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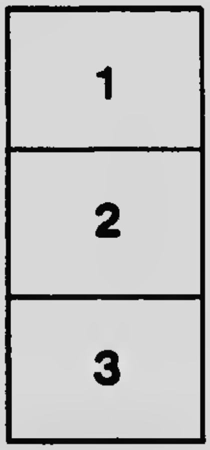

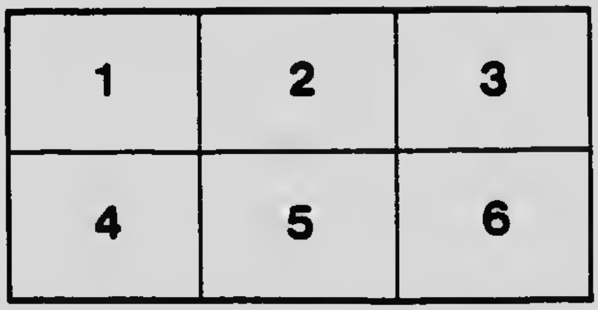

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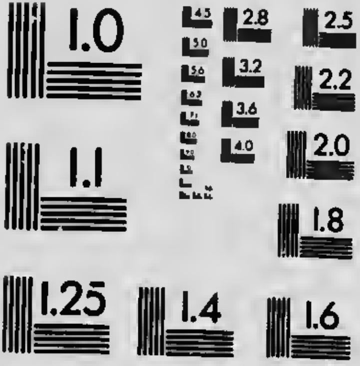

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Queen's University

Course in Banking

LESSONS I-II

Money and Banking

Queen's University.

COURSE IN MONEY AND BANKING.

Note.

The reading in this course will consist of Howard and Swanson's *Money and Banking*, Breckenridge's *History of Banking in Canada*, and supplementary notes. Each lesson will contain an assignment of reading in one or both texts, additional notes on points not covered, and questions based on both text and lesson-notes. The first set of questions is for review or quiz purposes only. The student should put them to himself, or where several men in the same branch or same town are taking the work, they will find it helpful to put the to one another. If difficulties are met in these questions, they should be taken up with the instructor. The second set contains questions to which concise and definite answers should be written out and sent in for criticism.

LESSON I.

The Modern Bank.

Read carefully: Money and Banking, Chapters 12 and 15.

Banks perform two functions, equally important, yet very different. They may receive deposits and act as agencies for investment; and they may furnish the community with part of its medium of exchange in the form of notes or cheques. A savings bank has to do with investment only; and this is the case with many banks of Continental Europe. A strictly commercial bank is not concerned with the sort of investment to which the term is commonly limited—that which looks to the creation of plant. But many savings banks, especially on the continent of Europe make long-time loans which are for investment and not for commercial needs.

A second distinction may be made in the various types of banks—namely, between financial banks and commercial banks. The former are more or less bound up with corporation activities, underwriting loans and making huge advances. The commercial banks deal with the ordinary commercial activities of the community and make short-time loans.

The Use of Credit Instruments.

The essential function of a bank of the commercial type, is that of insurance. It permits goods that are not ready for market to be used as the basis of present purchasing power. This work is accomplished through the use of commercial paper.

The volume of business that can be done by credit paper depends on several circumstances. Obviously, in the first instance, it depends upon the banking facilities of the country. If these banks are widely distributed, and are in close touch with small dealers, farmers, retailers, and the like, many transactions will be put through. This explains the "banking habit" of the people of Canada. Undoubtedly, Canadians and Americans pay by cheque much more extensively than the people of other countries.

In the next place, the density of population is an important factor in the growth of credit exchanges. A larger volume of business is settled by bank paper in a commercial centre than in an agricultural community, even although the proportion of business thus settled may not be larger.

Finally, the general education and intelligence of the mass of the people is an important factor. Men do not use banks unless they have confidence in them, and until they have won for themselves an established place in the commercial mechanism of the country.

Business Done by Credit Instruments.

A very large proportion of the business of the country, even in the retail trade, is done by credit instruments. At least 50 per cent. of the retail trade of Canada is settled in that way. Over 90 per cent. of the wholesale trade of the country is done with cheques and other credit documents. Probably 75 per cent. of the business of Canada is settled in this manner.

The Value of the Credit Economy.

The settlement of a very large proportion of exchanges by cheque may or may not be a good thing. Credit is so delicately adjusted that any shock to the stability of industry may easily upset it. The larger the volume of credit settlements the greater is the panic when confidence breaks down. A breakdown of confidence means an increase in the amount of transactions that must be settled by money. Therefore, a country should always be prepared to furnish a sufficient amount of legal tender money when such is required. If there is any tendency towards speculation it is decidedly better to reduce the volume of credit and have larger recourse to cash payments. If the habits of a people preclude this, then there ought to be some means of supplying additional currency when credit as a means of payment diminishes. This currency should be uniform with the ordinary currency and should be capable of being quickly emitted and recalled. That is, it should possess elasticity.

We cannot expect any social movement to continue steadily in one direction for an indefinite time. Evidence shows that there is a certain ebb and flow in the proportion of cheques used for business payments. The volume of credit transactions very likely tends to increase as population and business grow. It does not increase uniformly, but by periodic movements. It probably is not growing at the same rate as the rate of increase in the whole volume of business.

One point needs to be carefully borne in mind. However great the volume of credit exchanges, however extensive the use of credit may become in a community, they can never fully displace sales for direct money payment.

Questions for Review.

I. *On Text.*

1. What function does credit perform in industry?
2. What determines the interest rate on bonds?
3. How does credit economize the use of gold?
4. What is meant by the elasticity of deposit credit?
5. To what extent may it be said that gold is the basis for all credit?
6. What is the danger from the use of credit, in panics?
7. In what way is the bank a distributor of capital?
8. Do banks create capital?
9. Why must all private credits in the end be liquidated by cash?
10. Why should bank funds not be invested in fixed capital?

II. *On Lesson.*

11. What is the essential function of the bank?
12. What are the economies effected by the use of credit?
13. What factors determine the extent to which credit will be used in a community?
14. Is the extensive use of the cheque as a medium of exchange a good thing?

Questions requiring Written Answers.

15. How do banks supply a medium of exchange?

16. Why may it be said that banking is a quasi-public function?

17. Distinguish between commercial, savings and financial banks.

18. To what extent is bank credit used as a medium of exchange?

19. Have you found any particular difficulty in this lesson which you wish to have cleared up?

LESSON II.

Banking Operations and Accounts.

Read: Money and Banking, Chapters 16, 17 and 18.

It goes without saying that a bank ought to have a requisite capital from the beginning of its operations. There can, however, be no constant proportion between the amount of this capital and the extent of the business which may be built up by its means. The larger the business that can be built up on a given capital, the larger, of course, will be the profits. The point at which the extension of the business passes the line of safety must be determined by the kind of business carried on by it, and the conditions of the community in which it is established. At times in the history of banking attempts have been made by law to adjust the proportion of capital to loans and discounts; but nothing more than a conjectural line can be drawn, too rough to be of any real service. Those who risk their capital, and the directors, are best fitted to judge the proper relation between capital and business done, as they will act according to the law of self-preservation.

The capital of a chartered bank is, of course, divided into shares of $100 each, par value. The powers, rights and liabilities of each shareholder are determined by the amount of stock held by him, double liability being enforced under the Canadian law. Each share carries with it one vote, and dividends are allotted in proportion to the shares owned. Losses, if any should occur, are divided among the shareholders in the same manner.

Assets and Liabilities.

If, now, we set down the statement of account of a bank with a capital of $500,000, the first morning it opens its doors for business, we shall have the following:

Liabilities.	Resources.
Capital, $500,000.	Funds, $500,000.

It may at first sight appear a contradiction in terms that the capital should be regarded as a liability, and not a resource. But we must here distinguish between the financial liability for what has been received from the shareholders and the right of property in the thing received. The bank has become accountable to its shareholders for the amount paid in; in other words, the bank has assumed a liability of $500,000 to the shareholders. Against that liability it holds as a resource an equal amount in cash.

The bank requires to rent offices and secure furniture to carry on its business. Let us assume that it has expended $25,000 to secure this equipment. The account will then read:

Liabilities.	Resources.	
Capital, $500,000	Real estate, furniture, etc, ..	$ 25,000
	Funds	475,000
$500,000		$500,000

The bank, however, cannot answer the purposes of its existence or earn a profit until its idle cash is employed in some way. This cannot be done by simple investment in bonds or stocks. It is the chief business of the bank to promote the commerce of the country by lending to business men on collateral—advancing them capital against future business returns. The bank has heavy expenses to meet, and therefore cannot enter the ordinary field of the private capitalist. The bank is obliged to extend its operations beyond the amount of its capital and make use of its credit. In fact, it is only by such use of its credit that the establishment becomes in reality a bank.

This is done in part by discounting commercial paper. The period fc which such obligations extend varies with the custom of the trade and the country; but it must be short enough to require early repayment to the bank. The bank, above all, must keep its assets "liquid"—that is, easily convertible into cash. If the paper itself is used only as a collateral security, the note which is the actual object of negotiation with the bank is by preference usually made not to exceed four months. This provides for a steady succession of payments to the bank, and thus facilitates the reduction of the business if necessary, or its direction into new channels. The certainty of prompt payment at maturity, needed for this end, is presented in a high degree by the paper created in the ordinary course of business. The written promise of a merchant or manufacturer to pay on a fixed day, backed up by the deposit of securities, is an engagement which involves the credit of the promisor so far that failure is an act both of legal insolvency and of commercial dishonor. If proper selection is made, it is probably as safe an investment as can be found.

Other investments are made, however, either as a matter of policy or because these investments cannot be found. In this case the bank purchases such securities as combine safety with convertibility. Government, both provincial and federal, municipal and school-district bonds may be selected. Stocks are not so desirable a form of investment, being more liable to fluctuations in price. Mortgages, as has already been explained, are not admissible, except when held as a collateral security to some other that is more easily convertible; and even then mortgages upon real estate can be accepted as additional security only after the original debt has been contracted. The reason is clear; real estate is not a liquid asset, and fluctuates violently at periods of depression or crisis.

The results of the process of investment in commercial paper can be seen by the change in the bank statement. Loans on commercial paper give rise to (*a*) deposits and (*b*) profits on the transaction. Suppose the loans are $475,000 for three months at 6 per cent. The statement will then read:

Liabilities.	
Capital	$500,000
Undivided profits	7,125
Deposits	467,875
	$975,000

Resources.	
Loans	$475,000
Real estate, etc.	25,000
Specie	475,000
	$975,000

The bank has loans outstanding of $475,000 which mature at a fixed date; $25,000 in real estate, furniture, etc., as before; and $475,000 in specie (or whatever form the original payments for capital stock have assumed—gold or Dominion notes; we may term these funds "specie" for the sake of convenience). As liabilities the bank has $500,000 originally paid in by the shareholders; $7,125 in profits, which belong to the proprietors; and deposits of $467,875, which belong to borrowers, and which we have assumed they have left on deposit with the bank, and against which they may draw cheques. It may now be considered that the bank has fairly started on its career.

In our analysis of this hypothetical bank statement we have assumed that the loans have been left with the bank on deposit, against which cheques may be drawn. All Canadian banks pay both demand and time deposits on demand, even although they have the right to require notice with respect to the payment of the latter.

Let us suppose that depositors now call for cash to the extent of $50,000. The account will then read:

Liabilities.

Capital	$500,000
Undivided profits	7,125
Deposits	417,875
	$925,000

Resources.

Loans	$475,000
Real estate, etc.	25,000
Specie	425,000
	$925,000

If no further demands are made by depositors, it is clear that the bank can extend the scope of its operations, either by increasing its loans or by purchasing securities. We will suppose it has done both, and that profits have been made and expenses incurred. The statement would then read as follows (assuming that the bank has not yet had recourse to note issues):

Liabilities.

Capital	$500,000
Rest or surplus	130,000
Undivided profits	10,000
Deposits	2,500,000
	$3,240,000

Resources.

Loans	$2,500,000
Bonds and stocks	200,000
Real estate	75,000
Other assets	35,000
Expenses	5,000
Cash items, specie, legal tender notes	425,000
	$3,240,000

Leaving aside, for the moment, the consideration of several items that appear for the first time, the reader should examine carefully the relations between the loans and securities (assets) on the one hand, and the deposits on the other. Obviously, any increase of the loans or stocks and bonds must be made good in some form or other. The bank could provide for a certain amount of these by parting with its legal money reserves; but it is obvious that there is a limit to this procedure, for it would soon put the bank in a most precarious position. Therefore, loans are provided for by giving the borrower a checking account at the bank, and securities that have been bought may be paid for by the bank in the same way.

The extent to which this process can be carried on will depend in part on the business habits of the community and in part upon the legal money reserves which the bank maintains. If it is the business custom of the centre in which the bank is located to conduct its business mostly by cheque, it is obvious that this credit system can be carried to great lengths. But although this is the normal method of doing business in the United Kingdom, the United Sates and Canada, no banker can lose sight of the fact that there may be a sudden demand made upon the bank, by depositors, for payment of their accounts in legal tender money. That is why all prudent bankers keep a certain proportion of their demand liabilities in gold or legal tender notes. It will be recalled that this proportion is left to the good judgment of the Canadian banker, the only legal provision that the government has made being that the bankers must keep 40 per cent. of what reserves they elect to hold in the form of Dominion notes (legal tenders). Other governments fix a definite reserve, notable in the case of the banking system of the United States, all of which will be explained in detail in due course.

Of course, there is the constant temptation to deplete the reserves to increase the loans and securities, because it is from the latter that the bank makes its profits. But a proper cash reserve cannot be made good by securities, however excellent these may be. Although good commercial paper may be certain of payment at maturity, still the demands upon the bank are demands for cash, and cannot be answered by the offer of even the best securities. If a bank cannot meet demands made upon it in legal tender money, it has failed; and any offer of securities is merely a proposal to begin to divide the property of the bank. If, however, the bonds, stocks, and so forth, are wisely selected, they may form a very valuable secondary reserve; for in that case they can be readily sold for cash. In extreme cases, of course, even the best securities can not find a ready sale. Still, they form a very important auxiliary to the reserve of actual cash.

The natural method of securing the proper apportionment of resources between securities (including loans) and reserves, under ordinary circumstances, is by increasing or diminishing the loans, or in other words, the purchases of securities made from day to day in the regular course of business. If the bank stops its discounts, or even slackens its usual activities in making investments, the regular succession of maturing paper will gradually strengthen its reserves; (*a*) either by the discharge of the obligation in cash, or (*b*) by relieving the bank of obligation to pay, by the cancellation of deposit accounts or the return of its notes.

To turn to our statement, however. On the liabilities side are certain items classified as "rest" or "surplus," called incorrectly in the Canadian system "reserve." This has absolutely nothing to do with the real reserve of a bank, which is made up of legal money to meet emergency conditions. The "rest" is simply a part of the profits that has been carried to a special fund to strengthen the position of the bank. The item appears as a liability because the bank owes this money to the shareholders. The "undivided" profits are the profits earned but which have not been disposed of by dividend payment or otherwise. It is obvious that this is also a liability that the bank assumes toward its shareholders.

On the assets side are found "expense" accounts, which represent a certain amount of cash which the bank has paid out. They will disappear when the periodical statement of accounts is made, being deducted from the undivided profits. They are considered an asset for the present because the bank has discharged a certain part of its obligations in one form or another. "Other assets" covers any form of property held by the bank not otherwise classified—doubtful securities, or property held for temporary needs. For example, while a bank can not properly invest in a mortgage, it may be obliged to accept a mortgage in settlement from an embarrassed customer, to be held temporarily. "Cash items" include such demands on individuals or other banks as are collectable in cash; and can, therefore, be fairly considered the equivalent of cash in hand. They may be considered part of the reserves, which are then made up of cash items, legal tender notes and gold.

Questions for Review.

I. *On Text.*

1. How does bank credit promote industry?
2. Why is bank credit preferable to cash?
3. What is the difference between a cheque and a bank note?
4. What are the "secondary" reserves of a bank?
5. Why are bonds unreliable as reserves?
6. From the banker's point of view, what are the objections to a bond-secured currency?
7. The Bank of England notes have the quality of legal tender. What advantage does that give the bank over other note-issuing banks? Is it desirable to impart legal tender quality to Canadian bank notes?

8. To what extent should a bank build up its "surplus" or "rest" fund? (The term "reserve" is used in Canadian practice).

9. Should bank stock carry with it double liability?

II. *On Lesson.*

10. What is the relation between the amount of a bank's capital and the business it does?

11. What are the advantages of the branch bank over the local, independent bank? Are there any disadvantages?

12. What are the various items that may be included in the "cash" of a bank?

13. Why does the Government oblige the banks to hold 40 per cent. of their legal money reserves in Dominion notes?

Questions requiring Written Answers.

14. What part have "concealed" assets played in Canadian banking?

15. What are the arguments in behalf of an asset currency?

16. Should the amount of the reserve carried by banks be left to their discretion or should it be fixed by law? Discuss fully.

What are the limits to the earning power of a bank?

18. Have you found any difficulties in text or lesson?