CHAPTER VI

WHERE THE BANKER IS SUPERFLUOUS

THE abolition of interlocking directorates will greatly curtail the bankers' power by putting an end to many improper combinations. Publicity concerning bankers' commissions, profits and associates, will lend effective aid, particularly by curbing undue exactions. Many of the specific measures recommended by the Pujo Committee (some of them dealing with technical details) will go far toward correcting corporate and banking abuses; and thus tend to arrest financial concentration. But the investment banker has, within his legitimate province, acquired control so extensive as to menace the public welfare, even where his business is properly conducted. If the New Freedom is to be attained, every proper means of lessening that power must be availed of. A simple and effective remedy, which can be widely applied, even without new legislation, lies near at hand:—Eliminate the banker-middleman where he is superfluous.

Today practically all governments. states and municipalities pay toll to the banker on all bonds sold. Why should they? It is not because the banker is always needed. It is because the banker controls the only avenue through which the investor in bonds and stocks can ordinarily be reached. The banker has become the universal tax gatherer. True, the *pro rata* of taxes levied by him upon our state and city governments is less than that levied by him upon the corporations. But few states or cities escape payment of some such tax to the banker on every loan it makes. Even where the new issues of bonds are sold at public auction, or to the highest bidder on sealed proposals, the bankers' syndicates usually secure large blocks of the bonds which are sold to the people at a considerable profit. The middleman, even though unnecessary, collects his tribute.

There is a legitimate field for dealers in state and municipal bonds, as for other merchants. Investors already owning such bonds must have a medium through which they can sell their holdings. And those states or municipalities which lack an established reputation among investors, or which must seek more distant markets, need the banker to distribute new issues. But there are many states and cities which have an established reputation and have a home market at hand. These should sell their bonds direct to investors without the intervention of a middleman. And as like conditions prevail with some corporations, their bonds and stocks should also be sold direct to the investor. Both financial efficiency and industrial liberty demand that the bankers' toll be abolished, where that is possible.

BANKER AND BROKER

The business of the investment banker must not be confused with that of the bond and stock broker. The two are often combined; but the functions are essentially different. The broker performs a very limited service. He has properly nothing to do with the original issue of securities, nor with their introduction into the market. He merely negotiates a purchase or sale as agent for another under specific orders. He exercises no discretion, except in the method of bringing buyer and seller together, or of executing orders. For his humble service he receives a moderate compensation, a commission, usually one-eighth of one per cent. (12 1/2 cents for each $100) on the par value of the security sold. The investment banker also is a mere middleman. But he is a principal, not an agent. He is also a merchant in bonds and stocks. The compensation received for his part in the transaction is in many cases more accurately described as profit than as commission. So far as concerns new issues of government, state and municipal bonds, especially, he acts as merchant, buying and selling securities on his own behalf; buying commonly at wholesale from the maker and selling at retail to the investors; taking the merchant's risk and the merchant's profits. On purchases of corporate securities the profits are often very large; but even a large profit may be entirely proper; for when the banker's services are needed and are properly performed, they are of great value. On purchases of government, state and municipal securities the profit is usually smaller; but even a very small profit cannot be justified, if unnecessary.

HOW THE BANKER CAN SERVE

The banker's services include three distinct functions, and only three:

First: Specifically as expert. The investment banker has the responsibility of the ordinary retailer to sell only that merchandise which is good of its kind. But his responsibility in this respect is unusually heavy, because he deals in an article on which a great majority of his customers are unable, themselves, to pass intelligent judgment without aid. The purchase by the investor of most corporate securities is little better than a gamble, where he fails to get the advice of some one who has investigated the security thoroughly as the banker should. For few investors have the time, the facilities, or the ability to investigate properly the value of corporate securities.

Second: Specifically as distributor. The banker performs an all-important service in providing an outlet for securities. His connections enable him to reach possible buyers quickly. And good-will—that is, possession of the confidence of regular customers—enables him to effect sales where the maker of the security might utterly fail to find a market.

Third: Specifically as jobber or retailer. The investment banker, like other merchants, carries his stock in trade until it can be marketed. In this he performs a service which is often of great value to the maker. Needed cash is obtained immediately, because the whole issue of securities can thus be disposed of by a single transaction. And even where there is not immediate payment, the knowledge that the money will be provided when needed is often of paramount importance.

By carrying securities in stock, the banker performs a service also to investors, who are thereby enabled to buy securities at such times as they desire.

Whenever makers of securities or investors require all or any of these three services, the investment banker is needed, and payment of compensation to him is proper. Where there is no such need, the banker is clearly superfluous. And in respect to the original issue of many of our state and municipal bonds, and of some corporate securities, no such need exists.

WHERE THE BANKER SERVES NOT

It needs no banker experts in value to tell us that bonds of Massachusetts or New York, of Boston, Philadelphia or Baltimore and of scores of lesser American cities, are safe investments. The basic financial facts in regard to such bonds are a part of the common knowledge of many American investors; and, certainly, of most possible investors who reside in the particular state or city whose bonds are in question. Where the financial facts are not generally known, they are so simple, that they can be easily summarized and understood by any prospective investor without interpretation by an expert. Bankers often employ, before purchasing securities, their own accountants to verify the statements supplied by the makers of the security, and use these accountants' certificates as an aid in selling. States and municipalities, the makers of the securities, might for the same purpose employ independent public accountants of high reputation, who would give their certificates for use in marketing the securities. Investors could also be assured without banker-aid that the basic legal conditions are sound. Bankers, before purchasing an issue of securities, customarily obtain from their own counsel an opinion as to its legality, which investors are invited to examine. It would answer the same purpose, if states and municipalities should supplement the opinion of their legal representatives by that of independent counsel of recognized professional standing, who would certify to the legality of the issue.

Neither should an investment banker be needed to find investors willing to take up, in small lots, a new issue of bonds of New York or Massachusetts, of Boston, Philadelphia or Baltimore, or a hundred other American cities. A state or municipality seeking to market direct to the investor its own bonds would naturally experience, at the outset, some difficulty in marketing a large issue. And in a newer community, where there is little accumulation of unemployed capital, it might be impossible to find buyers for any large issue. Investors are apt to be conservative; and they have been trained to regard the intervention of the banker as necessary. The bankers would naturally discourage any attempt of states and cities to dispense with their services. Entrance upon a market, hitherto monopolized by them, would usually have to be struggled for. But banker-fed investors, as well as others could, in time, be brought to realize the advantage of avoiding the middleman and dealing directly with responsible borrowers. Governments, like private concerns, would have to do educational work; but this publicity would be much less expensive and much more productive than that undertaken by the bankers. Many investors are already impatient of banker exactions; and eager to deal directly with governmental agencies in whom they have more confidence. And a great demand could, at once, be developed among smaller investors whom the bankers have been unable to interest, and who now never buy state or municipal bonds. The opening of this new field would furnish a market, in some respects more desirable and certainly wider than that now reached by the bankers.

Neither do states or cities ordinarily need the services of the investment banker to carry their bonds pending distribution to the investor. Where there is immediate need for large funds, states and cities—at least the older communities—should be able to raise the money temporarily, quite as well as the bankers do now, while awaiting distribution of their bonds to the investor. Bankers carry the bonds with other people's money, not with their own. Why should not cities get the temporary use of other people's money as well? Bankers have the preferential use of the deposits in the banks, often because they control the banks. Free these institutions from banker-control, and no applicant to borrow the people's money will be received with greater favor than our large cities. Boston, with its $1,500,000,000 of assessed valuation and $78,033,128 net debt, is certainly as good a risk as even Lee, Higginson & Co. or Kidder, Peabody & Co.

But ordinarily cities do not, or should not, require large sums of money at any one time. Such need of large sums does not arise except from time to time where maturing loans are to be met, or when some existing public utility plant is to be taken over from private owners. Large issues of bonds for any other purpose are usually made in anticipation of future needs, rather than to meet present necessities. Modern efficient public financiering, through substituting serial bonds for the long term issues (which in Massachusetts has been made obligatory) will, in time, remove the need of large sums at one time for paying maturing debts, since each year's maturities will be paid from the year's taxes. Purchases of existing public utility plants are of rare occurrence, and are apt to be preceded by long periods of negotiation. When they occur they can, if foresight be exercised, usually be financed without full cash payment at one time.

Today, when a large issue of bonds is made, the banker, while ostensibly paying his own money to the city, actually pays to the city other people's money which he has borrowed from the banks. Then the banks get back, through the city's deposits, a large part of the money so received. And when the money is returned to the bank, the banker has the opportunity of borrowing it again for other operations. The process results in double loss to the city. The city loses by not getting from the banks as much for its bonds as investors would pay. And then it loses interest on the money raised before it is needed. For the bankers receive from the city bonds bearing rarely less than 4 per cent. interest; while the proceeds are deposited in the banks which rarely allow more than 2 per cent. interest on the daily balances.

CITIES THAT HELPED THEMSELVES

In the present year some cities have been led by necessity to help themselves. The bond market was poor. Business was uncertain, money tight and the ordinary investor reluctant. Bankers were loth to take new bond issues. Municipalities were unwilling to pay the high rates demanded of them. And many cities were prohibited by law or ordinance from paying more than 4 per cent. interest; while good municipal bonds were then selling on a 4 1/2 to 5 per cent. basis. But money had to be raised, and the attempt was made to borrow it direct from the lenders instead of from the banker-middleman. Among the cities which raised money in this way were Philadelphia, Baltimore, St. Paul, and Utica, New York.

Philadelphia, under Mayor Blankenburg's inspiration, sold nearly $4,175,000 in about two days on a 4 per cent. basis and another "over-the-counter" sale has been made since. In Baltimore, with the assistance of the *Sun,* $4,766,000 were sold "over the counter" on a 4 1/2 per cent. basis. Utica's two "popular sales" of 4 1/2 per cent. bonds were largely "over-subscribed." And since then other cities large and small have had their "over-the-counter" bond sales. The experience of Utica, as stated by its Controller, Fred G. Reusswig, must prove of general interest:

"In June of the present year I advertised for sale two issues, one of $100,000, and the other of $19,000, bearing interest at 4 1/2 per cent. The latter issue was purchased at par by a local bidder and of the former we purchased $10,000 for our sinking funds. That left $90,000 unsold, for which there were no bidders, which was the first time that I had been unable to sell our bonds. About this time the 'popular sales' of Baltimore and Philadelphia attracted my attention. The laws in effect in those cities did not restrict the officials as does our law and I could not copy their methods. I realized that there was plenty of money in this immediate vicinity and if I could devise a plan conforming with our laws under which I could make the sale attractive to small investors it would undoubtedly prove successful. I had found, in previous efforts to interest people of small means, that they did not understand the meaning of premium and would rather not buy than bid above par. They also objected to making a deposit with their bids. In arranging for the 'popular sales' I announced in the papers that, while I must award to the highest bidder, it was my opinion that a par bid would be *the highest bid.* I also announced that we would issue bonds in denominations as low as $100 and that we would not require a deposit except where the bid was $5,000 or over. Then I succeeded in getting the local papers to print editorials and local notices upon the subject of municipal bonds, with particular reference to those of Utica and the forthcoming sale. All the prospective purchaser had to do was to fill in the amount desired, sign his name, seal the bid and await the day for the award. I did not have many bidders for very small amounts. There was only one for $100 at the first sale and one for $100 at the second sale and not more than ten who wanted less than $500. Most of the bidders were looking for from $1,000 to $5,000, but nearly all were people of comparatively small means, and with some the investment represented all their savings. In awarding the bonds I gave preference to residents of Utica and I had no difficulty in apportioning the various maturities in a satisfactory way.

"I believe that there are a large number of persons in every city who would buy their own bonds if the way were made easier by law. Syracuse and the neighboring village of Ilion, both of which had been unable to sell in the usual way, came to me for a program of procedure and both have since had successful sales along similar lines. We have been able by this means to keep the interest rate on our bonds at 4 1/2 per cent., while cities which have followed the old plan of relying upon bond houses have had to increase the rate to 5 per cent. I am in favor of amending the law in such a manner that the Common Council, approved by the Board of Estimate and Apportionment, may fix the prices at which bonds shall be sold, instead of calling for competitive bids. Then place the bonds on sale at the Controller's office to any one who will pay the price. The prices upon each issue should be graded according to the different values of different maturities. Under the present law, as we have it, conditions are too complicated to make a sale practicable except upon a basis of par bids."

THE ST. PAUL EXPERIMENT

St. Paul wisely introduced into its experiment a more democratic feature, which Tom L. Johnson, Cleveland's great mayor, thought out (but did not utilize), and which his friend W. B. Colver, now Editor-in-Chief of the *Daily News*, brought to the attention of the St. Paul officials. Mayor Johnson had recognized the importance of reaching the small savings of the people; and concluded that it was necessary not only to issue the bonds in very small denominations, but also to make them redeemable at par. He sought to combine practically, bond investment with the savings bank privilege. The fact that municipal bonds are issuable ordinarily only in large denominations, say, $1,000, presented an obstacle to be overcome. Mayor Johnson's plan was to have the sinking fund commissioners take large blocks of the bonds, issue against them certificates in denominations of $10, and have the commissioners agree (under their power to purchase securities) to buy the certificates back at par and interest. Savings bank experience, he insisted, showed that the redemption feature would not prove an embarrassment; as the percentage of those wishing to withdraw their money is small; and deposits are nearly always far in excess of withdrawals.

The St. Paul sinking fund commissioners and City Attorney O'Neill approved the Johnson plan; and in the face of high money rates, sold on a 4 per cent. basis, during July, certificates to the net amount of $502,300; during August, $147,000; and during September, over $150,000, the average net sales being about $5,700 a day. Mr. Colver, reporting on the St. Paul experience, said:

"There have been about 2,000 individual purchasers making the average deposit about $350 or $360. There have been no certificates sold to banks. During the first month the deposits averaged considerably higher and for this reason: in very many cases people who had savings which represented the accumulation of considerable time, withdrew their money from the postal savings banks, from the regular banks, from various hiding places and deposited them with the city. Now these same people are coming once or twice a month and making deposits of ten or twenty dollars, so that the average of the individual deposit has fallen very rapidly during September and every indication is that the number of small deposits will continue to increase and the relatively large deposits become less frequent as time goes on.

As a matter of fact, these certificate deposits are stable, far more than the deposits and investments of richer people who watch for advantageous reinvestments and who shift their money about rather freely. The man with three or four hundred dollars savings will suffer almost anything before he will disturb that fund. We believe that the deposits every day here, day in and day out, will continue to take care of all the withdrawals and still leave a net gain for the day, that net figure at present being about $5,700 a day."

Many cities are now prevented from selling bonds direct to the small investors, through laws which compel bonds to be issued in large denominations or which require the issue to be offered to the highest bidder. These legislative limitations should be promptly removed.

SALESMANSHIP AND EDUCATION

Such success as has already been attained is largely due to the unpaid educational work of leading progressive newspapers. But the educational work to be done must not be confined to teaching "the people"—the buyers of the bonds. Municipal officials and legislators have quite as much to learn. They must, first of all, study salesmanship. Selling bonds to the people is a new art, still undeveloped. The general problems have not yet been worked out. And besides these problems common to all states and cities, there will be, in nearly every community, local problems which must be solved, and local difficulties which must be overcome. The proper solution even of the general problems must take considerable time. There will have to be many experiments made; and doubtless there will be many failures. Every great distributor of merchandise knows the obstacles which he had to overcome before success was attained; and the large sums that had to be invested in opening and preparing a market. Individual concerns have spent millions in wise publicity; and have ultimately reaped immense profits when the market was won. Cities must take their lessons from these great distributors. Cities must be ready to study the problems and to spend prudently for proper publicity work. It might, in the end, prove an economy, even to allow, on particular issues, where necessary, a somewhat higher interest rate than bankers would exact, if thereby a direct market for bonds could be secured. Future operations would yield large economies. And the obtaining of a direct market for city bonds is growing ever more important, because of the huge increase in loans which must attend the constant expansion of municipal functions. In 1898 the new municipal issues aggregated $103,084,793; in 1912, $380,810,287.

SAVINGS BANKS AS CUSTOMERS

In New York, Massachusetts and the other sixteen states where a system of purely mutual savings banks is general, it is possible, with a little organization, to develop an important market for the direct purchaser of bonds. The bonds issued by Massachusetts cities and towns have averaged recently about $15,000,000 a year, and those of the state about $3,000,000. The 194 Massachusetts savings banks, with aggregate assets of $902,105,755.94, held on October 31, 1912, $90,536,581.32 in bonds and notes of states and municipalities. Of this sum about $60,000,000 are invested in bonds and notes of Massachusetts cities and towns, and about $8,000,000 in state issues. The deposits in the savings banks are increasing at the rate of over $30,000,000 a year. Massachusetts state and municipal bonds have, within a few years, come to be issued tax exempt in the hands of the holder, whereas other classes of bonds usually held by savings banks are subject to a tax of one-half of one per cent.

of the market value. Massachusetts savings banks, therefore, will to an increasing extent, select Massachusetts municipal issues for high-grade bond investments. Certainly Massachusetts cities and towns might, with the coöperation of the Commonwealth, easily develop a "home market" for "over-the-counter" bond business with the savings banks. And the savings banks of other states offer similar opportunities to their municipalities.

COÖPERATION

Bankers obtained their power through combination. Why should not cities and states by means of coöperation free themselves from the bankers? For by coöperation between the cities and the state, the direct marketing of municipal bonds could be greatly facilitated.

Massachusetts has 33 cities, each with a population of over 12,000 persons; 71 towns each with a population of over 5,000; and 250 towns each with a population of less than 5,000. Three hundred and eight of these municipalities now have funded indebtedness outstanding. The aggregate net indebtedness is about $180,000,000. Every year about $15,000,000 of bonds and notes are issued by the Massachusetts cities and towns for the purpose of meeting new requirements and refunding old indebtedness. If these municipalities would coöperate in marketing securities, the market for the bonds of each municipality would be widened; and there would exist also a common market for Massachusetts municipal securities which would be usually well supplied, would receive proper publicity and would attract investors. Successful merchandising obviously involves carrying an adequate, well-assorted stock. If every city acts alone, in endeavoring to market its bonds direct, the city's bond-selling activity will necessarily be sporadic. Its ability to supply the investor will be limited by its own necessities for money. The market will also be limited to the bonds of the particular municipality. But if a state and its cities should coöperate, there could be developed a continuous and broad market for the sale of bonds "over-the-counter." The joint selling agency of over three hundred municipalities,—as in Massachusetts—would naturally have a constant supply of assorted bonds and notes which could be had in as small amounts as the investor might want to buy them. It would be a simple matter to establish such a joint selling agency by which municipalities, under proper regulation of, and aid from the state, would coöperate.

And coöperation among the cities and with the state might serve in another important respect. These 354 Massachusetts municipalities carry in the aggregate large bank balances. Sometimes the balance carried by a city represents unexpended revenues; sometimes unexpended proceeds of loans. On these balances they usually receive from the banks 2 per cent. interest. The balances of municipalities vary like those of other depositors; one having idle funds, when another is in need. Why should not all of these cities and towns coöperate, making, say, the State their common banker, and supply each other with funds as farmers and laborers coöperate through credit unions? Then cities would get, instead of 2 per cent. on their balances, all their money was worth.

The Commonwealth of Massachusetts holds now in its sinking and other funds nearly $30,000-000 of Massachusetts municipal securities, constituting nearly three-fourths of all securities held in these funds. Its annual purchases aggregate nearly $4,000,000. Its purchases direct from cities and towns have already exceeded $1,000,000 this year. It would be but a simple extension of the state's function to coöperate, as indicated, in a joint, Municipal Bond Selling Agency an dCredit Union. It would be a distinct advance in the efficiency of state and municipal financing; and what is even more important, a long step toward the emancipation of the people from banker-control.

CORPORATE SELF-HELP

Strong corporations with established reputations, locally or nationally, could emancipate themselves from the banker in a similar manner. Public-service corporations in some of our leading cities could easily establish "over-the-counter" home markets for their bonds; and would be greatly aided in this by the supervision now being exercised by some state commissions over the issue of securities by such corporations. Such corporations would gain thereby not only in freedom from banker-control and exactions, but in the winning of valuable local support. The investor's money would be followed by his sympathy. In things economic, as well as in things political, wisdom and safety lie in direct appeals to the people.

The Pennsylvania Railroad now relies largely upon its stockholders for new capital. But a corporation with its long-continued success and reputation for stability should have much wider financial support and should eliminate the banker altogether. With the 2,700 stations on its system, the Pennsylvania could, with a slight expense, create nearly as many avenues through which money would be obtainable to meet its growing needs.

BANKER PROTECTORS

It may be urged that reputations often outlive the conditions which justify them; that outlived reputations are pitfalls to the investors; and that the investment banker is needed to guard him from such dangers. True; but when have the big bankers or their little satellites protected the people from such pitfalls?

Was there ever a more be-bankered railroad than the New Haven? Was there ever a more banker-led community of investors than New England? Six years before the fall of that great system, the hidden dangers were pointed out to these banker-experts. Proof was furnished of the rotting timbers. The disaster-breeding policies were laid bare. The bankers took no action. Repeatedly, thereafter, the bankers' attention was called to the steady deterioration of the structure. The New Haven books disclose 11,481 stockholders who are residents of Massachusetts; 5,682 stockholders in Connecticut; 735 in Rhode Island; and 3,510 in New York. Of the New Haven stockholders 10,474 were women. Of the New Haven stockholders 10,222 were of such modest means that their holdings were from one to ten shares only. The investors were sorely in need of protection. The city directories disclose 146 banking houses in Boston, 26 in Providence, 33 in New Haven and Hartford, and 357 in New York City. But who, connected with those New England and New York banking houses, during the long years which preceded the recent investigation of the Interstate Commerce Commission, raised either voice or pen in protest against the continuous mismanagement of that great trust property or warned the public of the impending disaster? Some of the bankers sold their own stock holdings. Some bankers whispered to a few favored customers advice to dispose of New Haven stock. But not one banker joined those who sought to open the eyes of New England to the impending disaster and to avert it by timely measures. New England's leading banking houses were ready to "coöperate" with the New Haven management in taking generous commissions for marketing the endless supply of new securities; but they did nothing to protect the investors. Were these bankers blind? Or were they afraid to oppose the will of J. P. Morgan & Co.?

Perhaps it is the banker who, most of all, needs the New Freedom.