CHAPTER VI

ADVANCES TO CUSTOMERS

In the item of Advances to Customers we have reached what is the central portion of the activity of a bank. It is here that the banker is brought into direct relation with his customer in a manner which is essentially peculiar, and it is by the manner in which he lends the money entrusted to him that his capacity and usefulness to the community are judged. In receiving his money he is largely passive; he will open a credit account with no more than the assurance, by introduction or references, that his customer is a respectable person. But when he has to lend, he has to assure himself by inquiry, in every way in his power, that his loan will in the first place be repaid when due, and in the second that it will be used for legitimate purposes. It is here that all his faculties are called into requisition; his judgment must not be at fault, he must be cautious, but at the same time he must remember that he has to play an important part in helping the commerce and industry of the country, and indeed of the whole world. And it is from his advances that the banker has to look for most of his profit; it is here that he has to meet the competition of his rivals in the most acute form. He has to temper liberality with caution; if he is too liberal he may easily impair his profits by bad debts, and if he is too timid he may fail to obtain an adequate return on the funds which are confided to him for use. It is by his capacity in lending that a bank manager is judged.

It is not quite exact to say that the line in the balance sheet of "Advances to Customers and other Accounts" is the measure of the assistance which a bank is giving to its customers. In the first place the "other accounts" are to a certain extent a matter of interior book-keeping. For instance, under this head come cheques on branches which are credited to customers before they have actually been debited to the account of the drawer in another branch of the bank. These form a variable but always small percentage of the "Advances, etc." item. On the other hand, a more considerable part of the assistance which a bank gives is classed under the head of "Bills Discounted." A bank is always prepared to discount its own customers' bills, and in fact does so to a large amount. We shall see when we come to consider the Discount Market that one of the main heads under which bills may be classed, is that of customers' drafts on the firms, whether at home or abroad, to whom they have sold goods on credit on the understanding that the sale will be represented by an acceptance. The customers of the bank can either take these to a bill-broker and discount them on the market, or they can take them to their own banker, who is always ready to buy them for cash, provided, of course, that they are drawn on respectable firms and represent legitimate business transactions. If it is desired to know how far a bank is assisting the trade of its customers, this item must be kept in mind. The usual practice is to give each customer who applies a limit up to which his bills will be discounted, and to discount freely up to that limit; but, of course, to watch the bills, to see that they are drawn in the course of ordinary business for goods delivered to "approved" names, and to keep a careful eye upon any signs of "accommodation" bills or "cross-firing"—the name given to a practice which is occasionally adopted, where two firms draw bills mutually upon one another and discount them, preferably at different banks, so as to keep between them a permanent loan, using the proceeds of one bill to pay off another when due and then renewing. A careful manager can always detect such a practice by keeping his eye upon the account, and will naturally take steps to put a stop to it when he has good reason to suspect it. This is, however, somewhat of a digression, merely designed to show that in discounting a customer's bills a manager is brought into direct contact with him, and has to guide himself by the conduct of the account, exactly as in the case of an ordinary advance; whereas, as we shall see, this particular relation does not exist in the case of bills which are discounted on the market. We may now return to the general aspect of the Advances to Customers.

Advances to customers are of the most varied nature, and cover the whole range of the commercial and industrial processes of the world. They may vary from loans running up into the millions needed by foreign and colonial Governments to the overdraft of a few shillings, or even pence, in the account of some hard-working and perhaps hard-pressed operative. The security may be of no less varied nature—real estate, stocks and shares, commodities, personal guarantees, or the unsupported credit of the borrower. But one character they should all have in common; they should be running only for a limited time, with provision for reduction at least, if not full repayment, in periods to be measured by months rather than years. It is a cardinal point of sound English banking that there must be no "lock-up" of capital. A humorous banker is reported to have said that he would have on his books no "Kathleen Mavourneen" loans—"it may be for years and it may be for ever." The whole of the money entrusted to the bank by its depositors is withdrawable either on demand or at short notice; and the most evident prudence dictates that it should not be lent for a prolonged period. It is not the business of the banks to supply fixed capital to their customers; they cannot afford to do so, and where they have yielded to the temptation, the result has usually been disastrous. The prudent banker, when asked to grant a loan, will always inquire in the first place for what period the advance is required, and what is the prospect of its repayment by the expiration of the period. If he is not satisfied as to this, he must not let himself be tempted either by the value of the security or the rate of interest offered; his chief thought must be for the liquidity of his advances.

It is a familiar fact that this limitation of the British banks, the practice adopted after many years of development, forms a marked difference between British and Continental, and more particularly German, banking. In Germany it was, before the war, the custom of the banks to use their resources freely in the financing of new enterprises. An industrialist of good standing, who had got hold of some promising new process or opening for extended trade, which required means beyond those at his disposal, could always bring it before his bank and ask its assistance. The banks had at their command staffs of skilled experts in the leading branches of industry, such as engineering, chemistry, textiles and so on. They would refer to them the proposals made, and if a favourable report were received, the bank would be prepared to take a " participation " in the new venture. A company would be formed in which the bank would take shares, often a controlling interest, and one or more of the Directors of the bank would take seats on the board of the new business. The new process would be operated until it were proved successful. When the time came, an issue to the public would be made, and the bank would "unload," though often retaining a controlling interest in the company. In this way the banks held control of a large part of German industry, and were important factors in the creation of the great "Kartels" or trusts by which a small group of capitalists exercised an enormous influence over the industry and commerce not only of Germany but of the world. The German banks had very large Boards of Directors, who were told off to represent the bank on the various boards of companies in which the bank had a participation, and a system of "interlocking" directorates was thus formed which brought a great part of German industry under central control.

Now there can be no doubt that the German banks did in this way contribute largely to the development of German industry and commerce; and during the war it was a frequent complaint against English banks that they lacked the enterprise which would enable them to render the same services to British industry. But a little reflection will show that this criticism is ill-aimed.

The assistance which the German banks

gave was inevitably bound up with control; the banks would not risk their capital unless they were able to direct the application of it. Now it is clear that public opinion in England would not have tolerated the control of British industry by a few banks. Industry in Britain is based on individualism. Whether it may not be necessary to reconstruct it in the near future, if it is to hold its own, on the line of large combinations, such as the German Kartel or the American Trust, is a matter which may well be open to argument; but for the present Kartels and Trusts are objects of suspicion, and indeed in America are illegal. And it was as an essential step towards the formation of Kartels that the German banks assumed such wide control of industries. The English banks were not in a position to create such monopolistic associations, nor, had they been able, would public opinion have tolerated it. It is not merely a tradition of British banking, but a condition on which British trade has grown up, that the banks should act as auxiliaries, and not as controllers of industry. Indeed at the moment the tendency is to accuse the banking system of the country of an undue influence over industry. This is, of course, a direct contradiction of the accusation of want of enterprise in assisting trade, and both are without foundation. The aim of the banks is to aid all branches of trade, the consumer and the merchant as well as the producer, with absolute impartiality. There might well be an outcry if they were to adopt a novel policy and were to embark their customers' funds in supporting, as owners, particular groups of traders in a competition with their rivals which might easily prove tyrannical. It might easily be said of the German banks that they are the arbiters of commerce in their own country; but it must be placed to the credit of British banks that they have, in spite of uninstructed public outcry, steadily refused to take upon themselves so grave a responsibility.

Furthermore, it is necessary to keep in mind that German banking is not founded, like English, on the current account and the cheque. The English banking system, as has been explained in the first chapter, is, in fact, further advanced and more highly specialised than the German. The German banks were undertaking functions which in London are divided between the deposit banks and the great merchant banking houses. They thus had to provide a very large capital, enough to cover the risks which they were carrying in their industrial ventures as well as that which was the needed provision for the security of their depositors. But their deposits, especially those on current account, were far less in proportion than those of the English banks, because the use of the cheque was not so highly developed. Thus they could venture to risk a larger part of their capital in participation. In London the place of the banks in financing such outside risks is largely taken by the merchant bankers. The deposits which they take from the public are comparatively small; they are mostly private houses dealing with their own capital; and they are thus free from the responsibilities of trustees which weigh heavily on the Directors of the deposit banks. So it is that they are prepared to undertake such risks as the starting of new processes or the like which promise a return in profits adequate to cover the extra danger of loss. Outside the merchant bankers again there are in the City and elsewhere a not inconsiderable number of finance companies whose immediate object it is to undertake similar business. During the war the Government set up a Committee to inquire into the possibility of affording longer-term credits for the assistance of industry on the German plan.

The report of the Committee was unanimously to the effect that this was not business which the banks themselves could undertake. But it was agreed that an experiment should be tried, and a trading Corporation was formed with the express aim of giving such assistance. After several years of experience it can hardly be claimed that the operations of the Corporation have been so successful as to show that there was a real need for it. Nor, again, has the Government experiment in the same direction under the provisions of the Trade Facilities Act attracted business on such a scale as to show the existence of any great demand on the part of the industrial community. To all appearance the action of the joint-stock banks in confining their operations rigidly to the granting of short-term credits has not been any hindrance to British trade; the opportunities of financing offered by other bodies seem substantially to have provided all that was wanted.

The British banker then takes as his fundamental principle that his loans must be for a limited period only. As a rule he grants them for a period of six months and not more; at the end of that period they must come up for revision, and no renewal is promised.

The period is naturally dictated by the seasons of the year. Of some of the most important products on which the world depends it may roughly be said that it takes six months to harvest them and transport them to the markets where they are needed, and a second six months to distribute them to the ultimate users. The autumn season is the time when the raw materials have to be harvested and paid for, while the spring is the most active time for the retailer. Of course the seasonal alternation is less marked than it used to be, now that the southern hemisphere makes large contributions in great staples like wheat and wool. But it still remains true that there is a tendency for prices all over the world to rise in autumn and to fall in the spring; and it is in helping trade over these two periods that the banker has one of his most important functions. The six months' or seasonal loan may be said to constitute the backbone of his business. He smooths over the period in which the dealer has first to buy his stock and then to sell it and recover the proceeds from those to whom he has sold it. The merchant, in the most general sense of the word, must own sufficient capital to carry him on with a normal stock of goods, year in, year out; but it is perfectly legitimate business for him to seek from his banker help in carrying him over the fluctuations which always occur within the year.

Naturally the banker's customer does not always understand or accept this principle which guides the banker. So long as the banker is assured that his loan will be repaid within a certain short limit of time, he can afford to lend at a low rate of interest; and it is a common delusion on the part of customers that the banker should supply them with permanent capital in their business at the same low rate. Indeed some people have gone so far as to write books to show that the trader has a right to loans from his bankers on terms practically dictated by himself. But leaving these out of sight, there is always a certain tendency on the part of borrowers to get the better of the banker, and lure him into supplying them with permanent capital. For instance, a trader has built himself new premises, and comes to his banker for a loan, offering him as security a mortgage on his new property. The banker may be assured that the security is quite good for the amount asked; but he will tell his client that it is not the business of a bank to lend on mortgage, he must not lock up his money in buildings. He will point out that there are well-known channels by which loans on mortgage can be obtained. There are always private investors who are prepared to lend through their solicitors or otherwise; and there are the Insurance Companies. As they have liabilities spread over many years ahead, the maturity of which they can calculate with great accuracy, they are always open to consider advances with a currency of several years, and a mortgage maturing at a date convenient for their future payments is very suitable for their purposes. The client will promise that he will at once take steps to secure a mortgage, but asks for a temporary loan till he can find the permanent money. The request is reasonable; but if the banker grants it, he will very likely find that no active steps are taken to get the mortgage; excuses are made, and the loan drags on without repayment. The fact simply is that the interest which the banker is charging on his temporary loan may be 1% or 1½% less than will have to be paid for a mortgage. A prudent manager, when asked for a temporary loan in anticipation of a permanent mortgage on buildings, will always assure himself that negotiations for the mortgage are genuinely going on, and that both parties are more or less committed. Then, of course, he will lend with confidence.

A similar case which often arises is that of a company who come to their banker saying that they need more capital, and propose to make an issue of new shares or debentures. They ask for a temporary loan in anticipation of the issue, and then "are advised" from time to time that the moment is not suitable; and so, unless the manager is firm, the loan drags on till it becomes a part of their working capital. The general rule, of course, in such cases is that the money should not be lent at a lower rate of interest than that which they would have to pay in the open market for the new issue.

These, however, are only two specimens of the traps which beset the bank manager. The need of the rule is emphasised by many years of experience. It is to these "lock-ups" of capital that most of the troubles of the small country banks during the past century have been due. Local influences or local pride induced them in too many cases to lock up their resources in some neighbouring concern which was striving to advance more rapidly than its capital justified. The local banker was induced to invest his own resources in aiding the overgrowth, which he had no proper means of controlling. When this had once been done, the catastrophe was generally only a question of time.

It is, of course, by its loans and advances that a bank is drawn into the closest connection with its customers, and has its chief influence over the course of commerce. All advances demand a strict inquiry into the security offered. When this is of an undoubted character and easily realisable, such as first-class Stock Exchange securities, the advance will in most cases be readily given, and the only point open to debate is the rate of interest to be charged and the date at which repayment is to be made. But in a large proportion of cases where the advance has to be made for commercial purposes against securities which are themselves involved in the business, the bank manager has to keep himself closely acquainted with the manner in which the business itself is being conducted. More especially is this true where advances are made without security, simply on the credit of the customer. There are, of course, many cases in which the mere name of the customer is as good a security as gilt-edged stocks. But there are many cases—far more than is generally understood—where banks advance to a customer on the security only of their knowledge of him and of his business. Very large sums of money are lent, for instance, to farmers solely on the security of a statement which they put in showing the extent of their holding, the stock upon the farm, their rents, and the nature and extent of their other obligations. The bank manager is expected to verify these statements as far as possible by personal inspection; but still more he has to rely upon his knowledge of the personal character of the borrower, his habits, reputation and capacity. It is by his ability to advise the central control on such points, and of course by the success of his advice as tested by experience, that a bank manager is judged. It is not enough that he should avoid bad debts; he must not be too nervous about making advances, and must remember that a bank has to be liberal in lending where loans are justifiable. A bank has to take its share of risks which are inseparable from all business enterprise. It is in the choice of risks to be taken that the ability of a bank manager shows itself.

It is commonly said that it is harder now than it used to be in the old days of private banking for an enterprising and able young man to obtain from a banker that credit on the security of his character and capacity alone which will often give the start required for the foundation of a profitable business. For this complaint there is almost certainly no ground, and here I may perhaps refer to some remarks in connection with farmers' accounts which I made at the Annual General Meeting of the Westminster Bank in February 1923:

"We have had some figures taken out, and I confess they were something of a surprise to me. They refer, of course, to the loans we make for current business purposes. They show that of the total number of borrowers no less than 28% had their loans wholly unsecured, and a further 13% only gave partial security. In other words, 41% of the farmers who borrowed of us received credit on that personal knowledge by our managers of their character and business, which we are accused of totally ignoring. And I should like to add, to the honour of our managers and their judgment, that this is a class of business which we most willingly undertake, for it is one in which we make very small losses."

It is therefore pretty clear that, for the legitimate purposes of trade, credit on personal character is given at least as frequently as it was in the days before the concentration of banking control in London. But other risks of the old country banking system have been eliminated. The country banker in old days was in too many cases subject to influence which made it difficult for him to make his advances on a purely business foundation. It was difficult for him to say "No" to the neighbouring landowner whom he used to meet on the hunting-field and at the county club, or the local mill-owner who was, very likely, an all-important supporter at a general election. It was difficult for him to refuse to "nurse" some important tradesman who was plainly drifting into bankruptcy, but whose failure would be a local disaster. It was very largely considerations of this sort which led the country banking system into the misfortunes which ultimately doomed it to extinction. The central control of branches at all events largely eliminates the element of local influence, and ensures an impartiality of treatment for all parts of the country. Hence no doubt the complaints of those who would have been unduly favoured under the old system.

It may be said, however, that there is one broad distinction between the loans which a banker is asked to make—the distinction between "speculative" and "legitimate" advances; and it is supposed to follow that the banker is bound to discriminate against speculative advances. There is considerable truth in this; it is a distinction which the banker must always keep in mind, but which it is not always easy for him to observe.

The fact is that the distinction between "speculative" and "legitimate" resembles closely that between "firm" and "obstinate"; it is a question of the angle at which the observer is observing. The real distinction is between "speculation" and "enterprise," and the line between them must be differently drawn under different circumstances. The impulse to extend business boldly, to take risks, is the impulse under which all advance has been made; it is the mainspring through which trade recovers from a period of stagnation and sets off on the upward curve of the "trade cycle." In the course of the upward curve a point is reached at which "enterprise" becomes "speculation" and prices have reached a height which cannot be maintained. The banker has to do his best to mark this point, and before reaching it to put on the brake, in the interests of his clients as well as his own. This function he will endeavour, to the best of his ability, to fulfil; but it is a difficult and trying task, and it is, moreover, one in which he can only play a secondary part. It is after all the specialists in the various, branches of industry and commerce who have the most intimate means of forecasting the future for themselves. The only advantage the banker possesses is that he is in touch with many different branches, and can collate the information he is thus able to collect. But he must act chiefly by advice; instructions must be given from the central control to all branch managers to scan carefully all applications for fresh advances, and to put forward for sanction only those that are for legitimate trade purposes and have no element of speculation in them. But this action is slow; if anything drastic is needed, it is only the supreme authorities, the Treasury and the Bank of England, who can act immediately and effectively. It is perhaps permissible to say, with due discretion, that the great restriction of credit and fall in prices which took place in 1920–2 was brought about in this manner. The banks were approached and received an intimation that the Government had adopted a policy of deflation, and the banks were invited to support it by curtailing their credit facilities. The banks gave the authorities to understand that they were fully aware of the position, and were doing their best to stop speculation by a rigorous investigation of all new applications for credit; but that it was not in their power suddenly to cancel advances which had been already made for specific periods, nor did they consider themselves justified in refusing credits which appeared to them to be necessary for the maintenance of trade. The rate of interest which they charged for advances was, with hardly an exception, fixed in relation to bank rate; they could not suddenly raise the rate themselves, though the Bank of England could always oblige them to do so. There was, in fact, little that they could do. The Government, however, took the matter in hand. They deflated rapidly by very large repayments of public debt, involving reduction in the outstanding issues of Treasury notes and in the floating debt generally, and the Bank of England on April 15, 1920, raised its rate of discount to 7%. The effect was immediate, prices dropped, everyone rushed to realise assets, the value of securities pledged to the banks fell. But the effect on bank advances was much more gradual. It was not till 1922 that the full effect of the Government policy showed itself here. In that year the total advances, discounts, acceptances and endorsements of the banks had fallen by £140,000,000. The banks had to put forth every effort to relieve the strain upon their customers, and the amount of "frozen credits" which they were carrying became a matter of common talk. And yet, such was the irony of the situation, the banks were at the same time accused publicly of having brought about the slump by a violent curtailment of credit. The whole story is an apt illustration of the fundamental theme that alike the creation and restriction of credit generally are in the hands of the Government, in other words, of the Treasury and the Bank of England acting as a Bank of Issue. The deflation of the currency was assisted by the large Budget surpluses of the years 1920–1, 1921–2, and 1922–3. By means of these surpluses, together with the provisions for debt redemption contained within the Budgets, the floating debt was reduced by over £453,500,000. This reduction showed itself in the large ultimate reduction of the deposits with the banks, and this in turn involved a corresponding decrease in the power of the banks to give advances. The banks were but the last link in the chain by which the effects of the Government policy were brought to the banking accounts of the traders. It was perhaps not unnatural for the traders to fancy that the banks were the cause of the inconveniences from which they suffered. It will, of course, be understood that no criticism of the action of the Government is implied in what has been said. The policy of deflation was wholesome, though painful, and was carried out with courage and wisdom. But it was the policy of the Government, and the banks must neither be praised nor blamed for it.

The control thus exercised over the power of the banks to restrict or extend their loans, though it depends ultimately upon the restriction or extension of the currency, is exercised directly through the power of the Bank of England to raise or lower its rate of discount. The Bank of England holds the ultimate reserves of all the other banks; it is to the Bank of England that they have to look in times of stress. And the rate which the Bank imposes for a supply of currency controls the rate which the other banks have to obtain from their customers. Hence it is that the rate for bank loans is, with very few exceptions, based upon bank rate. The most usual rate for loans which may be regarded as fair banking risks, the average rate, in fact, for advances on what may be called average security, is generally "one per cent. over bank rate varying."

In addition to the rate for the loan, the banks almost always protect themselves by charging a minimum below which bank rate will not be followed. Naturally the "overhead" charges which the banks have to meet are very heavy indeed; and the minimum which they charge is such as to make sure that these are covered. When the bank rate falls very low the banks can in any case make little or nothing out of the money which they lend "on the market," and the whole of their profits have to come from loans to customers. It is therefore necessary to fix such a minimum. It may be said that in normal times the rate which the banker looks on as his ideal is "one per cent. over bank rate varying, with a minimum rate of five per cent.," or, as it is generally expressed, "one over minimum five." But here comes in the question of competition between the banks. Though there is a general understanding between banks that they will not openly "tout" for accounts of other banks, there is nothing to prevent private inquiries by customers themselves, and, in fact, the banks are kept well in order by this facility, and a bank which attempted to charge rates which were unduly high would soon find itself losing accounts to its competitors. The rates for loans are, in fact, settled by the "haggling of the market," and of a very open market. The same is the case with the rates allowed for deposits. But both are fundamentally controlled by the currency policy of the Government. It cannot be too clearly understood that there is nothing of the nature of a "Money Trust" between the banks; it is impossible that there should be one while the central control is so completely nationalised. The only "Money Trust" at the present time is that which is controlled through the Treasury by the Chancellor of the Exchequer.

The control of Government is, however, extended into some regions which might be thought to be a part of the internal economy of the bank. This is the case, for instance, with loans to public bodies, particularly municipal authorities. All municipal loans are entirely controlled by the Ministry of Health, in succession to the older Local Government Board. The Ministry inquires into all the circumstances of the loan, the manner in which it is to be employed, and the period within which it is to be repaid. The bank which keeps the account of the municipal authority is not in any way consulted; notice is given that the loan is to receive the sanction of the Ministry, and when that sanction comes, the bank has no choice but to make the advance or to see the account transferred to another bank. The terms of the loan, as regards interest, remain to be settled with the bank, subject always to the possibility of competition. The bank has, of course, no Government guarantee, but to all intents and purposes it acts as a Government department, as much as if it had been actually nationalised. It is the competition between the banks which has produced the effect of placing public bodies in the position of favoured customers; the possession of the accounts of the Councils is eagerly competed for between the banks, even at rates which are not remunerative. For to be the banker of the Council is regarded as the best possible local advertisement, and one for which the bank is prepared to make some sacrifice. It is not at all impossible that, if the banks were to be actually nationalised so that a Government monopoly was created, the result might be, curiously enough, that public bodies would receive not more, but less favoured treatment than they do at present.