

THE BANKER AND THE PUBLIC

Address of MILTON C. ELLIOTT
To be delivered at meeting of Texas Bankers Association
at Houston, Texas - May the 2d.

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MR. PRESIDENT AND MEMBERS OF THE TEXAS BANKERS ASSOCIATION:

One of the incidental benefits that may be said to have resulted from the passage of the Federal Reserve Act is that it has awakened both the banker and the public to a realization of the true relations that exist between them. The banker in studying the whys and wherefores of this legislation has necessarily viewed the subject of banking from a broader and more comprehensive standpoint and has appreciated more fully than ever the public responsibility that he assumes when he undertakes the management of a bank. The public has been awakened to a realization of the vitally important part that banking plays in the commercial life of the nation.

In recent years there has been a tendency to look upon banks as purely private corporations organized for individual profit, and under what we have called our banking system the right to start a bank has been regarded as an inherent right of every citizen. To challenge the right of any set of men to charter a bank if they can provide or procure the necessary capital would probably be regarded as unreasonable as to challenge the right of the same individuals to charter a corporation to manufacture shoes.

When we turn back the pages of history, however, we find that in their inception the incorporation of banking institutions

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was looked upon with fear and suspicion. The States were reluctant to grant charters and those that were granted contained exacting restrictions. The right of the Federal Government to incorporate a bank was the subject of litigation and bitter controversy for a number of years.

The great State of Texas, as you will no doubt recall, came into the Union with a provision in its Constitution -

"That no corporate body shall hereafter be created, renewed, or extended with banking or discounting privileges * * *. The legislature shall prohibit by law individuals from issuing bills, checks, promissory notes, or other paper to circulate as money."

As you know, it was not until 1903 that the legislature of Texas provided for the submission to popular vote of an amendment to the Constitution authorizing the incorporation of banks. This amendment was adopted in November, 1904, and in 1905 a general banking law was enacted under which banks might be incorporated. It seems that as late as 1852 there were no banks in Florida, Texas, Arkansas, Illinois, Wisconsin, Iowa, Minnesota, Oregon, California, and the District of Columbia.

One conception of banking advocated in the early days appears to have been that it should be conducted solely for the benefit of the public; that the profits from this business, like the revenue derived from taxation or from the collection of duties on imports, should be paid into the public treasury for the benefit of the people.

In the History of Banking in the United States by the late professor Sumner of Yale, he says, in speaking of the early banking

institutions -

"We observe that a bank was conceived of primarily as a means of creating wealth. Every one wanted to share in its beneficent operation. If the legislature created it, all the people ought to participate in its blessings."

Later in discussing the debates in Congress on the subject of renewal of the charter of the first Bank of the United States which expired in 1811, he says that -

"Nicholas of Virginia moved that 'provision be made by law for a general national establishment of banks throughout the United States, and that the profits arising from the same, together with such surpluses of revenue as may accrue, be appropriated for the general welfare, in the construction of public roads and canals, and the establishment of seminaries for education throughout the United States'."

When we contrast the attitude of the public in these early days with that of the present time, it is obvious that the pendulum has swung to the other extreme, and that the private interest of the stockholder or owner often overshadows the public responsibility that is involved in the management of a bank.

While the incorporators may take into consideration the needs of a community before undertaking to open a new bank, this is frequently a matter of business judgment from the standpoint of the prospective owner or stockholder. The State or Federal authorities may likewise make an investigation of the local banking facilities before granting a charter to a new bank, but here again the question to be determined is primarily whether the community can support another bank. When the charter has been obtained and a bank is opened for business other considerations than that of the service

to be rendered to the public are at times regarded as of first importance.

Competition with other banking associations naturally becomes an important factor. While this competition is no doubt desirable in so far as it encourages the officers and directors to build up and strengthen a bank, it becomes a dangerous element when these officers and directors lose sight of their public responsibility and view the success or failure of the bank solely from the standpoint of the amount of dividends that may be earned, or when they fall into the popular fallacy of judging the strength of a bank solely from its size as indicated by its balance sheet. It is, of course, true that a bank's earnings and the volume of its resources are both important elements in determining its success, whether we view the subject from the standpoint of the public or from that of the shareholder. It is, however, the source of its earnings in which the public is interested and the causes of the increase of its deposits. A bank may increase its earnings by speculative investments or by charging excessive rates of interest on doubtful risks. It may purchase deposits by paying a greater rate of interest than its business justifies. It may exceed its corporate powers but by the transaction may net a profit. In any of these cases its statement of condition may indicate success if we are to judge by the apparent results obtained. It is obvious, however, that a bank with good luck may increase both its earnings and its resources but may be operated without consideration of its public responsibility.

It is true that such instances are rare and yet we not infrequently hear bankers say that the administrative officers of the Government should limit their inquiries to the financial condition of the bank, and if it is solvent and its capital is unimpaired, it constitutes an illegal assumption of authority for an administrative officer to inquire into those operations which brought about improvement in its financial condition. When we analyze the business of banking, however, is it not true that the public has a very vital interest in each and every operation? And is not the assumption that banks are purely private corporations organized for the individual profit of the shareholder just as extreme a view as the early conception that the profits arising from this business should be paid into the public treasury? And is it not true that all administrative officers must take into consideration the public responsibility of banks and bankers when they are called upon to make rulings as to the operations of the banks?

I, of course, do not mean to suggest that bankers, as a general rule, look upon their institutions as organized solely for the profit of the shareholders. On the contrary, there is an increasing tendency on the part of the officers and directors of banks to consider general and not merely local conditions in the conduct of the banking business. Bankers are brought into such close and intimate contact with all commercial and industrial activities they are naturally alive to the interest of their communities. They must constantly study general conditions in

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order to anticipate the needs of the public. There are perhaps no set of men who have occasion to consider and do consider the public welfare as extensively as the officers and directors of our banking institutions. The public, however, has an interest in each individual operation of a bank as well as in the net result of these operations, and it is this fact that is sometimes lost sight of.

The comparatively few adverse criticisms of the Federal Reserve Act appear to be based primarily upon objections which indicate that those indulging in criticism have considered the private and not the public character of the banking business. For example, among the important provisions of the Act are those which relate to the collection and clearance of checks, and which authorize Federal reserve banks and the Federal Reserve Board to perform the functions of clearing houses. There is perhaps no operation of the banking business which better illustrates the public responsibilities assumed than that which the banker undertakes when he performs the service of collecting checks and other items payable elsewhere than at the counters of the bank.

Viewing the matter from the standpoint of public service it would seem that if the efficiency of this service can be increased by the adoption of a more direct and scientific method of handling these items, such a method should be welcomed, by the banker; and yet it appears that one of the principle objections urged against the system provided by the Federal Reserve Act is that the bankers are afraid the operations of this system will curtail their earnings from collection and exchange charges. Assuming this to be true,

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is not the objection based upon the assumption that the shareholders are entitled to receive these charges for the service performed, whether or not this service can be rendered by more direct methods on a basis which would benefit the public ? Is it not true that this objection is based upon the fact, that a clear conflict results between the interest of the shareholder and the interest of the general public.

It is not my purpose to undertake to discuss in detail the intricate operations that are involved in our present system of check collections and clearances, but as bearing upon the question of the bank's responsibility in these matters and of its duty to the public there are certain elementary principles involved, a discussion of which may serve to illustrate the necessity for the perfection of a more scientific system. Various experts are at work on plans designed to precipitate what they call the "float"; that is to say, to reduce the number and volume of items that are constantly in transit. These experts may not be agreed as to the details of operation which will best accomplish this purpose, but they apparently are agreed as to the necessity for improving this service by the adoption of more scientific methods. They are also more or less agreed that any system must have the cooperation of the banker in order to reach its greatest efficiency, and from the layman's standpoint it seems obvious that defects which are known to exist should be corrected, and that the correction of such defects should be brought about by the cooperation of the bankers rather than by corrective legislation.

In discussing the principles involved, my excuse for referring to certain elementary factors before an audience of this kind is that all banking operations are so closely inter-related it is difficult to discuss any one operation without considering the fundamental though well-known principles that are involved in that particular operation.

Under the Act of March 14, 1900, which amended Section 5211 Revised Statutes of the United States the gold dollar is established as the standard unit of value and all forms of money issued or coined by the United States must be maintained at a parity of value with this standard. The silver dollar, fractional and minor coins are made legal tender by statute within certain limitations and certain notes of the United States are likewise made legal tender. The volume of this form of currency or money, however, is, of course, inadequate to carry on the enormous commercial business of the United States, and bank credit as a medium of exchange takes the place of money in a very large proportion of our commercial business.

As the text writers express it -

"A bank has been aptly defined as a manufactory of credit and a machine for facilitating exchanges. It manufactures credit by accepting the business prospects of its customers as security in exchange for its own bank credit in the form of a deposit account. Business credit cannot be conveniently used for current business transactions, but bank credit in the form of checks and drafts is widely acceptable and is the actual medium of exchange for a large part of the community."

While a great many obligations are discharged by the use of checks and by an exchange of credits this is due to the fact that the public voluntarily and not by reason of any legal requirement

accepts these checks, and through an exchange of credits many obligations are canceled without the actual use of money. The public is willing to utilize bank credit in this way, because it furnishes a convenient method of handling commercial transactions and because it has confidence in the ability of the banks to pay these checks in legal tender whenever they are called upon to do so.

It would seem to follow that any system of check clearances and check collections which strengthens the ability of the banks to respond to a larger percentage of demands for legal tender results in a benefit to the bank by adding to the practical value of this medium of exchange.

Under our present system the 25,000 or more banks in the United States act more or less independently; each bank selects its own correspondents and makes its collections primarily through these correspondents. For example a customer in Dallas presents a check for \$1,000 drawn on a San Francisco bank. The Dallas bank, not having a correspondent in San Francisco, indorses and forwards this check to its correspondent in New York. The New York bank credits Dallas and forwards the check to Chicago. The Chicago bank, in turn, forwards it to Denver and the Denver bank to San Francisco. Until this check is actually paid in San Francisco the Dallas bank remains liable upon it as indorser. It is true that it has obtained a credit in New York, but if the check is returned this credit will be canceled. In the meantime, it has paid out

funds representing the face value of the check to the payee, and if it is returned unpaid, the bank must look to the payee or drawer for indemnity.

When we multiply this transaction by the number of items received by the 25,000 or more banks in the United States, and when we consider that each bank receiving an item for collection is likely to select one of its correspondents through which to send it, it is manifest that bank collections are not made through defined channels and that the time consumed in making a collection varies according to the route by which the several items happen to be sent. As a consequence, a very large number of items representing a very large volume of money are constantly in transit. In the meantime the bank which receives these items on deposit and forwards them for collection is under obligation to pay the amount they represent in legal tender if it is called upon to do so. If, by a more scientific handling of these collections, the amount in transit can be reduced and the time consumed in collection can be cut down, the banks to this extent are given a greater ability to respond to the demands that are made and this increased ability is a matter of interest to the public.

While the check performs a vitally important function in our commercial development and while it is estimated by some authorities that approximately 90% of our commercial transactions are carried on by its use, we must not overlook the fact, that this use is made possible by the voluntary act of the public and not by statute.

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I do not mean to question the soundness of the practice. The experience of nearly all nations has demonstrated the fact that real commercial development is made possible only through the scientific use and exchange of credits. Some economists go so far as to claim that if a proper system of credit exchange can be worked out there is no need for a metallic currency. Whether this view is extreme or not every factor which contributes to the ability of the bank which is used as a medium of exchange, to respond immediately to demands made upon it, strengthens the system and makes more valuable the credit used.

Bank clearances may be said to constitute the most direct method of exchange of credits as between banks. It is through this method that reciprocal balances are offset or canceled. Heretofore clearing house operations have been confined to the larger cities. If the banks in one city find that time can be saved by meeting at one place and exchanging reciprocal items rather than by having each bank send out by runner the checks drawn against every other bank in that city, is it not reasonable to assume that the same result may be obtained as between banks in the same general locality? And is not the plan provided for in the Federal Reserve Act merely the application of a plan which has been tried and used successfully in the larger cities? There can be no doubt of the fact that, as we increase the number of banks that clear through any clearing house, we will decrease the number of items that are in transit and will reduce the time consumed in making the exchange of credits.

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When Congressman Glass, chairman of the Banking and Currency Committee, made his report to the House, he voiced the hopes of the framers of the Federal Reserve Act when he said, in speaking of bank clearances and collections -

"The provision as it stands will result in an immense saving to the trades people of the United States. It will eliminate the amazing wastefulness incident to the many independent collection organizations by substituting one compact collection system."

It cannot be denied that the Act provides for a more scientific handling of this important function of the banking business. By clearing the various items received for collection through the agency of the twelve Federal reserve banks, the element of time will be materially reduced. For example, an item on San Francisco will not have to go through four or five intermediary banks, but may go direct from the Federal Reserve Bank of Dallas to the Federal Reserve Bank of San Francisco, and through an adjustment of accounts in Washington the transaction will be completed in a very much shorter time than is possible through the many independent collection organizations now in use.

The advantages of one compact system are obvious. The objections that are raised are founded primarily on local interests. A bank may prefer to send an item for collection to its reserve correspondent, since it shows immediately a credit with its correspondent, and not only counts this as part of the reserve which it is required by law to maintain but in many instances receives interest on this deposit. In counting as reserve an item which

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is drawn against some other bank than its reserve agent, it is treating a conditional credit as funds actually deposited with its reserve agent.

In other words, let us suppose that a Dallas bank sends a check on San Francisco to its New York correspondent, which is its reserve agent and receives credit on the books of its reserve agent. If the check is returned unpaid, it is charged back to the account of the Dallas bank, and until actually collected the Dallas bank remains liable on this check. It does not show this liability on its books, but takes credit for the amount of the check. This is one of the legal inconsistencies of this practice. When the Dallas bank receives this check and gives credit to the depositor it has a claim only against the drawer and indorsers of this check. The San Francisco bank, not having certified the check, has assumed no liability.

If, instead of receiving a check from its depositor, it accepted his promissory note and indorsed and rediscounted this note with its reserve agent, while it might show the credit thus established as part of its reserve, it would show on the other side of its ledger a liability to its reserve agent for money borrowed in addition to the liability shown on the individual ledger to the depositor.

The practice, therefore, of building up reserves by conditional credits presents an anomalous situation, and if banks should be required to discontinue this practice and should not be permitted to count collection items as reserve, until they have been actually collected, they would manifestly take into consideration the

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element of time and would undertake to reduce this to a minimum by the adoption of any scientific method of clearances.

It is, of course, realized that a change of this sort must be brought about gradually and the Federal Reserve Act provides a medium by which this can be done without disturbance to existing conditions. It would seem to be to the interest of the banks to adjust their operations so as to accomplish this purpose.

In the same manner it is to their interest to bring about by thorough cooperation the perfection in every detail of a scientific system of banking.

This is of especial importance at this time in view of the general disturbance of international trade conditions that results from the great European war.

No bank could be expected to liquidate its own assets in time to discharge any large proportion of its obligations in case of unusual demands if it had to rely solely upon its own debtors. The very nature of the banking business makes this impossible. The larger proportion of its loans and investments are made for fixed periods of time, while the larger proportion of its obligations are payable on demand. When these demands are in excess of normal and when the bank is under the necessity of converting its loans or investments into cash in order to meet these demands, it must rely primarily on other banking institutions.

When unusual demands are made upon a great number of banks, it necessarily becomes more difficult for the banks to convert their

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investments into cash.

The panic of 1907 is still sufficiently fresh in the memory of the banker for this situation to be fully understood and appreciated. The experience of that year demonstrated the fact that when the strain becomes general liquidation of assets becomes correspondingly difficult. You will recall that at that time the banks were forced to resort to various expedients in order to meet the demands made upon them. United States bonds were borrowed in order to increase circulation. In many localities banks found it necessary to refuse to pay out money except in small amounts. Clearing house certificates were used as a temporary substitute. Banks which had money on deposit with their reserve agents found it difficult to obtain this money for their needs since their reserve agents were likewise in need of additional funds. Banks in reserve cities which had been competing for country bank accounts began to question the advisability of soliciting and paying interest on those deposits.

The Federal Reserve Act provides a scientific remedy for the difficulties that were experienced during that year. One of its purposes is to make the reserve carried with a Federal reserve bank actual reserve which will be available when needed and not merely reserve in name. By a concentration of a part of the cash resources in the twelve Federal reserve banks funds are made available for use wherever they are needed. If the demands of one section are greater than the demands of another, the Federal reserve bank may obtain rediscounts with other Federal reserve banks, and

may thus acquire the benefit of the surplus funds in other districts. In addition to making the money in circulation available wherever it is needed provision is made for an increase of circulation by the issuance of the Federal reserve note.

The machinery has, therefore, been provided for a compact and scientific system of banking which gives additional strength to every member bank. The critics of the system do not deny that it is scientific and sound, but complain that it is composed of only 7,500 out of 25,000^{or}/more banks; that it does not represent the full force of our banking power. The advantages of the System, however, are fortunately open to the State banks and trust companies as well as to national banks, and it is possible for the State institutions to share in its benefits.

Bankers and economists are not agreed as to the effect that the European war is destined to have on the commercial business of this country. There are those who feel that during the readjustment of commercial interests following the close of the war this country must look for a reaction and can not expect an indefinite continuance of the present prosperous conditions; that the markets of the belligerent nations will be reopened, and that competition for the world's trade will make it difficult for this country to market to advantage its great resources; that securities held by citizens of other countries will be sold and will have to be absorbed by our markets; that following a period of commercial prosperity it will be difficult for those who have shared in and enjoyed this prosperity to readjust them-

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selves to new conditions; that plants and factories which are now making munitions of war and which are supplying the belligerent nations with necessities will have their output reduced and will have to find other field for their activities.

There are others who are inclined to the view that there will be no substantial reaction until sometime after the close of the war; that competitive markets will have to be reorganized; and that during the period of readjustment of the commercial affairs of those unfortunate nations which are now engaged in this great conflict, there will continue to be a great demand for our products; that many of our factories and institutions which are furnishing supplies to the belligerent nations are already operating on profits earned and are accumulating a surplus which will enable them to convert these factories to other uses.

The economists, however, are agreed that sooner or later we must face commercial conditions which are unprecedented in the history of the world; that, as one of the great commercial nations of the world, we must bear our proportionate part of whatever strain there may be. It can hardly be denied that any situation that may arise can best be met by a compact, effective banking system better than by an unorganized system of unrelated banks. The enormous banking power of the nation should be used to advantage.

I do not mean to question the strength of our banking institutions. It is manifest that our banks are stronger today than at any time in the history of the nation, and that we have the resources and the potential power to insure continued prosperity is

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no doubt true, but the responsibility is very largely with the bankers to determine the degree of that prosperity. By cooperation and proper organization and by a scientific use of these resources a greater degree of prosperity will follow than will be possible if the individual interest of the banker is to overshadow his public responsibility.

Those who believe in preparedness might well apply the principles involved to our banking situation. Whatever potential powers the banks may have acting independently, their efficiency will be increased by systematic organization. It is encouraging to note that the State authorities are acting in harmony; that the State laws are being remodeled along scientific lines; that the legislatures of most of the States have taken the necessary action to make it possible to perfect our banking system, and we have every reason to believe that we will ultimately have a banking system that will make it possible to utilize the banking resources of this country to far greater advantage than is possible at present. We have reason to hope and believe that whatever the outcome of this world struggle this country will be enabled not merely to insure its own prosperity, but to lend the assistance that its size and importance demands in the readjustment of the world's trade and the rehabilitation of the world's prosperity.