

The Banker's Responsibility



Address delivered by

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IF THE economic life of the country be compared to the automobile, the natural resources represent the machinery and human endeavor the fuel. The function of the banking system in this machine would be to provide proper lubrication. Banks can not create natural resources nor can they be a substitute for human labor, but they can work toward a more efficient use of resources and a more effective application of labor and thereby contribute to a smoother and more even working of the mechanism to prevent overheated parts and possible explosions.

There is nothing in the country's business life that approaches the banks in the wide-spread influence of their activities which are not confined to any particular line of commerce or industry but reach and influence all lines of endeavor. It is for this reason that banking can not be considered as a purely private business and so banks are supervised by Government agencies and regulated by statutory limitations.

Essentially, the function of a bank is to convert a person's ability to pay in the future into ability to pay at once. A storekeeper who wishes to lay in a stock of goods may not be in a position to pay for all of them at the time, but will be able to pay for them after some of the goods have been sold to the public. It is the bank's function, by lending him money, to enable him to convert his future paying capacity into present paying capacity. This is a

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simple and fundamental function. It involves no great or complicated mechanism and contains no mysteries in its workings. The great Dunbar said many years ago: "These functions imply no very complex operations. They require prudence, integrity, and patience, but they have no mystery."

With this definition of the primary functions of banks in mind, let me analyze the nature and order of importance of their responsibilities. First and foremost, their responsibility is to their depositors who have entrusted them with funds and are entitled to receive them either on demand or on dates stated in their deposit contract. In order to provide additional safeguard for the interests of the depositors, the owners of the banks contribute capital, and to this they gradually add undistributed profits in the form of surplus. These funds, placed by the owners of the business in a bank, vouch for the good faith of the proprietors. They are also a buffer between the banks' liabilities to their depositors and their claims on their borrowers. An adequate proportion of capital funds is, therefore, essential to the discharge of a banker's responsibilities.

More important, however, than the capital contribution is the exercise of care in making loans and buying investments. A bad loan is rarely a kindness to the borrower. Too many bad loans are a betrayal of the trust placed in the banks by the depositors. Therefore, the banker must discharge his responsibility to depositors by a careful scrutiny of his loans. If it were possible for a banker to confine all his

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advances in his own community to conservative and safe loans based upon production and distribution, with the assurance of assistance from the Federal reserve bank for seasonal and emergency requirements, there could be no serious objection to his conducting his institution in such a manner. However, I know from my own experience that loans of this character are not always available and even if they were available, such a policy would result in the banker having his deposits employed only a part of the time.

Loans of a capital or speculative nature made locally, even though they are good, do not always represent good banking. A bank should not be entirely dependent for solvency on developments in its own community, but should, in the great majority of cases, carry secondary reserves in the form of liquid investments—funds placed on deposit with out-of-town banks, commercial paper, bankers' acceptances or security loans the liquidity of which depends upon the marketability of the securities back of the loan. A certain proportion of funds not directly dependent upon the developments in a community has come to be considered as a fundamental condition of sound banking.

Second to the banker's responsibility to his depositors is his responsibility to the bank's stockholders. They have contributed capital to the enterprise and are entitled to as large a return on this capital as can be obtained by safe and legitimate use of the funds. It is the universal acceptance of the priority of the

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depositors' claims over those of the stockholders that indicates the extent to which a bank is a public utility. Fortunately, however, the concern of stockholders about bad loans is greater than that of the depositors; in fact, depositors begin to be concerned about bad loans only when their magnitude is such as to endanger the bank's ability to meet its liabilities. Stockholders, on the other hand, are constantly interested in the success of the bank's operations, because every profit made by the bank increases the value of the stockholders' equity in the business.

Responsibility of banks does not end with their depositors and stockholders. Banks also have a responsibility to the community in which they are located and from which they derive their deposits. If a bank invests all of its deposits in outside loans and securities, it is not fair to its community. If its outside loans and investments are safe and profitable, it is dealing fairly with its depositors and stockholders, but it fails in its responsibility to its own community. In so far as the use of a bank's funds in its own community is consistent with safety, local industries and enterprises are entitled to the first claim on these funds. This does not mean that bankers must be philanthropists. It simply means that their self-interest must be intelligent and farsighted. For if a community should be constantly deprived of its funds by investment outside, sooner or later this is bound to arrest its growth and prosperity. Ultimately it would lead to a drying up of the flow of deposits which supplied the bank with

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funds for its operations. The responsibility of the banker to his community is an application of enlightened self-interest. In popular parlance, the banker must play the game and do his bit in the community's work.

At this point I want to consider in what way the Federal reserve banks enter into the picture. Their capital, as you know, is supplied by their members. They are in substance a coöperative enterprise among banks for the purpose of taking care of seasonal and emergency needs for credit and currency. They prevent excessive strains by lending the support of the financial strength of the entire System to the needs of any community that requires and is entitled to it. Even more than the commercial banks, the Federal reserve banks are public institutions and the public interest is paramount in their responsibilities.

It is the business of the reserve banks to see to it that there is no shadow of doubt cast upon the validity of their note issue. The reserve banks must also safeguard their own deposits, which are the reserves of the other banks. These deposits must be used in such a way as not to permit the slightest doubt of their immediate availability upon demand. It is for this reason that the Federal Reserve Act prescribes rigid limitations about the use of reserve bank funds. While the direct responsibility of the reserve banks on deposits is to their member banks, it goes beyond that. It extends to the depositors of the member banks, because the safety of their funds depends to a certain extent upon the safety of their

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reserves carried with the reserve banks. Back of these reserve balances of the member banks are the reserves of the reserve banks themselves. These are the ultimate reserve basis of our entire banking structure. An all-important responsibility of the Federal Reserve System is the conservation of these reserves upon a proper gold basis.

At the risk of tiring you by stating what you already know, I remind you that for \$100 of deposits carried by a member bank, the reserve bank receives on the average about \$7.50 as a reserve balance. Against this reserve balance of \$7.50 the reserve bank must hold about \$2.50 in gold or lawful money. Thus the \$2.50 held by a reserve bank is the basis of \$100 of member bank credit. This in turn may be the basis of a still larger amount of non-member bank credit, because a large part of the reserves of non-member banks is held with member banks. This apparently narrow base of our credit structure is sufficient for safety only because of the coöperation of the banks through the Federal Reserve System. It emphasizes the extent of the responsibility of the reserve banks in protecting these reserves. The reserve banks must take a far-sighted view of the needs of the community and must maintain a stock of gold sufficient to provide for the country's growing needs.

It is, therefore, a responsibility of the Federal Reserve System to shape its policy in such a manner as to protect our gold reserves against too rapid depletion. During the past year, we lost \$500,000,000 in gold, and no one knows whether the redistribution

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of gold has been completed or whether the United States will lose additional gold to the rest of the world. Our gold reserves at the present time are \$1,000,000,000 in excess of the legal requirements and it is fortunate that they are, because it puts the bankers in a position to handle further export movements of gold if they should develop and to meet the growing credit needs of the country. The loss of gold for the past year has been a desirable thing, not only from the point of view of those who received it and used it as the basis of monetary reconstruction, but also from the point of view of the United States. It has removed from the foreign trade of the United States the risks arising from unstable exchanges and disorganized conditions among its foreign customers. The Reserve System's responsibility is to make such use of its reserves as are in the interests of the country in the broadest sense of the word. This involves close attention to developments both here and abroad and makes the framing of Federal reserve policies not only a matter of national but of international importance of the first magnitude.

The Federal Reserve System has also a measure of responsibility for the rapidity of the growth of bank credit in this country, although the experience of the last 14 years has demonstrated conclusively that this movement frequently attains such momentum that it is some time before Federal reserve policies become effective. You are familiar with the methods at the disposal of the Reserve System to accomplish these ends. They are primarily changes in discount and

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open-market rates and open-market policies in the purchase and sale of Government securities. Through these means the System can be an influence toward easier or tighter conditions in the money market, even though the influence may be slow in operating. It can, therefore, to a certain extent, encourage or discourage the growth of bank credit. All loans and investments of the member banks result in the creation of deposits. The growth of deposits in turn increases reserve requirements of member banks and when these are met by rediscounting, reserve policies and rates begin to be effective. It is a mistake, therefore, to assume that only one or another class of loans or investments may be supported by the reserve banks, while other classes of loans and investments may not.

Since the Federal reserve banks furnish the basis of credit growth in any field, whether it be commerce, industry, agriculture or the trading in securities, the Reserve System feels concern about excessive growth in any line of credit. It is impossible for a reserve bank to earmark the credit it releases, but when too rapid growth in any line of credit threatens to upset the financial structure of the country and make undue demands on the reserve funds, which should be conserved for the legitimate growth of the country's business, the Reserve System can properly use its influence against these undesirable developments.

Within the limits of its powers, the responsibility of the Federal Reserve System is for the credit structure as a whole. A healthy banking situation must

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be forever the primary concern of the managers of the Federal reserve banks and of the Federal Reserve Board. These responsibilities are sufficient to require our best efforts in the determination of the wise course of action. This is one of the reasons why it would be unfortunate if the Federal Reserve System were to be charged with still further responsibilities which are not directly related to banking, such as responsibility for the stability of the general price level or for the moderation of ups and downs in business conditions. It is my conviction, and I want to leave this thought with you in conclusion, that a healthy banking situation is the best guarantee of a healthy economic development in so far as it depends on the use of bank credit. It is towards sound banking conditions that the Federal reserve banks must work in coöperation with their member banks and with other banks which are a part of our banking structure. In my opinion, the country's entire banking system, from the smallest country bank to the greatest financial institution, and this includes the Federal Reserve System, can best discharge its public responsibility by concentrating its efforts on the maintenance of sound banking conditions.