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THE PRESENT STATE OF COMMERCIAL BANKING

It is a long settled fact that commercial banks in the United States occupy a paramount position of public trust. Accordingly, the public interest with which banking is vested has been recognized in a code of regulatory laws, devised out of hard and bitter experience, to restrain banks from engaging in rash or imprudent activities deemed to be of a kind that endangers the funds deposited in their care. The composite of individuals, businesses, and public bodies that are dependent on the commercial banking system for the protection of their deposits, and as the source of their credit needs, represents a very large sector of the entire public. In deference to this public interest factor, entry into banking is restricted to persons of proven integrity and established financial capacity who are able and willing to provide a margin of capital sufficient to absorb whatever normal losses may be incurred in the future course of the business engagements of their banks, which capital must therefore be in keeping with the total deposits entrusted to their custody. Commercial banking is a high leverage business that is operated largely through the use of depositor funds, with private capital funds making up only a relatively small proportion of the total funds employed. The disparity between the amount of a bank's capital and its depositor funds is another and vital facet of the public interest factor that attaches to commercial banking and which necessitates its public supervision and regulation. That even well-managed and carefully supervised commercial banks are not immune from or impervious to the ravages of adverse economic developments was revealed in the banking problems that marked the 1930's; and which accounted for the creation of the Federal Deposit Insurance Corporation as an agency that, by insuring

7/63. copies to Excell Thomas, Gamble Swann bank deposits, would act as a buffer to nip banking difficulties in the bud, thereby preventing their contagious spread throughout the commercial banking system. However, Federal deposit insurance was never conceived as a measure to shelter inappropriate banking practices. On the contrary, it was a clear acknowledgment that even soundly administered banks on occasion can confront adverse situations that are beyond their power to cope with unaided, but which can be surmounted, given the continued confidence of their depositors and backed by a Federally administered deposit insurance program.

The foregoing statement is meant to emphasize the inherent public nature of commercial banking which, in being entrusted to private enterprise, must meet exacting standards of performance; namely, when conducting the affairs of a bank for the advantage of private profit, the individual banker must be constantly aware of an overriding fiduciary responsibility to employ wisely the funds deposited in his care by a dependent public. The manner in which the banker should discharge his fiduciary responsibility has recently become the subject of active discussion.

A prominent and respected element of the banking fraternity has reached the conclusion that banking is undergoing an evolutionary development that has raised its lending and investing functions to a pinnacle of importance. The contribution that sound bank loans and investments can make toward national economic growth and activity is undisputed. However, a theory of commercial banking that gives primacy to aggressive lending and investing as the measure of a bank's participation in public service may risk subordinating a basic duty for protecting depositor funds to this assumed responsibility for first satisfying whatever eligible claims for credit are tendered for consideration.

A less vocal, and perhaps more temperate, element of the banking fraternity in no wise denies the economic utility of lending and investing but, in looking back over banking history, recalls that past banking problems often arose out of overambitious credit programs that, in tying up depositor funds in relatively illiquid loans and investments, eventually handicapped the commercial banking system in fulfilling its ordinary credit responsibilities and in meeting the withdrawal demands of depositors during times of economic stress. This school of bankers realizes fully that the credit facilities of the Federal Reserve System as a bank of last resort, and the background support of the Federal Deposit Insurance Corporation, stand mightily in defense against difficulties of a kind that plagued the commercial banking system in past years. Nevertheless, in the spirit of the inherited principles of private enterprise, it is their belief that banks should be as self-reliant and self-sufficient as possible and that resort to emergency relief from Federal agencies should be reserved only to rare occasions brought on by unforeseen and adverse circumstances. In keeping with this concept of banking, management considerations relating to the obligations due depositors as to the withdrawal accessibility of their funds must always outrank the claims of potential applicants for credit. Seen in this light, bank loans and investments are selected in ways that will offset and balance the kinds of deposits handled and thereby make possible a sort of automatic mechanism for meeting changes in deposit totals as they occur. In the eyes of this school of bankers, liquidity is a factor in the administration of a bank that deserves close attention. It can best be attained by matching off soundly selected assets against the various types of deposit liabilities controlled, with resort to emergency relief from a Federal agency becoming only a minimum possibility.

Bankers of this persuasion have little enthusiasm for proposed amendments to the Federal banking statutes that would relax existing lending and investing standards by permitting practices that tend to reduce, rather than strengthen, the factor of liquidity. Even within the limits of present legislation there has been a definite movement toward longer-term extensions of credit made against lower margins of equity, at the expense of somewhat lower liquidity standards.

Whether concern about an evolution in banking practices that singles out the credit function as being all important is justified will remain for history to record. However, pause should be taken to scrutinize some of the ramifications of these developments. It is a fair question to ask whether it is preferable for a bank whose business is largely conducted through the use of depositor funds, which in effect are borrowed monies, to operate almost exclusively within the deposit resources at its disposal, or whether it should further expand its activities by borrowing through the vehicle of negotiable time certificates of deposit or through the broad use of the Federal funds market. Is some degree of self-sufficiency sacrificed by such recourse to the use of borrowed funds, and can a harmful overexpansion of credit result? Along similar lines, is it proper for a bank to provide only a margin of private capital to secure its operations, as compared to its far larger use of depositor funds, to issue capital debentures or preferred stock, rather than to increase its common capital shares as an earnest of willingness to maintain a basic capital structure that is adequate of itself and senior to all claims except those of depositors? Passing on to the field of international finance, is it possible that the scope of banking practices now in vogue here and abroad, which involve heavy bank borrowings in both short- and long-term markets, is building a fragile and pyramidal structure of credit that rests on a too narrow base of equity capital and is overly dependent on a credit supported system of values and a reciprocating renewal of outstanding credits that are not of a freely self-liquidating character? Is too much importance laid on the advantages of credit and too little on the virtues of capital formation through the function of saving?

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