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J. H. Riddle

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Banking Developments and the Need for Research

BY J. H. RIDDLE

BANKING is a sixty billion dollar business in the United States today, yet probably no important industry has devoted so little attention to consistent scientific analysis of its problems. So far as research is concerned, banking is today in about the same position that industry was in 1900.

Certainly this lack of interest in research is not due to lack of unsolved problems. The failure of some 14,000 banks since 1920 is an indication of the inability of the banking structure to protect itself against economic catastrophe. The severity of the depression contributed in considerable measure to this failure record. During all these years we have been paying the price for war and the economic maladjustments that followed in its wake. On the other hand, we must admit that bank management has an unavoidable responsibility for guarding against contingencies of this character. Booms and depressions have always been characteristic of our economic system, and this will probably continue to be true in the future. It should be recognized that in a progressive economic society occasional maladjustments cannot be avoided.

Under these circumstances the problem which bankers face is this: can we develop a banking system which will stand up in periods of economic adversity and be a bulwark of strength, instead of aggravating the evils of depression as it has in the recent past? While I do not believe that our banking system can be held responsible for this depression, the breakdown in the banking system undoubtedly deepened and lengthened the depression and slowed up recovery.

Perhaps the greatest danger we face in any depression is that popular clamor may lead to measures which will prevent recovery. We may be led, on the spur of the moment, to discard an economic system that has served us well simply because for the instant it is out of adjustment; or we may be led to give up in a moment of hysteria the political and economic liberties which our forefathers gained through centuries of struggle. Anything which

deepens and lengthens our depressions, therefore, is a serious menace to our economic and political institutions. How will our banking system meet the next depression?

We have made substantial recovery from the chaotic conditions culminating in 1933. The fear of both bankers and the public has turned into confidence or even optimism regarding the future, due in part to business recovery. Thousands of weaker banks have been placed in liquidation. The capital structure of others has been rehabilitated and their bad assets written off. A greater degree of supervisory control has been provided for, and deposit insurance has been adopted with a view to preventing bank runs and losses to depositors. There is little doubt that many of the weak spots in our system have been cleaned up and that future improvements will be effected as the course of business moves upward.

It would be unfortunate, however, if these various remedial measures and piecemeal legislation should lead to a complacent and self-satisfied attitude with reference to the future of banking in this country. In many respects we have simply treated symptoms and provided for immediate relief without attacking the fundamental causes of our difficulties. We have superimposed on the system a few additional restrictions, measures of control and guarantees to depositors without providing for any material change in the more fundamental factors of structure and management. Many of the proposals for legislative reform which are brought forward from time to time and most of the theories of credit control have dealt with the superstructure of banking, with little attention to the foundations. An adequate diagnosis of our troubles is essential before effective remedial measures can be devised.

The first step towards any proper understanding of our problems or towards any permanent banking reform is to know the facts. Certainly if we are to prescribe wisely we must know the nature of our ills. What type of banking have our institutions been engaged in? What have been the trends in assets, liabilities, earnings and expenses? Why didn't our bank assets stand up during the depression? What type of assets best met the test and what type of assets suffered the greatest losses? What readjustments in our banking structure are essential to meet the revolutionary changes in our economic system?

It was with the desire to find out something about the causes of our past difficulties and the possibility of bringing about improvements in our system that the New York State Bankers Association decided in 1934 to make a study of banking conditions and developments in the state. You are familiar with the Commission for Study of the Banking Structure which was appointed in 1934, and the report which it issued in December, 1935.

In the foreword to that report the commission said in part:

"That banking in the state of New York, in common with the entire American banking system, is undergoing an epochal transition under the impact of the major economic changes of recent years, is universally recognized by students of the situation. In periods of great change, adaptability is the first prerequisite of survival. Banks, like other institutions, must adapt their policies and practices to the needs of the public, otherwise the reason for their existence disappears."

Changing Character of Banking

The commission's report placed special emphasis on the changing character of banking, referring to changes both in the character of assets and in the character of deposits which have been so noticeable during the past decade or more.

Changing Character of Bank Assets—Let us look for a moment at the changing character of bank assets. An analysis of bank portfolios indicates that commercial banks in the United States have been getting further and further away in practice from true commercial banking and that the proportion of bank assets consisting of capital loans and investments has been growing. In order to observe this change, a distinction should be made between (a) "capital assets," including under this heading investments, collateral loans and real-estate loans, and (b) "all other" loans, which include the commercial loans made by banks. In the national banks "all other" loans have declined from about 60 per cent. of total loans and investments in 1920 to about 20 per cent. in 1936, while "capital assets" have increased from about 40 to 80 per cent. in the same period. "All other" loans are now only about 40 per cent. as large in volume as they were in 1928 and about 35 per cent. as large as in 1920. Investments, on the other hand, have increased steadily and are now twice as high as in 1920. The ratio of investments to total loans and investments

has increased from 23 per cent. in 1920 to more than 60 per cent. in 1936. This is due largely, of course, to the great increase in the holdings of United States Government obligations. These figures relate to all national banks in the United States, but the same general pattern prevails whether one observes the state banks or the national banks, the city banks or the country banks. In other words, the trend has not been confined to any particular type of institution or to any particular section of the country.

Even the "all other" loans cannot all be assumed to be pure commercial or self-liquidating loans. The relative proportions of capital loans and commercial loans in the old sense of the word cannot be determined with accuracy. It is doubtful, however, whether there are more than four or five billion dollars of the old-type, self-liquidating loans in the whole banking system.

Much of the decline in commercial loans has been due, of course, to the depression, and as business expands this type of financing will increase substantially. The short-term commercial loan has a definite place in our financial scheme, but it is a question whether it will ever assume the same relative importance as in pre-war days.

This shift in the character of bank assets has been due in part to changes in the methods of financing used by business organizations and to changes in their method of conducting business. The speeding up of production and transportation has decreased the need for working capital, thus reducing commercial credit requirements. At the same time the concentration of both production and distribution in the hands of large corporations which are able to secure working capital easily through the sale of securities has reduced the demand for commercial loans from banks.

Easy Reserves—The pressure of easy reserves towards rapid credit expansion has been one of the most important factors in the changing character of assets. This factor has been operative during most of the period since 1914. These easy reserves, which encouraged expansion, have been due largely to four things: (1) lower reserve requirements as the result of the adoption of the Federal Reserve System; (2) imports of gold as the result of disturbed economic and political conditions in other parts of the world; (3) the gradual shift from demand to time deposits, which allowed greater expansion on a given volume of reserves; and (4) the easy money policies of the Federal Reserve System.

This urge to expand as the result of almost continuous pressure of reserves was a temptation which most banks could not resist. When they did not find a sufficient local outlet or sufficient self-liquidating short-term paper, they expanded into other types of assets. If assets of the highest grade were not available they took what was available. Neither the rate of growth of business activity nor the volume of savings of the people was the determining factor in the amount of credit expansion. Few banks realized the broader significance or the ultimate consequence of this type of credit expansion. It had an important bearing not only on the quality of assets but on the broader question of credit expansion and business stability.

Time Deposits—The changes in the character of bank deposits have been just as striking and just as significant as in the case of bank assets. The outstanding development to be noted is the rapid growth of time deposits relative to demand deposits. In 1900 time deposits, including savings, comprised less than 5 per cent. of the total deposits of all national banks (excluding inter-bank deposits). By 1920 the time deposits had increased to 25 per cent., and by 1932 to almost 50 per cent. of the total. Almost the entire growth in the deposits of national banks from 1920 to 1929 was in time deposits, which more than doubled in those nine years.

Part of this growth in time deposits probably represented a transfer from slow demand deposits to time deposits, a shift which was encouraged after 1917, when legislation was enacted requiring lower reserves for time deposits than for demand deposits. A large proportion of the increase, however, presumably represented savings. During the 'twenties the commercial banks engaged in extensive competition for savings deposits, not only with other financial institutions but also with each other. As a result, savings which otherwise might have gone directly into investments or into other institutions were attracted into the commercial banks. This competition led to the payment of high interest rates on deposits; in some sections as much as 4½ and 5 per cent. were paid. These competitive rates on time deposits led many banks to employ a large part of their funds in high-yield speculative loans and investments.

These competitive practices have been greatly curbed in recent years, however. The banking act of 1933 prohibits the payment of interest on demand deposits and gives the supervisory authori-

ties power to establish maximum rates on time deposits. Through voluntary agreement many bankers have reduced the rates which they pay on time deposits below the maximum levels permitted by the supervisory authorities. As a result of these and other factors time deposits have grown very slowly since 1933. Demand deposits, on the other hand, have increased very rapidly as a result of gold imports and the fiscal activities of the Government. Therefore the proportion of time deposits to total deposits has declined substantially since 1932. At the present time it is probably about 33 per cent. If we take banks outside the metropolitan centers, however, the proportion is about 45 per cent.

Because time deposits have been considered more stable than demand deposits they have usually been invested in long-term assets, and this has been another important factor in the growth of capital assets in banks. In the recent depression, however, it appears that time deposits of commercial banks were little different from demand deposits. They seem to have been withdrawn about as rapidly as demand deposits, and the power to demand notice of withdrawal proved practically worthless.

Basically, therefore, the picture is one of banks investing their funds to an increasing degree in assets of a more or less long-term nature, while their obligations are payable, actually if not nominally, on demand. Commercial banks are taking on more and more the characteristics of investment trusts in that they are investing the savings of the people, yet they guarantee the return of the depositors' money in full at any time, irrespective of conditions in the securities market.

Problems Arising Out of Changing Character of Banking

It is not my purpose to attempt to prove that capital assets as classified above are unsuitable for bank portfolios or to suggest that banks can give up what we may call investment banking and return to purely commercial banking. We face an accomplished fact. We have developed this form of investment banking over a period of years, and it is a question of making whatever adjustments are necessary to meet the situation. Making these adjustments will be a real test for bank management.

It is clear that the problem of investing in capital assets differs in many respects from that of extending commercial loans. The

factors which must be considered in making commitments are not the same, and the different risks are incurred. The complexities of the problems which the banker has faced under the changing economic order and the changing character of banking have left him somewhat bewildered, and he has not been able to test and perfect new rules and new standards of practice. By force of circumstances commercial banks have become involved in investment banking in a broad way without any adequate study or analysis of the problems involved or the implications of such a development.

There are many able students of the subject who believe that many of our past difficulties in commercial banking have been due to the poor quality of assets rather than to the form of the assets. They assert that the poor quality of real-estate loans and bonds, as well as short-term loans, has been responsible for most of the losses. There is much to substantiate this opinion. There is no doubt that most of our banking difficulties have been due to assets which should never have been in the banks at any time under any conditions. A detailed study of failed banks in this country reveals many appalling cases of gross mismanagement.

One may certainly question the practice of trying to invest at a profit funds on which banks have already agreed to pay depositors a rate of interest equal to or greater than the current rate on high-grade investments. Speculation has little place in a bank, and if banks cannot exist from the return on the highest-grade non-speculative assets then it is doubtful whether there is any justification for their existence. To live within the income from such assets it may be necessary to curtail costs sharply by reducing interest rates on deposits and to increase income through service charges on unprofitable accounts. This would place the cost squarely upon the banking public, and would be far safer and sounder in the long run than to accumulate assets of the type which led to so many difficulties in the past.

Emphasis upon the quality of assets alone, however, is not sufficient to meet the problems arising out of the unbalanced relationship between long-term assets on one side and short-term liabilities on the other. The weaknesses of this situation are most apparent in periods of liquidation, when sometimes the best-grade assets must be sacrificed at depreciated value in order to meet the demands of depositors. Several suggestions have been

made regarding the solution of the time-deposit problem in commercial banks. These suggestions include the following: (1) separate completely savings banking and commercial banking; (2) segregate the assets in the two departments; (3) change the contract with the depositor by the issuance of debentures or certificates of deposit with maturities of one year or more rather than passbook credits; (4) give more adequate recognition to the risks involved by devising a system for building up special reserves to meet losses and depreciation according to past experience. It is not my purpose to discuss these various suggestions or to indicate a solution. I merely mention them to illustrate the type of thinking that is being done on the subject and to emphasize the need for a solution of some kind.

Conclusion

The issue before each banker is broader than the mere welfare of his own institution. If we have learned anything from the depression it is the dependence of every bank upon the soundness of the entire credit structure. We cannot look upon our institutions as isolated units unaffected by the rest of the system. Credit extended in Pennsylvania or New York may have repercussions in Texas or California, and vice versa. If credit is granted excessively or unwisely in one section the whole system suffers. You may have a well-managed bank that has the strength of Gibraltar, but if the system breaks down you suffer along with the rest. To what extent will it prove necessary to remodel our banking structure and to what extent are we willing to give up our prejudices in the interest of a sounder and stronger banking system? The savings of the people should be entrusted only to those completely qualified in character and training.

A learned and respected member of the Federal judiciary, in a recent utterance before a meeting of bankers, made this pertinent observation: "Gentlemen, your acts over the next ten years will determine whether banking shall continue to be conducted by private interests, or become a function of the national government." This is the considered opinion of a man of wide experience in public affairs, and with a strong prejudice in favor of the capitalistic system.

Our banking problems cannot be settled in a month or even in a year. Continuous study and research are the price we must pay

for success in the field of banking just as in industry. If one problem is settled today a new one will arise tomorrow because we live in an age of change. Changes in our economic structure, national and international, make the process of adjustment a continuous one. S. Sloan Colt, while president of the New York State Bankers Association, said in one of his addresses: "It must be clear by now that lasting improvement in the banking system can rarely be obtained by legislation. The futility of trying to substitute arbitrary rules and laws for sound business judgment has been amply demonstrated. That is why a project wherein the men actually operating banks undertake to make a careful analysis of the banking problems is so important and may bring productive results. We have tried legislation for a hundred years; let us now try research and analysis."