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FOREWORD

There are so many things which the man at the home office has always known that it is sometimes hard for him to realize that to the man in the field some of these old familiar problems are coming up for the first time. Sometimes this very familiarity makes it difficult for the man at the home office to explain to a new man what has so thoroughly become a part of his own experience.

The series of articles presented herewith was originally published in serial form in THE WEEKLY UNDERWRITER for the purpose of instructing the men in the field with the technical points of the surety business with which they should be familiar. In book form it is believed that these articles will be found useful both to the man in the field and to the man at the home office. As a book of reference these articles will be found practical and instructive. The publishers bespeak for this book the hearty welcome which it deserves at the hands of the public, at the same time extending their thanks to the contributors who have made this publication possible.

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DEPOSITORY BONDS.

Legal and Moral Aspects of Underwriting—What the Agent Should Know About Them.

By E. King Wilson, Attorney, and Alexander Coulter, Manager Public Official and Depository Department of the Fidelity and Deposit Company of Maryland.

A depository bond is a bond given by a banking institution to secure a deposit of money, either public or private, and is conditioned, in substance, to honor, when presented, all checks drawn on the deposit. Bonds of this kind may be divided into two classes; those bonds which are required by law, and those bonds which are matters of private contract. The former class, which may be designated as statutory depository bonds, includes all bonds securing State, county or city funds; all bonds securing money deposited into court; all bonds securing money coming into the hands of trustees and receivers appointed by courts, such as bankrupt funds, and all bonds securing private funds coming into the hands of public officers, such as Indian funds. The latter class, which may be designated as private depository bonds, includes all bonds required by private persons, either individuals, firms or corporations, to secure deposits of private funds or of public funds, for which the persons requiring the bonds may be personally liable. It will thus be seen that a statutory depository bond may protect private funds and that a private depository bond may protect public funds.

By far the greater part of depository bonds executed by surety companies consists of bonds executed pursuant to some statutory requirement. However, there has, in late years, sprung up a considerable demand for private depository bonds, particularly in favor of concerns which, for business reasons, desire to make deposits of reserve or surplus funds in various sections of the country remote from their home offices.

A deposit of money in bank creates, as a general proposition, the relation of debtor and creditor, whether the funds deposited be public or private. It follows that the obligation which a surety assumes under a depository bond is strictly a financial or credit guarantee. The questions, therefore, which confront the underwriter are: Is the bank applying for a bond an acceptable risk, and if so, how much credit can be extended to it? In answering these questions the underwriter applies many of

the principles which govern the extension of credit in ordinary mercantile transactions, in addition to those principles which are peculiar to the underwriting of depository bonds.

POINTS FOR CONSIDERATION.

Some of the points which are given consideration in connection with depository bonds are:

1. The financial standing of the applicant bank.
2. The character and standing in the community of the officers and directors of the bank.
3. Nature of the deposits.
4. The locality of the bank and local conditions surrounding the bank.
5. The probability, in case of bank failure, of recovering a portion of the loss from the assets of the bank.
6. The relation which the total deposit to be made under the bond bears to the penalty of the bond.
7. The peculiar features, in the case of a statutory bond, of the laws applicable to such bond.
8. The term for which the bond is desired.
9. The protection which the bank has in the way of burglary insurance and fidelity bonds on its officers.
10. Indemnity agreements covering depository bonds.
11. Collateral security covering depository bonds.
12. The surrender of collateral securities.

It is impracticable for an underwriter, either personally or through his agents, to examine the applicant bank, even if the premium would justify the expense of such an examination, so that the underwriter must necessarily rely upon the published financial statements of the bank and the reports of examinations made by national bank examiners, in case of a national bank, and by State bank examiners in case of a State bank or trust company, supplemented by such information as he may obtain through his local agents. For the purpose of underwriting, it must be assumed that a bank's statement is correct.

THE BANK STATEMENT.

A bank statement is merely a summary of the financial condition of the bank, as shown by its books, setting forth on one side the items which make up its resources, and on the other the items which make up its liabilities. Among the resources are included loans and discounts, overdrafts, secured and unsecured, bank building, other real estate, furniture and fixtures, cash in bank, and cash in reserve and other banks. Among the liabilities are included capital stock, surplus and undivided profits, bills payable, notes and bills rediscounted, and deposits, including

time, demand, savings, etc. The underwriter considers these items separately and collectively, in order to determine whether or not they are in the right proportion. If a bank presents a statement, the items of which stand in the proper relation to one another, it is a good risk, provided it is not objectionable for any of the reasons which will be considered later.

The underwriter first of all must be satisfied that the funds of the bank are invested in "quick" or "liquid" assets—that is, assets which can be easily converted into cash to meet the daily demands of depositors or to meet the obligations of the bank, in case it should close its doors. Real estate and mortgage loans are not reckoned as "quick" assets. For this reason a bank with a relatively large investment in real estate or mortgage securities is not considered a good risk. Large real estate holdings not only show "slow" assets, but also indicate that the bank was not able to realize the sums loaned upon the security of real estate and was compelled to take it over to protect its interests—a fact which reflects more or less unfavorably upon the business ability of the men in charge.

The item of furniture and fixtures plays no part whatever in the case of very large banks, for they are often carried for the nominal sum of one dollar. However, in small banks, with very small surplus funds, there has been a tendency to put the value of the furniture and fixtures at a large figure, to that extent increasing the surplus.

It is imperative that a bank shall have on hand ready cash with which to meet the daily demands of its depositors. So important is this matter that national banks and State banks in nearly all the States are required by law to carry a reserve equal to a fixed per cent. of their deposits. This cash reserve can be carried in the bank itself or a part of it can be carried in other banks known as reserve agents. If a bank's statement shows that its cash reserve is below the proper amount, the bank is a questionable risk. The bank should be positively declined if a comparison of its statements shows that it is a constant offender in this respect.

The first items on the side of liabilities are capital, surplus and undivided profits. The capital is the fund contributed by the stockholders. The surplus represents either a fund paid in by the stockholders at the time of organization, or a fund set apart out of the earnings, or it may consist partly of each. The undivided profits represent the profit and loss account of the bank. From this account are taken current losses, expenses and dividends as well as the amounts which are carried to the surplus fund. While these three items are carried as liabilities, apparently in the same class with deposits, they are not in reality, as is well known, on an equality with deposits. In liquidating a

bank, depositors are paid before anything is distributed to stockholders. Therefore the capital, surplus and undivided profits constitute the fund which stands between depositors and loss. The larger the surplus of a bank, the greater the amount of loss which can be sustained and the greater the shrinkage that can occur in its assets without impairment of its capital and the resultant closing of its doors. There is no definite rule as to the relation which the capital and surplus, or either, shall bear to deposits. The national banking act is silent on the subject, except that it does provide the minimum capital for a bank in cities of a certain size, and that before declaring a dividend it shall carry one-tenth of its net earnings for the preceding half year to its surplus fund, until the same shall equal 20 per cent. of its capital. It would seem that a combined statement of all national banks, made up from their reports upon some date taken at random, would present the items of capital, surplus and deposits in the relation in which they should stand to one another in a very strong bank. If we take the combined statement as of November 26, 1912, we find that the capital and surplus fund together were about 28 per cent. of deposits, that the capital alone was about 16 per cent. of deposits, and that the surplus alone was about 12 per cent. of deposits. In other words, in a bank in which these ratios exist there could be losses or shrinkages in its assets in excess of 28 per cent. of the deposit without endangering depositors. With these figures as an arbitrary standard, a bank which shows larger or smaller percentages will be considered correspondingly strong or weak.

BORROWED MONEY.

Bills payable and notes and bills rediscounted show what money the bank has borrowed. Borrowing by banks is regarded as perfectly legitimate. However, very few laws expressly authorize banks to borrow money. Text book writers say that a bank has implied powers to borrow, and even to pledge its assets as security for sums borrowed by it. If a bank has excessive bills payable, it may be taken for granted that its best paper has been put up as collateral and that the least valuable paper has been retained by it, thus weakening materially the bank's condition and rendering more probable the closing of its doors in case of large demands by depositors. Where a comparison of a bank's statements shows that it is an habitual borrower in large amounts, even at periods of the year when good banking does not recognize the necessity of borrowing, it may be safely said that the bank cannot realize upon its paper sufficient sums to pay checks of its depositors.

A large line of depositors shows the confidence of the public, and, what is vastly more important, furnishes to the bank the