ACCOMMODATION PAPER AS PART OF THE CAPITAL OF CORPORATIONS, FIRMS AND INDIVIDUALS.

An address delivered by Mr. Smiley, of the People's Saving Bank of Detroit, at the last annual meeting of the Michigan bankers convention:

The first question that comes up in connection with this subject is, what is a bank? I take it to be an association of persons incorporated under the proper act commonly called stockholders joined together for the purpose of engaging in the profession of finance the lending of money and reception of deposits being two of the main objects. Generally speaking, a bank should encourage business and foster legitimate enterprise by temporary loans, for reasonable time, on sound security; provided, of course, that the moneys they lend to this purpose do not perform any other than the proper function of banking, namely, the circulation of commodities the bringing into existence, of at least an equal value, of commodities or the transference of them from one set of hands to another, on their progress from the producer to the consumer. No bank was ever intended to furnish "capital" either to corporations, firms or individuals if such be required a general or special partner should be taken in; but many banks do furnish it, involuntarily perhaps, but nevertheless it is furnished. In more cases than one by injudicious lending, out of proportion to the borrower's means, or it becomes so embedded in and filtered through the various ramifications of the customer's business that it is impossible to get it back without seriously embarrassing, and possibly smashing, him. What is such an advance but capital supplied, and of what use would such paper be to any bank in the event of necessity requiring it should be paid, or even in the event of requiring to convert by re-discount temporarily?

The next question is, what is accommodation paper? It may generally be stated paper for which no value has passed—in contradistinction to "bona fide" commercial paper, where goods have been had and received in value for the paper given; if accommodation paper is single named, it is, as a rule, evident on the face if endorsed, it is merely the lending of one name to another But there is no value—a genuine trade bill must represent value given and received.

One of the more immediate causes of the widespread increase of accommodation paper is "unwise competition" and "unchecked crediting." I quote from a well known banker as follows:

"The natural right of prescribing the limits of borrowing should clearly rest with the lender, not with the borrower—if there is a loss, it will fall on the lender, not on the borrower the latter cannot lose what he never had. Limits are assigned to almost everything else, even society is a labyrinth of checks, counter-checks and limits, but to "mercantile credit" there is absolutely, as things are now, no check whatever; unseen and unsuspected, it expands and spreads until it permanently pervades the whole vast extent of our commercial system, until finally, like firedamp, it becomes known by explosion only."

Principally, however, for the reason that the money raised by accommodation paper is so often used in speculative ventures of all kinds in which the money becomes locked up in land or plant, etc., and in such cases all the parties to the paper are engaged in a venture, the failure of which would affect equally their financial position.

It is a question of evidence between the two forms of discounts—in the one there is the plain evidence of commodities exchanged and the financial responsibility of two individuals whose positions are not subject to risk of impairment from the same source, while in the other there is the possibility apparent that the parties may be engaged in some enterprise together in which banking funds should not be put at stake.

Thus you will all readily see that the exercise of the most minute care is necessary in dealing out credit on accommodation paper It is the easiest thing in the world for such paper to degenerate into "a lock up," and "a lock-up" is very often the predecessor of a "bad debt."

That there is, and it is right there should be, legitimate accommodation paper goes without saying. Take, for instance a well-conducted lumberman's account. In the fall the bank makes him advances for the purpose of putting in his camps and otherwise preparing for the winter's cut—these advances have to be kept up until well into the following year—until such time as he begins to ship his lumber. For the lumber sold he obtains cash or commercial paper. With either one or the other he repays the bank the advances before obtained, and thus "cleans up" his account year by year, carrying out the old rule that "it is a good thing to see the color of a man's money once a year at least.'

But such a transaction can very readily be turned into an illegitimate and very undesirable one. Suppose the borrower has gotten out all his logs; they are at the mill, partially converted into lumber, have been and are being shipped; that he is dealing with an easy-going bank officer, and prevails upon that officer to let him use the money for what he calls "extending his business," by purchasing more pine lands, or making other investments of a permanent nature. Now, this is just the point where the "banker's temporary loan" becomes practically "the lumberman's capital," because the money which should have been employed in repaying the temporary advance is put into property, from which it can only be recovered by a very slow process; it becomes, as I have already said, "a lock-up"—an unavailing asset of no practical use to the banker, it is an eyesore, and to the borrower a positive detriment.

I quote from Mr. James G. Cannon, when speaking of customers' liabilities as follows:

"It is very important to know if any portion of this liability is to banks in which the firm has an account, or whether the item represents notes sold on the open market At his own bank a merchant sometimes expects renewals and the continuation of his discounts, but from the public he is liable at any time to be entirely deprived of his accommodations in case of panics or even an ordinary tight money market. For this reason many houses prefer to sell their own paper in the open market, and keep their banks open for accommodation when they are unable to secure outside credit. If it is a case of buying paper and not a credit to a customer of a bank, it is important to know where the bank accounts are kept, and if their bank grant them continuous lines of discount throughout the whole year. Accommodations of this kind partake of the nature of capital furnished by banks. This practice, in my opinion, is not in accord with good banking principles, as it is mutually detrimental in its results to the bank and to the customer, for a bank is not organized for the purpose of furnishing fixed capital to any firm or corporation."

I cannot emphasize too strongly these remarks. They are absolutely sound in their reasoning, and any banker who neglects such common sense endangers the safety of his bank. Mr. Cannon more especially refers to "single name" paper here, and in dealing with this class of paper it must be apparent that while in the aggregate a large amount of information may be obtained concerning the name offered by careful, persistent, diligent inquiry, yet one can hardly ascertain the definite position of a borrower so well as he can that of a customer doing business directly with and confining his borrowings to his own bank. Now this purchasing of paper on the name of a firm only is practically supplying capital, unless it is intended to be but temporary, and it very often becomes fixed. The first questions, therefore, that would naturally occour to a banker when offered such paper are:

1. Is the concern entitled to offer its single-named paper to a bank or on the street at all?

2. Is it in a position to meet this paper under any circumstances?

No renewals are bargained for. The banker regards it as so much cash to be paid in at a future specified date to assist him meeting his own obligations. If there is the smallest doubt in the banker's mind of ability to pay, primarily from the concern's own resources, or secondarily by being able to command a loan elsewhere, even in the event of a tight money market, than he had better, without the least shadow of a doubt, decline the transaction, and let some one else—less particular—supply the capital. The ways employed and the modes adopted in the commercial world for the obtaining of a continuous supply of money are many and devious. Firms and corporate bodies do so through various sources, and frequently through brokers and from bankers in cities situated widely apart. The mere fact that it is drawn from various sources, and that Paul is often borrowed from to pay Peter, makes it none the less capital supplied. I should never advise a banker, and no conservative banker would accept the advice if I gave it, to take a continuous line of accommodation paper from any concern, but more especially where he failed to approximately ascertain from reliable sources the aggregate amount generally borrowed, and whether it fluctuated up or down according to the seasons, or remained fixed or nearly so. Suppose the case of a prosperous house which pays cash for all purchases borrows but moderately, although continuously, a fluctuating amount, and which furnishes a balance sheet to its banker and keeps him posted as to the amount of its total borrowings from time to time. There are such cases, and I think them legitimate and desirable customers. They are, however, the exception.

Again, if a banker ascertains that any concern, having due regard to the course of the money market at the time, has been compelled to pay a rate of interest high for the position the firm is supposed to occupy, it should be sufficient reason for calling a halt before accepting such paper.

It may be the firm was forced to pay one bank by borrowing at an abnormal rate from another. Far better to keep your quick asset in your vault than to take such an evident chance of adding to the merchant's fixed capital.

Grave deliberation is necessary, and additional caution should be observed when the paper of any great trust or combine, with ramifications all over the country, is offered, or when the paper offered is that of a concern depending on, or which has been favored by, special legislation. Unless the corporation can be considered as simply beyond all question, the invariable rule should be to insist upon the individual indorsement of responsible stockholders If this be refused—that is, if the parties themselves interested decline to take any risk upon a concern about which they are supposed to know everything—how can they expect a banker to take the risk, with money, too, for which he is only trustee; in other words, why should he do what they are afraid to do? If he should yield, 100 to 1 he turns what might have been a convertible asset in case of necessity into permanent capital, which he cannot convert, no matter what his necessity, for the same causes which affect him affect them

In dealing with and discounting for a merchant his "bills receivable," one would imagine that "fixed or permanent capital" could hardly get a foothold there, but it does in a very insidious and dangerous way. I refer particularly to "supply accounts;" houses practically owned by the parent concern, in their power, owing large sums and having no independent choice of where to buy goods; houses which may owe the parent concern one sum, and be prevailed upon to accept for perhaps twice the amount, when the latter wants "paper." The proper course would be to weed out such paper. A lot of it is always under discount when houses run such accounts, and in reality forms a part of the merchant's capital. It does not partake of the character of "bona fide" customer's notes, and it would be wiser to take the straight paper of the merchant himself.

In former times the merchant, when he had fully completed a sale of goods, if his customer needed time, took paper. This paper then became the "bills receivable" of the merchant, and, in turn, when money was needed, either to purchase goods or provide for some of the merchant's own "bills payable," become the "bills discounted" of the bank. This was the natural, business-like course. To-day this practice has almost wholly ceased—for goods sold the merchant has nothing to show but a lot of open accounts. Now he cannot use open accounts, so he has to get his banker should he need money, to make him a direct loan on accommodation paper. To my mind, the old practice was infinitely more preferable.

1st. It was more businesslike. Each transaction had a beginning and an ending, and there was a tangible something all the way through to show for the goods sold.

2nd. When a merchant had gotten together a reasonable lot of paper he took it to his banker, discounted it, and took up his own paper. Nowadays he is prevailed upon very often to let a customer's account run, and therefore lets his own paper run.

3rd. The average man having a note payable at a bank in his own city, right under his nose, is much more likely to take care of it than he is to remit for an open account he may owe a merchant residing miles away. In fact, I know that merchants in the present day have objected to giving notes simply because they knew they would have to take care of them when