Remarks of

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before the

PENNSYLVANIA BANKERS' ASSOCIATION

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Mr. Chairman,
and members of the Trust Company Section of the
Pennsylvania Bankers' Association:

In accepting your courteous invitation to join you on this occasion I said to your Chairman that I thought the topic he has announced - The Banking Functions of Trust Companies - would be especially appropriate at this particular time. The question is one that is of large general and permanent interest, but just now has special significance.

As you are aware, many strong trust companies are either joining, or considering membership in, the Federal reserve system. National banking associations have, under the Federal Reserve Act, been granted certain trust company powers. Many of them have been approved in the exercise of these powers by the Federal Reserve Board and are already doing considerable business under them. The question is thus plainly suggested: What is to be the line of division between the banks and the trust companies in the future? In other words along what line is our banking development to be carried by these two classes of institutions? With trust companies as members of the Federal reserve system and with national

banks exercising functions heretofore regarded as peculiar to the trust companies where will the line of division between them run in the future?

From the abstract standpoint it would probably have been well had trust companies, from the start, confined themselves to the operations especially belonging to their field in the narrower sense, and had the banks similarly limited themselves. This, however, has not been the history of our banking development during the past few decades. The trust company has come, in many cities, to perform most important and extensive banking functions. We must suppose that this has been the result of real demand and that there is a good reason for growth in the direction I have mentioned. The fact that this mixture, or fusion, of functions has occurred, must have been due to public appreciation of the combined service or public desire that the two classes of duties should not be wholly separated. I do not believe that economic institutions develop after any haphazard plan. There may be survivals; obsolete institutions may be perpetuated; or peculiar legal conditions may bring about undesirable or temporary ramifications that would not have occurred had it not been for some special, or local, or perhaps temporary, cause. But this is certainly not the case with trust companies. They have taken on banking func-

tions because these were needed and because they could thus serve the public. On the other hand, it is not strange that banks have at times felt themselves hard-pressed by trust company competition and have in many cases found that the more liberal laws governing trust company organization and operation subject them to unfavorable conditions. To these circumstances must be ascribed the grant of trust powers made in the Federal Reserve Act. Congress might have proceeded, abstractly speaking, by attempting to legislate the trust companies out of the commercial and banking business, although it probably would not have succeeded without the aid and cooperation of State governments. Be this as it may, the line of action chosen has been the opposite - that, namely, of throwing open the field for the exercise of trust powers to the banks. This is a condition and not a theory, and it is with the results of it that we are directly concerned at the present moment.

Must it be supposed that, as time goes on, the banks of the country will gradually expand their trust powers while the trust companies will expand their banking powers until the two classes of institutions have reached something like a parity of function so that many of them stand upon substantially the same basis? In order to follow such a line of development much more legislation would be needed as well as many changes in banking and trust company practice. It is not likely that such a situa-

tion will be reached in the near future. It is, however, possible, and even probable, that the development will be to some extent, at least, in that direction. The foundation has already been laid for it and we must expect progress to occur along lines that are already marked out. Nevertheless it is practicable to direct the development and to make it rational and sound; to avoid unnecessary conflict and waste of energy in that kind of competition which does no good and which merely pays too high a price for lessons of experience better and more cheaply learned in some other way. There is a dividing line between the trust company and the bank that can and must be clearly drawn if our further advance in banking in the United States is to be efficient and economical.

The key to the solution of this problem of relationship between the banks and trust companies is found in the Federal reserve system and in the new banking conditions that are being developed under that system. As I have indicated, it is as certain as anything in the banking future that the banking functions now so well performed by trust companies will continue to expand. They will maintain themselves as popular banking institutions, receiving large funds subject to check, making transfers, doing a foreign exchange business, engaging in many of the lending activities that are common to the commercial banks of the country,

and otherwise occupying and cultivating the field in which they have already established themselves under public encouragement. Our effort to shape conditions must devote itself primarily to the character of their assets and the adjustment of this character to the business they are doing. Almost all, I think, will admit that in proportion as any banking institution accepts demand obligations it should hold itself ready to meet them promptly and with only the least possible necessity of relying upon outside aid. Heretofore trust companies have deposited the bulk of their ready cash with banks. They have looked to these banks to pay them interest upon the deposits so made, and in case of necessity to assist them with advances upon collateral, usually of a long-term nature. So satisfactory have been the relations thus created between the trust companies and the banks that many of the companies have hesitated to enter the Federal reserve system. They have known that they could not keep their reserve funds at interest were they to become members, and in many cases they have doubted whether they would normally be in position to obtain aid from the Federal reserve banks in case of necessity because of the fact that they had not the kind of paper eligible for rediscount with the reserve institutions. With the first of these considerations I confess I have never had much sympathy. The pay-

ment of interest by one bank to another upon reserve deposits is uneconomic and unsound in principle. In our own country it has been for many years an established practice, although the best bankers and financiers have recognized its evils and have wished to correct it. The fact that some of the strongest trust companies in the country are already members of the Federal reserve system and that others are daily joining it shows that the logic of the case appeals strongly to trust company managers - so strongly, in fact, that they have in these representative cases chosen to forego the interest they have been receiving upon their reserves carried with the banks. You are all familiar with the argument against the earning of interest in this way and it is not necessary to urge the matter in detail. Belief on this point is very much like belief in a religious principle - either you hold to it or you do not, and, if not, no argument that I could present on this occasion would convert you.

The other point - the question of the assets held by the trust companies - presents a quite different problem. On that subject, there is a large field of discussion and a still larger field of work for the improvement of existing conditions. Undoubtedly if trust company managers heretofore exercising non-banking functions for the most part could find adequate and sat-

isfactory investments in live commercial paper eligible for rediscount with Federal reserve banks they would willingly place a substantial part of their funds in this form, to the proportionate exclusion of the longer-term investments that have heretofore absorbed the greater part of their resources. They would then be in as good a position as the commercial bank to take advantage of the opportunities of the Federal reserve system. Indeed they would be able to make, if anything, better use of them inasmuch as they could with safety invest a much larger share of their resources, while at the same time feeling assured of ready cash when it was needed. The danger of sudden demands on them being relatively less urgent, and their need for cash in vault correspondingly smaller, they could keep their funds closely invested, as many of them now do, but with the assurance, as just indicated, that such investment would not result in cramping them at times of need. Yet the fact remains that hitherto the trust companies have not gone largely into the commercial paper field. Will they do so in the future? The answer to this question is found by inquiring why they have not in the past held more commercial paper - a query to which the reply is very plain. A trust company is, as its name implies, vested with certain highly responsible and onerous duties. Its funds must be as secure as good judgment and sound investment ability can make them. It

must not take any more risk than is absolutely unavoidable. Yet, as every banker knows, investments in commercial paper involve either a rigid and careful scrutiny of credits or else acceptance of the judgment of others with respect to the credits. The trust companies have not maintained large credit departments. That has not been the kind of business for which they were fitted or the field which they chose to enter. On the other hand they have not been disposed to accept a mere personal assurance of the soundness of given paper. They have desired to find a field of absolutely reliable investment in business paper which they could with confidence enter and in which they would find the investments they sought for their funds, upon as safe a basis as that provided by the securities market, while at the same time obtaining a more liquid type of assets available for conversion into immediate resources when necessary. Precisely such a type of investment the Federal Reserve Act was designed to supply. Its provisions with reference to commercial paper and acceptances were intended to stimulate the development of the material of a discount market, while its organization sections were intended to afford the structure of such a market. If a true discount market could be built up in the United States the trust company would there find precisely what it needs as a field for the investment of that part of its assets which it

is willing to use as secondary reserve. It would be able to buy commercial paper with the indorsement of the commercial bank which had investigated it, or better still, to purchase the acceptance of such commercial banks themselves. It would thus be able to employ its funds in the support of the commercial business of the country, while the banks of the nation would first have devoted themselves to the analysis of credits, the study of the conditions surrounding them, and the approval and guaranteeing of paper presenting itself from time to time. For this they would have been adequately paid, and such demand would have sufficed to compensate them for the risk and labor involved in the service they thus rendered. The trust companies, on the other hand, would have assured themselves of the employment of their funds at remunerative rates, free of risk, and under conditions ensuring to them the possession of a liquid asset. Were they members of the Federal reserve system they would have sought possession of paper which they could turn into cash upon demand, and even when not members, they would have been in position to obtain their accommodation indirectly through some other channel. The existence of the discount market would have assured to them not only the immediate opportunity for safe investment in commercial paper, but also the certainty of power to withdraw funds when desired and to apply them to the meeting of their own

obligations. I do not for a moment suppose that the trust companies would or should thus employ the whole of their assets. To do so would be to place themselves in very much the same position as the commercial bank - an outcome which is hardly to be expected, even under conditions most likely to favor it. What I do mean is that the trust company would have found it wise to pay a portion of its resources into a secondary reserve of this kind; and would thus have protected itself far better than in the past, while at the same time continuing to earn the income necessitated by the fact that it usually paid interest to its depositors upon their dormant accounts.

No great change in banking or commerce comes about immediately, and the change to which I have made reference is too far-reaching in its significance to be produced without much effort and more or less unavoidable delay. Since the beginning of the European war, we have made some progress in the development of the acceptance market in this country. The maximum amount of bankers' acceptances available since the opening of the war is probably about $300,000,000, but the amounts coming upon the open market - that is to say not discounted and held in portfolio by the banks which made the acceptances - are of course very much smaller. These acceptances have, moreover, been largely given by the institutions of the cities, including the larger trust companies. The practice of accepting and

that of purchasing acceptances of others has not thus far been widely diffused. To encourage the development of which I have spoken wherein a trust company becomes the purchaser or holder of substantial amounts of absolutely safe commercial paper it will be necessary to bring about something of a revolution in the commercial and banking practice of the United States. I need hardly say that my remarks have no reference to those cities where the trust companies are already under the law largely in the commercial banking business, but to the much larger part of the country where development has been far less marked.

What must be the nature of this change? We can answer that question by reviewing very briefly the status of commercial paper in the United States at the present time and the new conditions which it has been desired to establish in the market for commercial paper. The practice of the past has been that of borrowing from banks upon the "straight single-name" paper of individuals or corporations. Borrowers have made more or less frank statements of condition to the banks from which they sought accommodation and the latter have determined the amount of credit to which they were entitled. When this has been ascertained the credit has been extended, and the result has been to finance given trades or industries through the agency of the manufacturer or producer. He has obtained the necessary advances from his bank and has "carried" the trade

dependent upon him by giving its members time within which to pay their indebtedness, subject to discount for prompt returns. The Federal reserve system recognized the demerits of some phases of this system and sought to improve upon it by adapting the European practice to conditions in the United States. Following the intent of the Federal Reserve Act the Federal Reserve Board has defined and described the trade acceptance and the bankers' acceptance and has fixed preferential rates of discount on these two classes of paper good at Federal reserve banks. The thought has been that merchants would seek to obtain from their customers acceptances evidencing the existence of indebtedness, and that in this way the commercial operations of the country would be represented by definite units of desirable paper. It should hardly be necessary to say that no substantial progress in banking method is made if the buyer of goods merely gives to the seller a trade acceptance which the latter carries in his safe until maturity, or which he discounts with his own bank after indorsing it. Such a change may be desirable from the narrow standpoint of ease of collection or from that of the local relationship existing between the seller and the buyer. It does not, however, introduce any new element in banking practice, nor does it furnish in and of itself any reason why the upright merchant or manufacturer should

be able to obtain from his bank a greater volume of credit than he could otherwise have obtained upon the strength of his own statement of condition. It is necessary that the business men and the bankers of the country should take advantage of this new mechanism by altering their methods of borrowing. Such alteration in its essence involves a radical change in the location of the business man's financing. If a manufacturer, for example, has sold goods to a retailer, he has evidently parted with the goods and he expects to obtain reimbursement out of the funds arising from the sale of these goods to the customers at or near the point to which they are shipped. The financing of the operation should, therefore, be transferred from his bank to the bank at the point of shipment - that is to say where the buyer is located. If the local banker at that point is willing to accept the paper drawn upon the buyer the conditions conform to the best banking practice for two reasons - (1) The process of financing is now conducted at the point where the goods are located and where the funds from which payment must be made are in process of collection; (2) The aid of the local banker has been enlisted in passing upon the credit to which the local merchant or buyer is entitled. Long-range credit is eliminated and the unsatisfactory features of our past method of financing trade are done away with. The commercial transaction is now fi-

nanced on the basis of local judgment and with local funds. Perhaps there are some who are inclined to suggest that the effect of such a change in method would be to limit each community to the banking resources there existing and that as a consequence the amount of business that could be locally done would be greatly restricted. This might be the case if it were not that we have in existence a system of rediscount one of whose main purposes it is to provide a market for satisfactory paper of the kinds to which I have referred. The Federal reserve system aims to afford a place at which such paper may be rediscounted and thus stands ready to pour into any community that portion of the funds thus jointly owned by the banks of the district or of the country to which the business there originating is entitled. There is nothing in the proposed method which cuts down the opportunities of a community, but on the contrary there is everything to encourage those opportunities, improve them, and reduce the cost of doing business to which the members of such a community have been subjected in the past. Whether the paper thus offered be trade acceptances indorsed by the local banker or a local banker's own acceptances is a matter of detail. The point is the shifting of the process of financing the business operation from the producer's or manufacturer's bank, where it has heretofore been concentrated, to the bank with which the buyer

habitually trades and which knows him and his circumstances. Such a system is restrictive only in so far as it tends to prevent over-buying and to make each community responsible for its own judgment with regard to the credit of its members. It is not only the scientific way of financing trade, but it is the plan that has proved itself in those countries which have been most successful as traders and producers. That there is opposition to it in some quarters is not surprising. Many naturally dislike any innovation which looks in the direction of sounder and more stringest credit and which seeks to eliminate doubtful elements upon which persons of weak and questionable credit may rely for the expansion of their operations.

While it is true that the introduction of this great change in commercial and financial practice calls primarily for the initiative of the manufacturer, jobber, merchant and credit man, and for the earnest cooperation of the banker, it is also true that the undertaking will be greatly advanced if it can likewise have the cooperation of the investment institutions of the country. Why should the community undertake so difficult an innovation as this? There are some enlightened members of all branches of trade who not only appreciate the advantage to the public at large that may be reaped from a far-reaching and desirable reform, but the rank and file will adapt themselves to

the change only as they are persuaded that it is beneficial to their business in the narrower sense of the term. They want to know how they will profit from it. This, however, is fortunately the easiest phase of the situation to make clear. With the development of a discount market based upon standardized credit in the way I have just outlined the rate of accommodation is reduced to its lowest terms. The man with small capital but first-class credit becomes entitled to and will receive the rate prevailing in the market. The banker who passes upon his credit and indorses his paper or accepts for him, as the case may be, obtains his due remuneration in the form of a commission, while the investment institution which eventually takes and holds the paper up to maturity receives the going rate of interest upon its advance. Since the credit is unquestionable and is moreover capable of liquidation at any moment, such an institution is safe and conservative if it invests a much larger proportion of its funds than it would otherwise be warranted in doing. It is therefore better that it should have, let us say, $100,000 of prime acceptances with good banking names upon them, yielding 3½ or 4%, than if it should have an equal amount of money technically on deposit in banks at 2%, since we know that such deposits must be made to earn interest and are frequently employed in collateral loans which may or may not be promptly paid in the event of

stringency. True, the commercial bank may wish to hold its acceptances or its indorsed paper, whether originating with itself or with some other bank, as an investment. Many banks at the present time do so. This, however, is not the ideal condition, for good banking practice tells us that the process of discounting should, if possible, be separated from that of accepting or indorsing. It is just here that the trust companies of the country can be of great service both to themselves, to the banking community, and to the public in general. If a situation can be created in which the banks of the country, small and large, will devote their activities primarily to passing upon commercial credit and guaranteeing the paper that comes into their hands, the trust companies and other investment concerns can with confidence assume the function of carrying this paper. They will be warranted in placing their trust funds in such a form because of the safety they will enjoy through bank guarantees, while they will be warranted equally from the general public standpoint since they will be possessed of paper eligible for rediscount and hence convertible into available funds upon demand. They can in this way harmonize their banking and trust functions and serve as an indispensable element in the nation's commercial banking system. Their competition, so-called, will be a help and not

a limitation upon the banks of the country, and the latter will find their power to make profits increased by reason of the existence of such an auxiliary. Where the trust companies are practical banking institutions, that is to say in those places where their banking functions have overshadowed their trust functions, they will find the new plan the only means by which they can get the advantage of the Federal reserve system and receive from it the benefits to which, as members, they will be entitled or which, as nonmembers, they may reap through the existence of a flexible and effective discount market.

Changes such as this are not, as I have said, likely to be brought about at once. They will not be brought about at all except through the comprehension and appreciation of their meaning on the part of those who are to profit from them and to carry them into effect. In speaking recently to gatherings of business men I have endeavored to make clear the business man's direct and urgent interest in taking up this change in commercial practice. He must take the initiative, and it is to him that the community must look for the first steps in the movement. But his efforts will be unsuccessful unless he can have the aid of the banks and investment institutions of the country. I have shown that they have an important interest

in the matter from the narrow profit-making standpoint. How much larger is this interest when viewed from the standpoint of the community as a whole! We can never make the nation's bank resources fluid and safe until we have established the credit of the country upon an unimpeachable foundation, and until the great majority of all those who are carrying on the business of banking in whatever form have united in the cooperative system of organization which gives to each the benefit of the combined results of all. Such a system is that of the Federal reserve. Let us now, however, make the mistake of supposing that the mere organization of such a system is enough. Many persons have fallen into the error of supposing that the establishment of the machinery of cooperation and creation of banks which could be relied upon in emergency to render help with an abundant issue of flexible note currency is all that is necessary. Indeed there are those who have asserted that such endeavors have made panics a thing of the past, but little reflection is needed to show that this is taking the shadow for the substance. The Federal reserve system will be useful in proportion as it succeeds in renovating and strengthening the credit business upon which banks rest. If it does not do this; if it does not perform its functions every day, then it is more or less of a failure. It must be continuously and actively at work passing upon credit, transferring it from one point to another, and rendering it acceptable to all who are entitled to its use.

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