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The Improvement of Credit Department Methods in Member and Reserve Banks

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Financial history can be divided into three eras—the era of barter, the era of money, and the era of credit. We are at present in the era of credit, and at a time when the financial statement of the borrower is an absolute necessity. When we look at it now, it seems strange that twenty-six years ago there was no such thing in existence in this country as an organized credit department in a bank. For many years previous to this, business houses, doing business on credit, had organized credit departments and were making a more or less successful effort in getting statements from customers, yet though banks were lending large sums of money, and in some cases were getting what purported to be statements of the borrowers, they had no credit departments, to which these statements were sent, analyzed, and what we may call "standardized" for comparison from year to year.

I have been unable to find a record of any bank that had a credit department prior to the year 1890. About this time, some of the large banks in the East, doubtless made uneasy by the expansion of credit that preceded the panic of 1893, were led to establish credit departments for their protection. It is probably safe to say that the banks, which had taken this precaution, were in better condition to stand the stress when it came than those which had not so acted. Perhaps it was the panic of 1893 that caused the awakening. Anyhow, from that time on, the development of organized credit departments in banks in large centers was comparatively rapid. They realized that the old way of coming to a general conclusion as to the status of a borrower, based on more or less haphazard statements and investigations, confirmed by the general knowledge of the discount committee and board of directors, was dangerous. They saw that definite, tangible information was necessary, and realized that it was well worth while to have men whose business it was to get this information and keep it up to date. The larger banks have realized the situation for a number of years, but the smaller or country banks, have not yet come to a complete realization of the necessity of credit records.

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Prior to the opening of the Federal Reserve Banks on November 16, 1914, I had talked to many country banks throughout the United States and while as a rule they would agree that credit records were a good thing, they seldom seemed to think it was worth while making any effort to establish them in their banks. Of course, every bank that ever made a loan had something in the nature of a credit department, but, in the majority of cases, it was a nook in the cashier's brain, and it is self-evident that such a department was sure at times to have information much too general.

When the Federal Reserve Board issued the regulation, warning all members of the Federal Reserve System that, in time, it would desire statements from the makers of all notes offered for rediscount, a great step was made toward having all member banks, at least, establish credit departments. This first circular was issued by the board on November 10, 1914. In its Circular No. 3, Regulation B, Series of 1915, issued January 25th, which superseded this circular, the following is contained:

> "It is recommended that every member bank maintain a file which shall contain original signed statements of the financial condition of borrowers, or true copies thereof, certified by a member bank or by a notary public designating where the original statement is on file. Statements should contain all the information essential to a clear and correct knowledge of the borrower's credit and of his method of borrowing."

In an appendix to this circular is given the information that is desired in credit files of member banks, as follows:

> "The credit files of member banks, referred to in the above regulation, should include information concerning the following matters:
>
> (a) The nature of the business or occupation of the borrower;
>
> (b) if an individual, information as to his indebtedness and his financial responsibility;
>
> (c) If a firm or corporation, a balance sheet showing quick assets, slow assets, permanent or fixed assets, current liabilities and accounts, short-term loans, long-term loans, capital and surplus;
>
> (d) All contingent liabilities, such as indorsements, guaranties, etc.;
>
> (e) Particulars respecting any mortgage debt and whether there is any lien on current assets;
>
> (f) Such other information as may be necessary to determine whether the borrower is entitled to credit in the form of a short-term loan."

This, at least, set up a standard, showing the character of the information that it was thought wise should be carried on the credit records of all banks.

The first thing the Federal Reserve Banks had to do, when they were established, was to open up credit departments, since it was self-evident that they should not accept rediscounts without having credit information, at least concerning their member banks. Every Federal Reserve Bank found that it had two classes of member banks to deal with—first, the banks in the large cities, all of which had some kind of credit departments, and some of which had highly developed credit departments; and second, the country banks, the majority of which were operating under the old system of having the entire credit department in the cashier's brain. The problem before the Federal Reserve Banks then, was: first, to establish their own credit departments, knowing that the larger banks could furnish credit information; and, second, to educate the country banks to realize the necessity of and help them inaugurate the plan of keeping credit records. It seems strange that the requirement of a statement from customers should have been considered by many of them as a hardship and caused the cry to go up that there was too much "red-tape" in the system. However, it has not been so long ago that even a borrower in a large city could be found, who, when asked for a statement, would draw himself up and act as if insulted, and this is still the attitude of those in small centers, who have not been helped to a realization of the need of a statement by their local banks. I might state here that, while the regulations of the Federal Reserve Board, under certain conditions, waived statements at the inauguration of the system, the Federal Reserve Bank of St. Louis felt that it could not do a higher service to the community than that of requiring statements to accompany all notes offered to it for rediscount. It felt that the sooner this was the custom in its district, the easier it would be for the banks and the better for the district. The consequence is that we have never accepted a note for rediscount that was not accompanied by a statement in regard to the maker or of the party, such as an endorser, upon whose credit the local bank granted the loan. We have tried to have a signed statement of the maker of the note, but where this was impossible, upon the theory that the local bank did not grant a loan without knowing something about the borrower, where necessary, have accepted a statement made by the bank on behalf of the borrower, giving approximately what he owned and what he owed. It is extremely gratifying to report that, with many banks, the trouble they anticipated in getting statements from farmers and other borrowers was never realized. In fact, where the bank has asked for such statements tactfully, as a rule, they have succeeded in getting them. It is also interesting to find out from experience that the statement has frequently been of even more benefit to the maker of the statement than to the bank that required it. If there were time, interesting experiences could be told in regard to this.

Reduced to their simplest terms, the problems have been:

First. To get the large city banks, which already maintained credit departments, to require their customers, who in the main have very large businesses, to give more satisfactory statements. I think it is fair to say that, in the last year, many commercial houses have been taught to make better and more nearly uniform statements of condition than heretofore they have thought necessary. There is a decided tendency toward requiring an audited statement from commercial houses, and these interests, themselves, are beginning to see the wisdom of it.

Second. It has been necessary to convince the country banks that general statements of condition of customers are dangerous, that from their smaller local business interests a signed statement from the books is necessary, and that it is as necessary for the farmer to give a statement as for any other business man in the community to do so.

Finally, the Federal Reserve Banks have had to establish credit departments of the very highest efficiency possible.

There are certain essentials which it is necessary to know before a conclusion can be reached as to the credit standing of anyone. They are as follows:

First. It is necessary to know the man, his moral responsibility, and his business methods.

Second. The business, its character and relation to the community, whether the capital is sufficient under the circumstances; what proportion is fixed and what proportion circulating or liquid. Does it keep its liabilities well within its assets?

Third. Will the man, firm or corporation, plus that particular business, result in profits and the payment of obligations? It is the duty of any credit department to find out these things, not any one of them, but all of them. Its duty is to gather the data, analyze and systematize it, so that conclusions can be promptly reached.

In order to get these essentials of credit information, banks must get certain data, and I believe that all the information necessary can be gathered from the following sources:

First. The record of past experiences with the borrower, whether interest was paid promptly and principal met at maturity, the extensions asked for, etc.;

Second. The average monthly balances of the depositor who is a borrower;

Third. The statement of condition furnished by the borrower, and;

Fourth. The replies to inquiries made through correspondence in regard to the borrower and his business; the result of personal investigation among the trade; clippings from newspaper, and agency reports.

Sources one and two, above mentioned, are within the bank, and a good way to keep a record of the loans and average monthly balances is by cards. The third source, is a statement of condition of the borrower, and the fourth source, is work of the credit department, itself, acting as an investigator. This data should be systematized and kept up to date, so that whenever a loan is presented, the second time, it takes but an instant's reference to the records for the bank to come to a conclusion as to whether it is a good loan or not.

Statements of condition that come to a bank are made by the business men of the community, and when I say business men, I mean to include farmers. For some reason, the latter have too long been considered in a class by themselves, when, in reality, the operation of a farm, to make a living, is as much of a business as the manufacturing of steel. These statements should not be so long as to be burdensome to the one making them out or to the one who has to analyze them, but it is necessary that they be thorough and give the essential information. They should also be as nearly uniform as is practicable. A great step towards uniformity of statements was made by the establishment of the Federal Reserve Banks. For instance, the Federal Reserve Bank of St. Louis, in order to have uniform statements used throughout its district, has with great care prepared three forms of statements, which are believed to be applicable to all characters of business arising in this district. Since in agricultural communities particularly, the getting of statements was in the nature of pioneer work, our farmer's statement is in as simple a form, and still thorough, as we know how to devise. It contains no such words as "credit" and "debit" or "quick assets" and "current liabilities," but simply asks that the farmer put down what he owns and what he owes. Our second form of statement is for use by merchants, whether individuals, corporations, or partnerships. Our other form of statement is for use by manufacturers, miners, quarriers and other producers. These last two statements are very nearly the same in wording, but the latter statement asks for a little more information than the former, such as raw material, machinery and fixtures used in the business, and one or two other items. These statements also include the profit and loss account, not in the usual form, but asking for the debits and credits in this account, so that the way the profit and loss is arrived at is shown by the figures. In the merchant's statement, we also ask for merchandise purchased since last statement and merchandise sold. This gives us the "turn-over" and also serves as a check on the profit and loss statement.

I do not mean to say that our statements are the best that can be devised, but, as they are furnished free to all member banks of the St. Louis district, which in turn distribute them to their customers, we are getting established uniform statements in this district. As the system develops, it would seem that it might be advisable for the twelve Federal Reserve Banks to come together and agree on uniform statements to be used for the different characters of business. This is a practicable way by which uniform statements can be introduced throughout the United States; for non-member banks that wish to keep themselves in safe condition will see the wisdom of also requiring statements from customers, and I believe will follow the standards suggested by the Federal Reserve Banks.

As I have intimated, in my judgment, it is necessary that the Federal Reserve Banks have established what may be called model credit departments. They should be as nearly perfect as possible in every detail. These departments have to analyze two types of statements—first, the statements of the makers of the notes, which come through the local bank to the Federal Reserve Bank; and second, the statements of the member banks, which endorse the paper offered for rediscount.

These credit departments have to know two things about the offerings—first, is the paper eligible commercial paper under the Federal Reserve Act; and second, is it safe? Before the paper can be accepted for rediscount by a Federal Reserve Bank, it must be both eligible and safe. Two factors are looked for in all statements—current liabilities and quick assets, and any statement of condition to be in satisfactory form, must give sufficient information to allow the credit department to arrive at these two items with accuracy. Those who are familiar with credits, know the controversies that arise in such business as the lumber business, the mining business, etc., as to what constitute quick assets. If you do not wish to have the miner count coal in the ground as a quick asset, you must have a line in your statement so worded that he will not include this, or, if he does include it, the statement must be clear to that effect.

The statements of customers, which come into a bank, should, of course, be standardized on forms which the bank uses, so that a statement of one year can be compared with the statements of other years. This standardization will be much easier when the statements of customers become more uniform.

The Federal Reserve Bank, also, has to analyze and standardize, for comparison, the reports of condition that come in from member banks. Federal Reserve Banks receive copies of reports of condition as called for by the comptroller of the currency. Since the method in use by the Federal Reserve Bank of St. Louis, for analyzing and standardizing the statements of member banks through one operation, is, as I believe, absolutely new and not in use in any other place in this country, I am going to describe it somewhat in detail. This method I think I can say was invented by T. C. Tupper, vice-chairman and deputy federal reserve agent of the Federal Reserve Bank of St. Louis, who is in charge of our credits. In order to put it into effect, he uses a Burroughs standard statement machine. The blanks are printed in size 13¼ inches long and 10¼ inches wide. They contain four columns, so that information gathered from four separate reports of condition can be inserted. These blanks contain thirty-one items, set out under each other as follows:

QUICK ASSETS:

1. Cash and Exchange
2. Loans and Discounts
3. Overdrafts
4. United States Bonds
5. Bonds and Securities
6. Total Quick S

LIABILITIES:

7. Circulation
8. Due to Banks
9. Individual Deposits, Demand
10. Individual Deposits, Time
11. Rediscounts
12. Bills Payable
13. Bonds Borrowed
14. Margin in Quick S

FIXED ASSETS:

15. Banking House
16. Furniture and Fixtures
17. Other Real Estate
18. Other Assets
19. T
20. Capital
21. Surplus and Profits
22. Total Capital and Surplus S

INVESTED:

23. In Banking House
24. In Furniture and Fixtures
25. In Other Real Estate
26. In Bonds and Securities
27. In Loans and Disc. T

DIRECTORS' LIABILITY:

28. Direct
29. Indirect
30. Statutory Bad Debts
31. Other overdue Paper

The first five items under quick assets are listed on the machine and the sub-total key pushed down, which prints the total quick assets on the sheet. Then the subtracting key is set and items 7 to 13, inclusive, are printed. This makes the machine deduct the liabilities from quick assets. Then the sub-total key is pushed again, and this gives item 14, "Margin in Quick." Then, under fixed assets, items 15 to 18, inclusive, are printed and the key for totals pushed and the amount printed, thus clearing the machine. This gives the margin in quick plus fixed assets. Then items 20 and 21 are printed, giving item 22, "Total Capital and Surplus," which should be the same as the sum of the margin in quick plus fixed assets as given above. This affords a machine proof of the analysis. When item 22, "Total Capital and Surplus," is printed, the sub-total key is pushed down, the substracting key is set, and then items 23 to 26, inclusive, are printed. Then the total key is pushed down, and the result gives that proportion of the capital which is invested in loans and discounts. This last figure is the amount of paper that the bank has, which even if bad, leaves the bank solvent for its debts. This operation also clears the machine. Then items 28 to 31 are printed on the machine, no total being taken.

On the back of these statement blanks are lines on which to insert the names of the officers and directors of the bank, also columns to show for four years the comparison of the following items:

Earnings, after deducting losses and expenses;
Dividends paid during year;
Net earnings, or surplus after payment dividends.

This gives an accurate analysis of the bank's condition so standardized that it is easy to compare the figures from year to year. The method also saves a great deal of time, since, as the statements come in, the head of the credit department can mark them, for instance, item 1 on the form above mentioned includes 10 to 20 on the report of condition made out in the comptroller's form. This insures that the report to the comptroller is carefully gone over by someone who thoroughly understands credits, and after these reports are so gone over and marked, they can be turned over to any clerk who can run an adding machine, and the form that we have adopted be filled out. These, what we may call standardized forms, are kept in a looseleaf binder and from them, at a glance, the condition of any member bank can be obtained any instant.

I have mentioned this method in detail, because we have used it for quite a little time now and have found it thoroughly effective and a great saver of time. We believe that by applying the same principles, a similar machine analysis and standardization can be made of statements of condition of all borrowers of money. As yet, however, we have not found that statements of the same borrowers are coming before us with sufficient regularity to make it advisable to use this method on them.

The National Association of Credit Men has done most excellent work in the way of getting credit information. Several years ago it issued an argument for the requirement of statements of condition from all those who do business on credit and the influence of the association has had great effect in developing proper credit standards.

The Federal Reserve System has already demonstrated that it is effective, and I believe that one of the greatest results of its establishment, though perhaps an indirect one, will be seen in the improvement in business methods of business concerns, manufacturers, farmers, etc., in the community. Its leadership in asking for statements of condition will help all those, who extend credit, to require such statements, and the farmer, firm or corporation, that gets in the habit of at least once a year expressing an actual financial condition in cold figures, will immediately improve business methods. An accurate statement may bring about a change of policy, which will turn the business from a losing business to a successful one. If the individual business man or farmer sees in black and white his condition and does not continue guessing at it, as is too often done now, he will commence to stop the small leaks and will make money by saving it. In fact, proper credit departments in member banks and Federal Reserve Banks mean the proper keeping of accurate records by business interests in general, and this, in turn, means safe business and profitable business, and a great gain for the whole community.

Standards

The fact that they are honored more in the breach than in the observance does not diminish the value of standards,—they are there just the same, and men gradually learn to recognize them. Take the standards of credit practices. Many may smile at the statement of standards set out as expressing the requirements of good order in business and credits, yet it is necessary to have these standards to guide when the break comes, and violations, conscious or unconscious, of the laws of business and credits, have brought in full force their demoralizing effects.

This is why the Association undertook to frame canons of commercial ethics; not with the expectation that they are going to be conformed with, or their value and necessity fully recognized, but because a clear statement of standards is good to have. Year in and year out the successful credit grantor can measure his success in the proportion that he has observed consciously good standards.

The Special Committee on Credit Ethics offers the Eighth Canon of Commercial Ethics. It is thoroughly sound and its observance will insure health, clean conscience and good order to those who observe it.

> "The stability of commerce and credits rests upon honorable methods and practices of business men in their relations with one another, and it is improper for one creditor to obtain or seek to obtain a preference over other creditors of equal standing from the estate of an insolvent debtor, for in so doing he takes, or endeavors to take, more than his just proportion of the estate, and therefore what properly belongs to others."

The seven preceding articles of the Canons of Commercial Ethics can be found on page 34 of the January, 1915, "Bulletin."