whereby our choicest investment securities —stocks and bonds so absolutely sound when clear financial skies prevail—may be exchanged for cash at the prices paid for them—or divided into bits or otherwise apportioned pro-rata among the anxious withdrawing depositors without the formality of our having to peddle them out, or sell at so-called panic prices at the stock exchange, when the financial squall is in progress; it is, however, at such a time that the careful commercial paper buyer, the banker who has in his portfolio a goodly proportion of his deposits, say 30% to 40%, invested in a choice line of high grade commercial paper of standard names, notes carefully selected, bought in the open market *wihout the slightest obligation of renewal and having large current maturities*, occupies a much stronger and more enviable position than his brother banker, who, in order to get something more than a mere "note of hand" as he expresses it, has an equally large percentage of his investments in high class stocks and bonds, all of which, however, are, as we have shown in the last analysis, based upon nailed-down, immovable assets whether represented by a certificate of stock of one of our standard railroad lines or by the mortgage bond of the railroad or other sound corporation.

A member of a very prominent investment banking house, large dealers in investment securities, in a most brilliant address delivered last year before the Southern Commercial Congress at Atlanta, said, "Capital may be divided into two classes, speculative capital which is bold, and investment capital which is timid." Advocating the discouragement of all speculative capital and the encouragement of investment capital, he said, "Encourage the coming of that *capital* which will come to build your railroads, harness your water power, generate the electricity which shall propel your cars, operate your mills and light your streets and houses, capital which will come to mine your minerals, erect your mills and install your looms;—capital which will come seeking these and other channels for investment anxious to make the Southland its home and to remain with you, *so long as it can be of service.* Mark this: "*Remain so long as it can be of service.*" This then is the true picture of "investment capital" as portrayed by the investment banker himself; it is truly absolutely fixed, locked up in real estate, in plant, in bricks and mortar, machinery and equipment, nothing which may be readily liquidated. While this form of capital is absolutely essential to our development, and the country needs lots of it, nevertheless the securities represented thereby are not the liquid sort we should too freely have in our assets to enable us to pay the current demands of our depositors.

Even the old Stock Exchange argument is, in the last analysis, weak. The fact is that a rush to convert stocks and bonds into cash at a time when public confidence is shaken, destroys absolutely their marketability and in fact precipitates a Stock Exchange panic. This exchange is, after all, but a huge hopper capable of caring for just so much grist and when put to the unusual test of absorbing and distributing a greater quantity, hastily pressing in, in times of financial stress, the machinery becomes clogged and revolves slowly, being utterly unable to perform its function. After the trouble is all over it will be seen that no one but the man with the long vision who saw what was coming and got his grist in the mill first, is happily served.

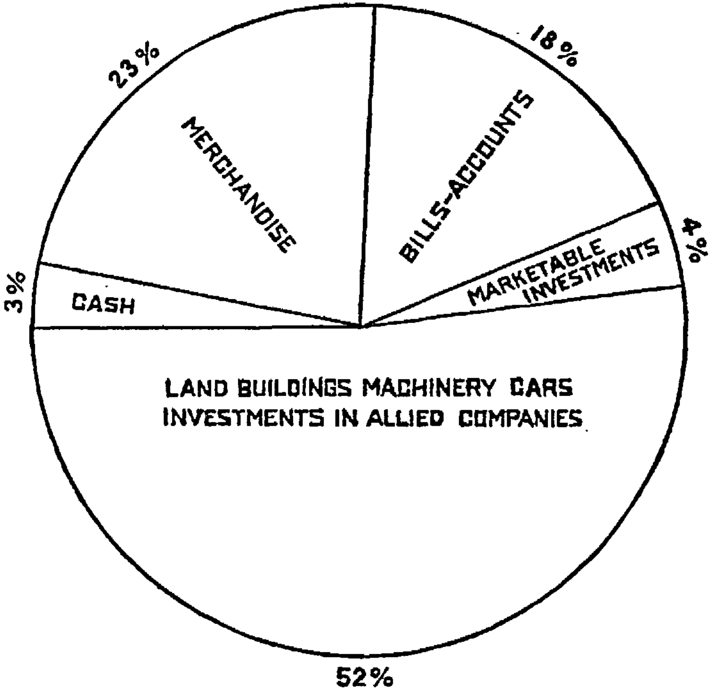
We must then bear in mind that bonds and stocks are seldom actually liquidated but simply change ownership, often passing from weaker to stronger hands, precisely as happened in the case of the securities of the Tennessee Coal & Iron Company during the 1907 trouble.

On the other hand it is increasingly evident that a continuously larger number of banking institutions have learned the solid value of Commercial Paper as a banking asset, and have consequently taken to buying it. The following item recently appeared in the Commercial & Financial Chronicle: "The Northern Trust Company of Chicago has recently decided to engage in the buying of commercial paper. Until its entrance into this field, the institution made no loans that were not secured; it is pointed out that the buying of commercial paper gives an institution an outlet for its funds that a strictly collateral market does not always provide, and, if the paper is well selected, does not involve any more risk." The "Record Herald" states that "There is now but one of the larger Chicago banks which adheres to the policy of making no loans that are not secured." This increase in the number of buyers has steadily brought an increase of intelligence in purchasing paper and in the study of credits generally, adding to the safety of the whole transaction both for the borrower and the lender.

The commercial paper market should and does provide for the banker a means of making short time investments of a specific but flexible nature and the banker buying such paper, having carefully gone into the matter as he should, has the consciouness that the funds so employed are to be converted by the borrower into assets of an absolutely liquid character. In the case of a merchant, into new stock for the current season's business; in the case of a manufacturer, into materials which are worked into finished product. In each instance this merchandise in turn becomes accounts or bills receivable and eventually once more the cash with which the maker is enabled to meet the obligation as it matures. Long experience has shown that the banker investing a portion of his funds in this class of paper—assuming of course discretion is used in the selection of names—has in his portfolio a real liquid asset, which, even in times of greatest stress, is naturally and automatically converted into cash affording him the comforting assurance that he can depend upon this as a positive source of funds with which to meet even the extraordinary demands of his depositors at short notice.

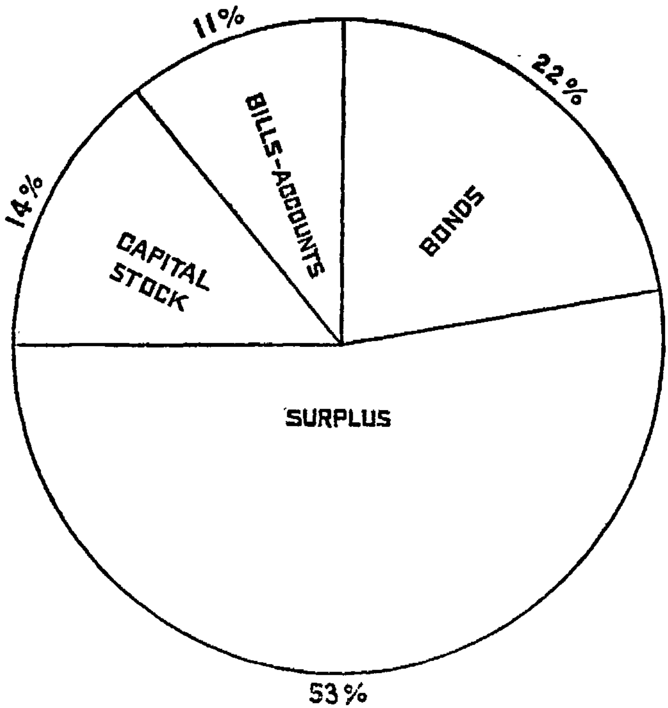
In closing it occurs to me that it may be interesting to analyze a statement of a large concern which frequently borrows money in the commercial paper market. I am presenting a balanced statement of assets and liabilities of this corporation—a large packing house—together with a statement in graphic form which will visualize their condition, showing the proportion of quick assets to current debt, and the proportion of fixed assets invested in land, buildings, equipment, etc., in which the stockholders' and bondholders' money is invested. These figures are taken from public records, in this instance from "The Commercial and Financial Chronicle."

ASSETS



Cash	3%	$ 4,356,416.
Merchandise	23%	32,550,210.
Bills and Accounts	18%	24,980,147.
Marketable Investments	4%	5,518,991.
TOTAL QUICK	48%	$ 67,405,764.
FIXED ASSETS: Land, buildings, machinery, cars, investments in allied Companies	52%	72,492,949.
Total	100%	$139,898,713.

LIABILITIES



Bills and Accounts	11%	15,405,346.
Bonds	22%	30,000,000.
Capital	14%	20,000,000.
Surplus	53%	74,493,367.
Total	100%	$139,898,713.

In round figures the assets of the Company under discussion approximate \$140,000,000, sixty-seven million odd, or 48%, in quick assets, and seventy-two million odd, or 52%, in fixed assets. Against this they had outstanding obligations as follows: Bills and Accounts Payable, fifteen million odd, or but 11%; Real Estate Mortgage Bonds issued against real estate, buildings, etc., thirty million even, or 22%, making a total debt due public of forty-five million, equal to but 33% of their total assets. The remaining capital and surplus, stockholders' money at the risk of the business, amounted to the comfortable sum of ninety-four million odd dollars, making up the remaining 67%. This is an ideal statement—an exceptional one as a matter of fact—and I am presenting it in this fashion in order to portray or visualize, if possible, their liquid condition.

Let us assume for a moment they are about to issue \$1,000,000 worth of paper maturing, say, in from four to six months. The "Bills and Accounts Payable" wedge shown in the Liability circle will be first increased or expanded by that amount, while the "Cash" wedge, shown in the circle of Assets, will be increased correspondingly. This money will then be employed in the purchase, say of hogs or beef on the hoof, thus moving naturally from the "Cash" account to the "Merchandise" wedge, temporarily enlarging it. In a short period this in turn becomes a marketable product, and in due course moves on to the wedge entitled "Accounts and Bills Receivable." My understanding is that in the packing house trade this is an unusually liquid item, all accounts being ordinarily due in from ten to thirty days, so that it is but a step further before this wedge is again automatically reduced, simultaneously enlarging the original "Cash" wedge, thus supplying in a perfectly natural way the funds to take care of and retire the original issue of paper which had gone to "Accounts and Bills Payable," it having served its full purpose. If the times covering the period of this operation have been normal, and the business well and profitably managed, it will not only before the maturity of the note return the original $1,000,000 back into the "Cash" account but will turn in $1,000,000 "plus"; that is, $1,000,000 plus the regular business profit naturally accruing to the Company in the ordinary course of its business.

Author(s): Harold L. Reed

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Author(s): Morris A. Schapiro

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Author(s): Robert F. Wallace

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