COMMODITY LOANS

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Loans secured by readily-marketable non-perishable commodities are a profitable, sound and constructive outlet for the loanable funds of commercial banks. This statement presupposes, of course, that the loans will be made in conformance with accepted and proven standards and will be surrounded with the safeguards that prudence and experience dictate.

The most common reasons for this type of borrowing are to finance seasonal production or the concentrated seasonal purchases necessary to assure a supply of commodities adequate for several months sales. The commodities which meet the collateral requirements are many and varied, may be packaged or in bulk, and range in character from cheese to coal; the records show that approximately 3,000 different types of commodities have been so employed. About 30% of field warehouse loans are made to canneries.

Many bankers have thought of these loans as being in the category of marginal credits, perhaps only one step removed from so-called "last resort" situations. Experience has long since removed them from that status. It is true that many commodity loans are made to undercapitalized businesses or to those to whom unsecured credit in the required amounts is unwarranted because of weak or unbalanced financial statements. However, these ordinarily unfavorable factors do not necessarily constitute barriers to making these loans provided the other requisite elements are present.

This type of inventory financing during the postwar period will probably differ from the pre-war variety both in the tremendous volume which may be experienced in the days ahead and in the circumstances under which such financing will be transacted. For example, the Committee for Economic Development has estimated that 23,000,000 radio receivers will be needed to meet requirements, more than 7,000,000 electric clocks, 10,000,000 electric irons, 5,000,000 electric refrigerators, 1,500,000 waffle irons, 3,000,000 washing machines and several million automobiles. These items, a host of others, and the thousands of parts that go into them will present a challenge to industry never before offered in the history of the world. A general idea of the vast amount of financing required to accomplish the indicated production and distribution job is readily apparent.

Unfortunately, not much that is authoritative is generally known about the working capital condition of business. Indications are that the working capital of companies whose net worth exceeds $1,000,000 is not only the highest on record but is also in extremely liquid form. It is not yet possible to evaluate fully what effect the impact of reconversion costs, of ultimate contract renegotiation, higher wages, and of possible decline in inventory values will have. It seems reasonable to assume that there will be some dislocation even in big business.

However, it is in the realm of the smaller companies that the effect of the postwar readjustments is anyone's guess. Undoubtedly many of them will ultimately fail and many of those that survive will require considerable financial help if stocks are to be replenished and a backlog of supply is to be built up. With the enormous volume of production anticipated, it is inevitable that they will require working capital loans far above the amounts of unsecured credit to which they are entitled. Likewise it seems obvious that in such circumstances and if the commercial banks are to maintain their traditional position of suppliers of seasonal working capital, commodity loans by banks will play an increasingly important role.

We have previously stated that such loans can be properly made despite a borrower's weak or unbalanced financial statement; I must now repeat with equal or even greater emphasis that they must also be made "in conformance with accepted and proven standards and surrounded with the safeguards that prudence and experience dictate." Although orthodox credit ratios and other usually required factors yield in preeminence to other tests, the factor of management still occupies high place. Does it know its business, is it well regarded by the trade, do its financial statements indicate progress and solvency, is the current inventory clean and readily saleable, has it thought through its present problems, and what are its plans for the future.

Both informed bankers and industrial leaders are in general agreement that the financing of inventories during the coming reconstruction period will raise questions the answers to which will be obscure, to say the least. The program will be vast and it is well known that large reserves of foods, immense stockpiles of metals, and surpluses of many other commodities owned by or earmarked for the government overhang the market. However, these are not insurmountable barriers but only factors to be considered.

The descriptive term "non-perishable" is here used to designate those commodities which do not deteriorate rapidly in storage over a period of several months, or at least during the period between their completion or ripening, and their sale. Readily-marketable goods are those which can be sold on the open market any day for cash. Wheat, corn and other grains, potatoes, hay, coal, oil and gasoline, for example, command a daily cash market. Canned goods of known standards can usually be sold by a broker without inconvenience to the lender. Goods which have a limited market and which require a sales force for their sale, cannot be considered readily marketable unless the manufacturer has non-cancellable orders from responsible buyers and, for example, they have been made up in large quantities because of resulting lower production costs, and are to be shipped and billed as required by the buyer. Collateral of this type presents unique risks such as quality of workmanship and materials, adherence to contract specifications, and the financial and moral responsibility of the buyer, all of which call for special vigilance, experience and some degree of technical knowledge on the part of the lender. In this connection it must be borne in mind that a finished product, such as machinery bearing a trade name, has a very restricted market which usually disappears completely if the manufacturer discontinues operation.

It is important to ascertain whether the borrower is over-loaded on the commodity to be pledged, and whether its market is firm. In a period of changing markets it is necessary to keep in close touch with price trends. Maintenance of adequate insurance protection against insurable potential hazards of reasonable expectancy, with proper loss payable clause in favor of the lender, is of course essential. Other safeguards are largely self-suggestive and are prompted generally by the fact that the loan is made primarily on the value and marketability of the collateral and specifically by the nature of the commodity pledged and other circumstances present in the loan.

There remains then for our consideration only one other fundamental principle of collateral lending, namely, possession and control of the collateral.

Due to the nature and bulk of commodity collateral, it cannot, of course, be stored in the bank's vaults along with the stocks, bonds, mortgages and other documentary evidences of value customarily pledged. Other arrangements must be made to safeguard the lender's interests until the loan is repaid. This requires a specialized service which can be satisfactorily obtained only through the employment of a financially responsible and experienced bonded public warehouseman who will take possession and exercise full control of the collateral and issue warehouse receipts to the lender.

There are three kinds of merchandise warehouses:

1. Dry storage warehouses, which are used primarily for the accumulation and distribution of "nonperishable" goods;
2. Cold storage warehouses, which are used for the accumulation and distribution, and frequently the financing, of "perishable" goods;
3. Field warehouses, frequently called branch warehouses, used almost exclusively for credit purposes: these have been mostly dry storage, but recently have been utilized in the cold storage of perishables.

The first two types of warehousing are frequently referred to as "terminal" warehousing. The principal difference between the terminal warehouse and the field warehouse is that in the first instance the goods to be stored are shipped to the warehouse, whereas in the case of the field type the warehouse is brought to the goods. Whether terminal warehousing or field warehousing is used is ordinarily not material to the lender so long as a bonded public warehouseman of known good reputation is employed. Each type of warehousing has its advantages and the particular choice seems to be largely a matter of convenience and economic expediency. Inasmuch as field warehousing is most frequently used in connection with commodity loans, we shall confine this discussion primarily to it.

In warehouse receipt financing, there is no substitute for the integrity and responsibility of a bona fide public warehouseman. There are several such which operate in nearly every state, who are able and experienced in the handling of all types of commodities. The requirements of the law of pledge must be complied with. Possession of and control over the goods pledged must pass from the owner of the goods to someone else. Subsidiary warehousing, whereby a dummy organization is set up by the owner of the goods to act as a warehouse company and to issue warehouse receipts against which the owner of the goods attempts to borrow money, is not good warehousing and no banker should accept such receipts as collateral.

The customary procedure is for the warehouseman to take charge of the goods and store it in the field warehouse which is usually located on the premises of the owner of the goods. The warehouse is leased from the owner by the warehouseman who them places his own bonded custodians on the premises. The goods are labeled to show the financial interest of the lender in them. The warehouseman issues a nonnegotiable warehouse receipt to the owner of the goods, which recites, however, that it is "for the account of and to be delivered without surrender of the warehouse receipt upon the written order of the" lender. The warehouseman gives the lender periodic reports on the goods in storage, thereby making it comparatively simple to watch for slow-moving or stagnant merchandise. Should there be any loss of collateral the lender can recover from the warehouseman who, in addition to his financial responsibility, is heavily bonded with warehouseman's legal liability insurance.

A lender should always ascertain whether the merchandise is what it is stated to be in the warehouse receipt. He must remember that the warehouseman stores what is deposited with him and describes it in the receipt as it is represented by the depositor. While this does not mean that the warehouseman will shut his eyes to an obvious fraud, he does not attempt to pass upon quality or type of merchandise, or the contents of packages. The amount of money to be loaned and the kind of merchandise to be loaned against is a matter for determination by the lender and should, of course, be predicated upon the scope and condition of the market and the management and reputation of the borrower. Usually loans should be margined on the basis of the price which can be realized for the merchandise on a forced sale. Smaller banks may find their correspondents' Commodity Loan Departments of considerable help in locating and advising of changes in market conditions or in disposing of repossessed collateral. Correspondents will often relieve smaller banks of excess loans of this type or make the entire loan and permit the smaller bank to purchase a participation in it. The basis for releasing pledged collateral should be determined at the time the loan is made. In this connection much depends upon the nature of the commodity and its market. Release step-ups are not unusual if the lender finds himself drifting into a position of holding odd lots of merchandise toward the end of the loan.

The field warehouse plan of collateralizing loans has been used for many years and has been tested in the courts of many states. There does not appear to be any question as to its legal status and its desirability as bank paper. State and National bank laws are becoming increasingly liberal as to the legal limits on these loans. According to the latest information available to the writer only 7 States restrict such loans to the limits prescribed for open line credits, 15 States place no limit upon such loans, while 26 States and the District of Columbia permit such loans to be made above the limits prescribed for open line credits in amounts ranging from 10% to 100% of capital and surplus conditioned upon varying margins of collateral value and types of documents. National banks are permitted to loan from 15% to 50% above the open line limit conditioned upon the margin of collateral.

Our own experience with this type of loan as observed by the Review Section has been limited and indicates that either few nonmember State banks are extending this type of credit or that the loans so made are mostly considered satisfactory by the examiner. However, we have recently had two situations develop which illustrate certain adverse potentialities present in these loans when normal safeguards and sound lending principles are ignored or deliberately violated.

Both of the banks referred to are located in the State of Georgia, were examined in January of this year, and were found to have heavy excess commodity loans purportedly secured by collateral ownership of commodities in storage or in process.

The banking laws of the State of Georgia place no limit on loans secured by field warehouse receipts provided the loans do not exceed 80% of the value of the goods pledged, the security is fully insured, and title is transferred to the lender.

Bank number 1 has assets of $1,200,000 and total capital of $56,500. On the date of examination it was lending $440,000 to a local peanut shelling company which is an interest of one of the directors of the bank. The loan was supposedly secured by a bill of sale covering farmer stock peanuts in the borrower's warehouses, also a lien on the plant and equipment valued by the management at $100,000. The inventory value of the peanuts was $373,148. All of the collateral was in the possession and under the control of the borrower. The examiner was unable to find any evidence of fire insurance coverage, although the bank reported that such coverage existed. The loan therefore was not only wholly disproportionate to the size of the bank, but also appeared both unsound and nonconforming. Fortunately the moral responsibility of all parties concerned is apparently good; the loan is now greatly reduced, well margined and insured, and seems headed for complete and satisfactory liquidation. As the result of close supervision and good salesmanship on the part of our District Office, the management has been induced to adhere to orthodox methods and sound lending policies in future similar transactions.

Bank number 2 has assets of $2,893,800 and total capital of $102,558. As of the date of examination it was lending a local cotton oil company $1,665,000 of which $1,650,000 was purportedly secured by a bill of sale of peanuts and soybeans valued at $1,619,100 all of which were in the possession and under the control of the borrower. Management is self-serving and unreliable; the loan is unsafe, undercollaterallized, and nonconforming. While the bank has sought to satisfy the State Authority and the Corporation by belated efforts to correct the situation, past performance unfortunately indicates that no confidence can be placed in its promised reform. Consequently the bank has been cited for continued unsafe and unsound practices under subsection (i) of the Federal Deposit Insurance Law.

Although these two examples illustrate some of the potential dangers which lie in this type of lending, they likewise point out that the weaknesses revealed are not flaws necessarily inherent in the plan but are primarily the results of the violation of sound lending policies, the failure to exercise ordinary business caution and prudence, and, in the second case cited, self-serving and greed carried to a point where it appears criminal.