CHAPTER IV

DEPOSIT BANKS

ROUND the Bank of Issue, the centre of the whole banking system, are ranged a group of Banks of Deposit which carry on the distribution of credit. These may be numerous and individually comparatively small, as in the United States, or few and very large, as in England, France and Germany. But their functions are largely analogous. The fact that within the last few years deposit banking in England has been concentrated into a small number of large banks has focussed the public view upon them to a disproportionate extent, and produced a very exaggerated idea of the functions which they carry out and of the power which is in their hands.

In the first place it must be pointed out that the main credit system of the country is outside their sphere of influence. They have little or nothing to do as owners with the constant volume of credit which is kept afloat by the aggregate capital of the trading concerns of the country—the standing amount which all industrial and commercial businesses, from the producer to the retailer, carry on their books as an asset in the form of debts due to them, the credit given by the manufacturer to the merchant, by the wholesale dealer to the retailer, by the retailer to his private customer, or in holding their normal stocks of raw materials and goods, manufactured or in course of manufacture. Nor, again, are the banks connected with the great capitalisations of industrial companies. They are not, except incidentally, owners of the shares or debentures by which the industrial and commercial companies obtain credit from the public. The banker holds aloof from all kinds of capital investment. He may give his services in issuing a loan to the public, or he may take debentures and other securities in pledge as security for loans; but he uses caution in taking shares as security, and if they are not fully paid up it is likely that he may decline them. It may then be said that the main credit system of the country, the gigantic amount carried by trade in the form of capital or capital debts, is independent of the banker altogether.

The banks deal, in fact, only with the bare fringe of this great mass of credit, the result of centuries of thrift and of profits put into the stock of the country's capital. A manufacturer of table mustard is reported to have said that he lived entirely on what people left on their plates. In the same way it may be said that the deposit banks live entirely on capital that people do not want at the moment. No business of any extent can foresee exactly from day to day what calls may be coming in, or what opportunities for favourable purchases may suddenly present themselves. Even a small household wants a certain amount of "loose cash" for housekeeping purposes. It is with this floating capital that the banker deals, and on it his business is entirely founded.

Deposit banking grew, as we have seen, out of the need of a safe place of deposit. The obvious risks of hoarding coin for current needs in troublous times led the holders to look round for those who were accustomed to the custody of precious metals, and knew how to deal with them. In London they went to the goldsmiths. The goldsmiths gave them "goldsmiths' notes" in the nature of deposit certificates, and these as they became familiar, passed from hand to hand, and served for currency as representing a similar amount of precious metal held in safe custody by responsible persons. The goldsmiths, provided they accepted money repayable only after a certain term, could obviously make a profit on the deposit by re-lending it, so long as they in their turn could stipulate that it should be repaid to them before the original deposit became due; they thus assured themselves that they would be in funds to meet their depositor's demand at the due date. It then became possible for them to allow their depositor a rate of interest on his deposit, less, of course, than that which they could obtain by lending; the difference between the two rates constituted their profit, that is, their recompense for their services in giving safe custody on the one hand and meeting the requirements of the borrower on the other.

Of course the goldsmith had to depend on his judgment in giving credit, and was bound to take proper security for his loan. Unfortunately the goldsmiths, trusting to the word of the King, made large advances to Charles II; and the monarch, true to his character, did not hesitate to repudiate his obligation as soon as he found it convenient to do so. The consequence was that "goldsmiths' notes" could not be redeemed; payment was suspended in 1672 and great distress was caused. A shock had been given to deposit banking which it took some time to get over. Yet the advantages of the arrangement were so patent that the idea was not only re-established but extended. The goldsmiths found by experience that they could take deposits withdrawable not at a fixed future date, but at any time at the will of the depositor, with confidence that, if such deposits were on a large scale, a sufficient proportion of them would always be left untouched for a certain period to enable the holder to lend up to something like that proportion. This became the foundation of the "current account," on which the depositor might draw at will. One thing further was needed—the invention of the cheque, by which drawing on the current account was facilitated. When the cheque had come into general acceptance, as a negotiable instrument which could be passed from hand to hand, the system of deposit banking was established, and has gone forward with steady development to the present day. It is essentially a London invention. It was by basing their business on the double system of the current account and the deposit account that the London goldsmiths developed into bankers. They were able to do so under the shelter of the Bank of England, because the Bank did not compete with them for deposits at interest.

The deposit banker's business depends on two conditions. First there must be persons with spare cash which they do not need for the moment, which they are prepared to put on deposit, for a certain consideration; second, there must be people who are in need of money, and are prepared to repay temporary loans within a short period. The banker deals in "short money" on both sides. He is essentially a broker whose business it is to link up money needing temporary investment with borrowers needing temporary loans.

It is important to insist upon the fact that the banker's business is founded on his deposits, and limited by them, because a fashion has grown up lately of regarding the joint-stock banks as "creators of credit." They are, of course, creators of credit in the sense in which every lender, even the kind-hearted man who gives a "little loan" of *5s.* to a needy friend, is a creator of credit. But this is not what is meant. By using an ambiguous phrase it is meant to imply that the "banks," meaning the joint-stock banks, can increase to an unlimited extent the amount of credit current. In this sense the idea is plainly untrue. The State is a creator of credit in that sense, because it can not only create paper currency to an unlimited extent, but by making it legal tender can force it into the hands of everyone to whom it owes money. But this power, as we have seen, has been withdrawn from all banks in England. The banks can lend no more than they can borrow —in fact not nearly so much. If anyone in the deposit banking system can be called a "creator of credit" it is the depositor; for the banks are strictly limited in their lending operations by the amount which the depositor thinks fit to leave with them.

It has indeed been argued that every loan by the banks creates a deposit; that so long as the banks go on increasing their loans, so long will their deposits grow in the same degree, and that thus the banks can be regarded as creating credit. Unfortunately this theory will not stand confrontation with facts. Reference to Table A (below) will show at once that the course of events in the first half of the year 1925 gives a decisive answer to this hypothesis. The months in question show a marked growth in the item of Loans and Advances to Customers, amounting in the aggregate of the "Big Five" balance sheets to as much as £29,525,000.

TABLE "A"

AGGREGATE AVERAGE WEEKLY FIGURES OF "BIG FIVE" FOR FIRST SIX MONTHS OF 1925

	Current and Deposit a/cs.	Loans and Advances.	Discounts.	Investments.
	£	£	£	£
January	1,514,631,000	745,859,000	235,289,000	266,501,000
February	1,502,293,000	748,639,000	225,172,000	258,071,000
March	1,470,092,000	765,443,000	195,239,000	254,316,000
April	1,472,197,000	771,461,000	184,024,000	249,646,000
May	1,466,779,000	773,257,000	192,884,000	246,680,000
June	1,489,848,000	775,384,000	197,929,000	240,422,000

But this great increase in advances was accompanied not, as should have been the case according to the theorists, by a corresponding increase in the money lodged, but by a large decrease. All the banks, in order to meet the additional call upon their resources, resorted not to any "creation of credit," which was out of their power, but to their investments at long date, that is, their Government stocks and bonds, which were sold to provide the money for which the borrowers were asking. In other words, the creation of credit in one direction is only made possible by a corresponding cancellation of credit in another; the banks can only lend more to their customers by lending less to the Government.

The deposit banks may be looked on as an elaborate lubricating system, designed to keep the machine of industry in good going order. Every business, and indeed any individual, needs to have a certain amount of loose capital, and in addition successful businesses and thrifty individuals are always, especially in time of prosperity, but also, to an extent not often realised, in what are called "bad times," accumulating reserves of savings. In the latter case the savings are held in hand temporarily, awaiting a good opportunity of permanent investment. The demand for loose capital varies from time to time, from business to business, and from place to place. For whatever reason, the supply of loose capital is always there; the function of the deposit bank is to bring the two together, to take away the superfluous lubricating oil where it is running over, and carry it to the point where it is wanted at the moment. The banks have to follow the currents of trade and production; they have no means of controlling them. They are the servants, not the tyrants of industry. The great bank amalgamations of recent years have been only steps in the perfection of the organisation for "piping" the country together. Some districts are generally provided with a superfluity of loose capital, others are short of it. The banks have now spread their branches throughout the country in a manner which makes them extraordinarily sensitive to the needs and the resources of each district. Not so long ago it was easy for a bank in a district hungry for loans, such as the great manufacturing centres generally are, to find the demands beyond the resources at its command. It had the choice of either "getting over-lent," to the damage of its liquidity, and possibly even of its credit, or of letting good business go by. This is the chief consideration which has gradually forced the small local banks into the great combinations which now conserve and distribute the liquid capital of the whole country.

The banks have to compete with one another to obtain the deposits which form their base of operations. It has already been pointed out that these are of two kinds, deposits on current account and on deposit account. The latter are for a definite period, which is a matter of arrangement between the depositor and the bank. There is, however, one important exception. A very common period of deposit for London and the home counties is "seven days' notice," *i.e.* the money is deposited on the understanding that it can be withdrawn by giving seven days' notice; but it is also a usual condition that it shall remain at least a month on deposit before notice expires. The rate for seven days' money is what is usually called the "Bank deposit rate." It is fixed for London by a meeting of the clearing bankers held immediately upon any change in the Bank of England rate of discount, and it depends directly on that rate. Before the war it was regularly fixed at 1½% below the bank rate. Thus when the bank rate was 2%, as it was for the greater part of the period from February 1894 to September 1897, the bank deposit rate was ½%. When the bank rate was 5% the deposit rate would be 3½%, and so on. But during the war a new practice grew up, and for some years now the deposit rate has been fixed at 2% below the bank rate. This, of course, means that the banks are obtaining a larger margin of profit between the rate they are paying to their depositors and that which they are charging to lenders. The reason is that there has been a great increase since the war in "overhead" expenses, salaries and the like, which have to be met by a similar increase in the banker's "turn" on his transactions.

It must be noticed that this deposit rate only applies to the "Metropolitan area," the City and County Council district, though in practice it is used over most of the home counties and south of England. It has, however, a less precise application to the main industrial regions of the Midlands and north. Here by tradition the rates for deposits do not vary so directly with the bank rate. This is a relic of the old division between country banking and London banking to which attention has already been called. But though the effect of the deposit rate is thus limited, it is of great importance as affecting the value of money in the "money market" of London. To this we shall have to recur later.

With regard to the treatment of current accounts there is a similar difference between London and the country, dating from the days when deposit banking was growing up in

London beside the issue banking of the country. In London it is the general custom not to allow any interest on current accounts. The bank gives its services in keeping the account in consideration of having the use for nothing of a certain "free balance." The amount of this is fixed roughly at a sum the interest on which will about cover the cost of the account; and this again is roughly estimated on the number of cheques passed through it in the course of the year as indicated by the number of pages in the ledger taken by the account. If a free balance is not kept sufficient to provide in interest the cost of keeping the account, the banker will naturally require to be remunerated by charging a fixed commission on the turnover of the account.

In the country it is usual to allow a fixed small rate of interest on the whole of the current account, while charging by way of remuneration a fixed percentage on the turnover, however large. This is purely a matter of tradition But it must be borne in mind that it is not quite correct to speak of allowing no interest on the current account as the "English practice"; it is, in fact, the London practice. And even in London it does not apply to the balances kept by foreign banks with London banks. Interest is always allowed on the full amount of these. The rate is now usually agreed between the banks when they meet to settle the deposit rate. The agreed rate used to apply to all "foreign money" (*i.e.* sterling balances maintained by foreign banks with London banks) not fixed for more than thirty days. This term has been recently reduced to fourteen days. For all money fixed for longer periods each bank can make its own terms, and competition is very severe.

It is, however, not only by the offer of interest that the banker seeks to attract deposits. He is ready to perform many other services for his customers, and many of these he is willing to perform gratis. The most important of these is the custody of valuables other than cash. This may be divided into two parts—the custody of marketable securities, and the custody of boxes and similar parcels.

The custody of securities is a regular part of the business of every branch. It includes not only the safe-keeping of the documents which represent the investments, the share certificates, the bonds, deeds of property, and so on; but to this duty is in many, probably most, cases added the task of collecting the interest in cases where it is not paid in automatically. This is particularly the case with bearer bonds, a form in which a large proportion of our foreign investments is held. The interest on these is represented, as a rule, by coupons which have to be detached from the bond and presented for payment at the paying office. This is a task which is difficult for the private holder to perform, and which is a simple matter of routine for the banker. In addition to these a watch has to be kept on announcements of bonds "drawn," where they are liable to be drawn for repayment. The banker endeavours to keep an eye on the lists of drawn bonds published in the papers, and see whether any of those which he holds for account of customers have to be presented and paid off. Similarly other securities may have to be converted or exchanged, and the banker is looked to for the detailed execution of such transactions. The banker also is prepared to arrange for the sale or purchase of securities through a stockbroker, in that case sharing the commission with the broker. And generally speaking it is expected of every bank manager that he shall be prepared to obtain expert advice and information for his customers on all matters of investment and finance. The bank has to rely entirely upon the tact and judgment of each manager in this respect; a heedless word may involve serious loss, if not in money, at least in reputation.

In giving custody to parcels and boxes, sealed and locked, with contents unknown, the banker is not without anxiety. The risk he runs may be illustrated by an incident which occurred some years ago. A lady deposited a locked box with her bankers, contents unknown. One day a man appeared with an order signed by the lady directing that the box should be given up to him. The bank accordingly gave up the box. After a time the lady came and asked for it, and was told that it had been surrendered on her order. The lady showed that the order was a forgery; she stated that the box contained her jewellery of the value of some tens of thousands of pounds. The bank satisfied themselves that the order was forged; they were advised that they had no defence to the claim, and paid a large sum in compromise on the simple declaration that the contents of the box were of a stated value.

The fault of the bank lay, of course, in their not recognising the forgery. But even apart from forgery the bank runs risks, for instance from theft. When a bank accepts parcels for safe custody, if it makes a charge for its services it is undoubtedly liable if they are lost. If it makes no charge, it claims that it is what the law calls a " gratuitous bailee " and incurs no liability so long as it guards its customer's property with due diligence, which practically means if it guards them as carefully as it guards its own property. The generally accepted definition of the duty of a gratuitous bailee is as follows: " He is bound to take the same care of the property entrusted to him as a reasonably prudent and careful man may fairly be expected to take of his own property of the like description." But the legal point has never been settled, and it would be difficult in fact, even if possible, for a bank to disclaim liability. But the risk has to be taken in most cases, and this particular form of accommodation is a very material addition to the services which the bank undertakes on behalf of its customers.

It may be as well to mention at this point a few of the other miscellaneous services which a bank will now render, though in most cases it makes a charge. It will give guarantees for all sorts of risks in cases where it is satisfied of the position of its customers; for instance, it is continually called upon to give guarantees for the issue of new certificates for shares where the original is said to have been lost or destroyed; it guarantees the delivery of documents such as bills of lading where they have been delayed in the post and the delivery of goods is required. All the large banks now have departments which will undertake trusteeships, the executorship of wills, the administration of family trusts and the like. This is a comparatively new business, but is rapidly growing. Again, departments are established to assist customers in making income tax returns and claiming exemption —a region in which expert assistance is much needed in dealing with all the complications of recent tax legislation. A bank is often used as a business address by customers who are abroad or frequently have to change their residence at home. American banks in particular make a feature of the "Travellers' Departments" opened by their European agencies and branches; and it may be noted that a considerable responsibility and risk is involved in the task of correctly re-addressing and forwarding letters; any mistakes such as the omission to forward letters containing valuables or documents of importance may lead to serious claims.

When the banker has inspired confidence in the public by his record and reputation—which count, of course, far more than the amount of his capital—and has made clear to them the nature of the services he is prepared to render them, whether by paying interest on their deposits or in other directions, he can reckon upon their deposits flowing in. He will indeed have to reckon with the keenest competition from other banks of like standing with his own; but this competition has now reached a point where there is little or no room for further concessions to the public; and business has to be attracted mainly by approaching the customer in the most literal sense—by placing a branch of the bank as near his front door as possible. Good and well-situated premises are the best and most indispensable advertisement for a bank; but they are a very expensive advertisement. Before the war it used to be calculated that a branch in a well-chosen spot ought to be paying its way in from three to five years. Since the war, owing to the growth of " overhead " expenses in general, not only salaries, but cost of building, of postage, of stationery and all the thousand and one details of daily expenditure, the time before the paying stage may be taken to have doubled. Yet the competition between banks in the opening of new branches has been keener than ever since the war. Each of the " Big Five " banks has taken the whole country as its domain. There is no more that sense of friendliness which impelled the smaller banks of old to abstain from poaching on territories which were marked out by tradition as " belonging " to particular houses. At most, the practice of touting for customers of other banks is disapproved; yet complaints often arise. The banks often meet to discuss matters of common interest, whether the London banks at the Clearing House Committee, or British banks in general at the British Bankers' Association, which includes Scottish, Irish and Overseas banks. The clearing banks also fix the " deposit rate " of interest, which always depends on the bank rate, and applies only to the City and County of London. But beyond these limits it can be confidently said that there is no understanding, secret or other, between the banks; there is nothing of the nature of a "money trust" or combination to exploit the public. The public has the benefit of competition between the banks in its fullest form.