Recent Trends in Commercial Bank Lending and Borrowing*

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ECONOMIC PERFORMANCE IN 1965

1965 was a year of economic achievement on a broad front. At the year-end, the nation was in its 58th consecutive month of economic expansion, the longest period of continuous growth in peacetime history. Spurred by buoyant consumer demand and record business capital outlays, total output over the year rose by about 7½ per cent in money terms and 5½ per cent in real terms. Total employment reached a new peak, and the unemployment rate fell to its lowest level in eight years. Productive capacity expanded sharply. Yet many businesses were using their plant and equipment at close to—and in some cases above—their preferred operating levels.

And so the year ended with mounting pressure on resources. These pressures are being accentuated by the expectations of businessmen that additional military demands will be superimposed on an already high general demand.

COSTS AND PRICES. As the margin of unused resources contracted, pressures on costs and prices mounted. After several years of gratifying stability, 1965 witnessed a pickup in the rate of advance in the over-all price level—threatening not only the continuation of steady economic expansion but also further improvement in the international position of the dollar.

BALANCE OF PAYMENTS. While the deficit in our international balance of payments was cut sharply in 1965, it was still well over $1 billion, however calculated. Most of the improvement occurred in the second quarter of the year, reflecting the initial impact of the voluntary credit restraint program. The initial large return of funds from abroad and the cutback in foreign loans outstanding were "one-shot" propositions temporarily producing capital flows to the United States. Although the program continued to be effective throughout the year, it contemplated moderate outward capital flows. Another factor affecting our balance of payments in 1965 was a decline in the size of our trade surplus; imports rose more rapidly than exports.

INCREASED DOMESTIC CREDIT DEMAND

As the year progressed, the demand for credit rose rapidly, and interest rates came under pressure. Late in the year, it became clear that the existing level of rates could be maintained only if the Federal Reserve increased the already swift pace at which it was providing reserves to the banks. But such a policy would have been inappropriate in view of actual and threatening inflationary pressures as well as the continuing international payments problem. In these circumstances, two related steps were taken early in December. The discount rates of the Federal Reserve Banks were increased; and the maximum rates commercial banks might pay on time deposits under the Federal Reserve Board's Regulation Q were raised. These actions were not intended to choke off the flow of credit. The discount rate increase was intended to dampen mounting demands on banks for still further credit extensions that, in our judgment, would have added considerably to inflationary pressures. The increase in permissible rates under Regulation Q was intended to enable banks to attract and retain deposits of businesses and individuals and thus make more effective use of funds already available in the economy to finance their loan expansion. These Federal Reserve actions should help to protect the value of the dollar at home and abroad, and should promote the attainment of still another year of sustainable economic growth in 1966.

* An address before the eighteenth national credit conference sponsored by the Credit Policy Committee of the American Bankers Association, New York City, January 31, 1966.

COMMERCIAL BANKS AS SUPPLIERS OF CREDIT

In 1965 the commercial banks demonstrated their flexibility in meeting the credit demands associated with substantial economic growth and their ability to attract large flows of savings.

FOREIGN LOANS. At the same time the commercial banks played an important part in holding down our 1965 international payments deficit. The guidelines under the voluntary credit restraint program permitted a 5 per cent increase in extensions of credit by banks to foreigners in 1965. The actual increase was less than 1 per cent. This moderate increase contrasted sharply with a 30 per cent advance in 1964, prior to the program. This self-restraint in foreign lending in 1965, of course, enabled the banks to extend more credit to domestic borrowers.

DOMESTIC LOANS. On the domestic side, commercial banks once again played a major role in providing the funds necessary to finance record levels of business and personal spending. During the year, total bank credit to domestic borrowers rose more than 10 per cent—the highest rate of expansion in many years. Virtually all this increase was accounted for by a growth in loans; bank lending to nearly every domestic sector advanced at a fast rate.

CONSUMER LOANS. Bank credit provided strong support to personal expenditures in 1965. Commercial banks increased their direct loans to consumers by more than 15 per cent last year, as against a gain that averaged about 9½ per cent per annum over the preceding four years. At the same time, there was a sizable advance in the type of bank credit that goes to consumers indirectly. For example, bank loans to nonbank financial institutions, such as sales finance companies, rose by 26 per cent—more than double the average annual rate of increase in the preceding four years.

REAL ESTATE LOANS. Although residential construction was sluggish in 1965, bank real estate loans registered a record dollar gain. Many of these loans apparently represented new mortgages in connection with the purchase of older houses having lower mortgages; many other loans represented the refunding or enlargement of existing mortgages with the proceeds used for major home improvements, the purchase of durable goods, and a variety of other purposes, such as educational expenses of the homeowners' children.

BUSINESS LOANS. While the banks were expanding their loans to consumers last year, they were also increasing their loans to business concerns by almost $11 billion, or 19 per cent; this was more than double the average annual rate of expansion in the preceding four years. The 1965 experience was actually a continuation of an acceleration in bank borrowing by business concerns that started in the second half of 1963. Over the two and one-half years ended last month, business loans have increased by almost 40 per cent. In retrospect, the reasons are fairly clear. Prior to mid-1963, business concerns had been able to meet the bulk of their financial needs out of cash flows generated by undistributed profits and by depreciation allowances. But as over-all economic activity accelerated, the growth of internally generated funds failed to keep pace with the rapid expansion in capital outlays and in working capital required to support higher sales volume. Accordingly, business firms in the last two and one-half years have turned increasingly to banks and other lenders for additional funds. If the Internal Revenue Code is amended, as recommended by the President, to speed up the payment of corporate income taxes, demands by business firms for credit will rise even more.

Not only have the commercial banks provided business concerns with an unprecedented amount of credit, but the banks have also been gaining in relation to other suppliers of credit. Since mid-1963, banks have supplied over a quarter of all outside funds borrowed by business—in the credit markets as well as through other means, including trade financing. In the 1955-57 period, when business capital spending was also high, the banks provided one fifth. Furthermore, the banks' rising share in business financing has been accompanied by a similar performance in satisfying credit needs elsewhere in the economy. Thus, in the last four years, commercial banks have supplied about 40 per cent of the total funds raised in the credit markets by all private domestic nonfinancial borrowers. In earlier years, by contrast, banks rarely filled more than a quarter of such credit needs. This expansion in bank credit has been facilitated, of course, by the generous provision of bank reserves by the Federal Reserve.

In competing for loans, banks have aggressively sought out and then met the changing needs of business as they emerged in a dynamic economy. More banks are engaging now in financing on the basis of commercial receivables. A number of banks have developed or expanded departments for each of many industries—from such old-line industries as mining, petroleum, and real estate to such new industries as electronics, aerospace, and atomic energy. As a result, there is now more flexibility than ever among commercial banks in adjusting to shifts in the relative rates of growth among industries.

Banks have been making more loans based on the earning power of a firm rather than on its readily salable assets. Essentially, this has meant that banks are becoming more important suppliers of intermediate and longer term

capital to business. The weekly reporting banks in New York City, for example, increased their term loans to business by well over $2 billion in 1965; these loans accounted for two thirds of the over-all gain in their business loans. At the year-end, over 60 per cent of the business loans at these banks had maturities of one year or more, compared with about 55 per cent three years earlier.

Another development has been equipment leasing. While still relatively small, direct leasing by national banks rose to nearly $200 million at mid-1965 from only $50 million a year earlier. Here in New York State the Superintendent of Banks, on the advice of an advisory committee of banking experts, has recommended that the State Banking Law be amended to authorize state banks to enter the field of leasing.[1] This and other recommendations proposed by the committee, and endorsed by the Superintendent, are designed to eliminate competitive inequalities in the position of state chartered banks vis-à-vis national banks whenever consistent with sound banking principles. Similar efforts may be expected of other state supervisory authorities as they strive to improve and modernize their banking laws and regulatory procedures.

SOURCES OF STRENGTH OF BANKS

BANKS AS COMPETITORS FOR LIQUID FUNDS. The growing role of commercial banks in the credit markets is due in large part to the aggressiveness of banks in competing for the liquid balances of the nonbanking sector of the economy. Their ability to compete has been facilitated by the flexible approach of the Federal Reserve toward interest rates on time and savings deposits. In order to keep permissible rates on such deposits in line with other domestic and foreign money market rates, the Federal Reserve Board has raised the maximum rates payable on member bank time and/or savings deposits under Regulation Q four times in the last four years.[2] Federal Reserve action in raising the rate ceilings was taken with the expectation that banks would exercise prudence in availing themselves of the enhanced flexibility in competing for funds. The last three revisions of Regulation Q have focused particularly on the liberalization of rates for deposits of short maturities; now the maximum rate on all time deposits is 5½ per cent. Accordingly, banks have been able to compete vigorously even for relatively short-term funds.

MARKETABLE CERTIFICATES OF DEPOSIT. Accompanying this greater rate flexibility, banks also developed new deposit instruments to attract funds which might otherwise have moved into other short-term investments. The most prominent such instrument is, of course, the negotiable time certificate of deposit; it has been the fastest growing component of time and savings deposits since it was first used nationally in 1961. Large business concerns have found the certificates highly attractive. At present, negotiable certificates of deposit account for well over 10 per cent of all interest-bearing deposits at all commercial banks, and for considerably higher percentages at money market banks. For some New York City banks the percentage is over 50; for most New York City banks the percentage is over 35.

SAVINGS CERTIFICATES. Another type of certificate of deposit that has been growing in popularity is the savings or investment certificate. This instrument is designed to appeal to individuals, eleemosynary institutions, and small business concerns; it enables banks to attract and retain deposits of their more interest-sensitive savings depositors.

Reflecting in part these developments with respect to certificates of various kinds, commercial bank time and savings deposits advanced at a 15 per cent annual rate in the first three years following the January 1962 increase in Regulation Q ceilings; the rate of advance was even more rapid in 1965.

OTHER INSTRUMENTS. Banks also sought additional short-term funds by issuing promissory notes and nonnegotiable "acknowledgments of advances" to corporate customers and others. These instruments brought over $0.5 billion net to weekly reporting member banks in 1965. I shall comment later on these instruments.

Banks in New York City have obtained additional funds on short term by entering into repurchase agreements on Government securities with corporations. Such repurchase agreements rose from $200 million to $500 million in 1965.

CHANGING STRUCTURE OF BANK ASSETS AND LIABILITIES

The broadening role of commercial bank lending operations in recent years makes it more likely that the widest possible spectrum of credit demands can be satisfied at a

[1] For the committee's recommendations, see *Report of the Advisory Committee on Commercial Bank Supervision* submitted to the Superintendent of Banks of the State of New York, December 1965.

[2] In October 1962, Congress amended the Federal Reserve Act to remove the interest rate ceiling on time deposits of foreign governments and monetary authorities and international financial institutions; the amendment was initially effective for a three-year period, was subsequently renewed, and is presently due to expire in October 1968.

commercial bank. Yet, this broadening role and the surge in bank loans in recent years do raise some questions.

LOAN-DEPOSIT RATIOS. One such question relates to the sharp run-up in bank loan-deposit ratios. The average loan-deposit ratio of all commercial banks reached a postwar high of about 63 per cent at the end of 1965, nearly 20 percentage points above the figure of a decade ago; about 5 percentage points of the rise occurred in 1965 alone. Even recognizing the significant change in the composition of their assets and liabilities, many banks may now be operating at or above their preferred loan-deposit ratios, somewhat as a number of manufacturing concerns appear to be operating above their preferred capacity utilization ratios. Consequently, the present high level of loans relative to deposits could soon become a constraining factor in bank lending.

I would hasten to add, however, that the upward trend in loan-deposit ratios over the last several years does not necessarily mean that banks in general are now overextended. One should look at more than the bare statistical ratio. One should examine the items involved in the ratio—the composition of loans and investments, and the nature of the deposits—and the ability of the banks to provide for the additional needs of their customers. The steady and balanced nature of the current economic expansion has probably contributed to the avoidance of some of the excesses of previous expansions. For example, there may be far less financing of possibly excessive and speculative inventories among total bank loans now than in earlier expansions.

The changing composition of commercial bank liabilities since 1960 has also contributed to the acceptability of higher loan-deposit ratios. Time and savings deposits, and also bank capital accounts, have grown far more rapidly than demand liabilities. In fact, between 1961 and 1965, the rate of gain in time and savings deposits has been nearly seven times as fast as the increase in demand deposits. Savings deposits generally have good stability. And so do many time deposits; but the stability of the marketable certificate of deposit is related to available rates on other money market instruments.

Many banks may be willing to live with higher loan-deposit ratios in good part because they have an understandable faith in the quality of their earning assets and a confidence in their ability to maintain deposit levels. But such confidence may not be sustainable, particularly in the case of banks that have a sizable volume of certificates of deposit and find that conditions are not conducive to renewing or replacing the certificates.

RESERVES AGAINST DEPOSITS. We all know that time and savings deposits carry lower required reserve ratios than do demand deposits and that there are no reserve requirements for capital accounts. Consequently, in building up time and savings deposits and adding to capital, banks have reduced the proportion of their assets held as required reserves. In addition, on several occasions in recent years, the Federal Reserve has acted to reduce the amount of reserves needed by the banks; it has reduced the percentage of required reserves in respect of demand and time deposits and it has permitted vault cash to be counted as reserves. Since the end of 1960 the reduction in effective reserve requirements on deposits, combined with the increase in capital accounts, has made possible about one third of the total advance in the average loan-deposit ratio. Thus, total bank earning assets—loans and investments—have increased relative to deposits.

SELECTIVITY IN MANAGEMENT OF ASSETS. Although the current levels of loan-deposit ratios may well be equivalent to considerably lower ratios than in the past, banks in the period ahead will have to be particularly selective in managing their assets. Happily, the business expansion to date has apparently been characterized by few destabilizing excesses. Fiscal and monetary policy have contributed to the continued viability of the expansion; and current economic prospects are good, provided we deal appropriately with price and cost pressures and we keep pressing for solutions of our balance of payments difficulties. There is a real danger, however, that long continued prosperity and the increasing need for larger income to pay for the higher cost deposits may lull bank management into a complacent acceptance of lower credit standards and the relaxation of procedures that should continue to be strict.

Even if the steady pace of the economic expansion is maintained, bankers will have to think about the capacity of bank portfolios to adjust to the flows of interest-sensitive liquid balances. The realities of the marketplace suggest that banks cannot expect their competitors to stand still in the face of the large absolute and relative gains of banks in the money and credit markets. Thus, although time and savings deposits are more stable than demand deposits on a day-to-day or month-to-month basis, such deposits may still prove quite variable over time as investors respond to changing rate differentials among competing short-term earning assets. Even if corporate time deposits remain at a high level they can and do move from one bank to another in response to small rate differentials. Thus, these deposits may simultaneously be stable for the banking system as a whole, yet volatile for individual banks. That volatility implies that management should preserve its ability to adjust to a failure, however temporary, to renew or replace maturing time deposits.

EQUIPMENT LEASING. I would also raise a word of caution about equipment leasing. As the advisory committee to the New York Superintendent of Banks has pointed out,[3] equipment leasing has the same underlying purpose and practical effect as other commonly accepted financing devices such as a term loan secured by a chattel mortgage. Therefore a leasing proposal should be approached with similar considerations and caution. For example, the term of a lease of equipment, or of a loan secured by a chattel mortgage on equipment, should be related to the useful life of the equipment being financed. It would be a departure from sound banking practice for a bank to rent equipment to a succession of lessees under circumstances in which the bank would have full risk of ownership.

TERM LOANS. Commercial banks are uniquely qualified to meet the short-term credit needs of business, and such lending is their primary responsibility. But, if banks commit larger and larger portions of their available funds to credits maturing in several years or more, will they be able to satisfy the shorter term requirements of business, especially if the Federal Reserve reduces the pace at which it supplies reserves to the banking system? Another way of looking at this matter is to raise the question whether bankers should not advise borrowers to turn more frequently to the capital markets and sell shares or bonds in order to meet their long-run needs for funds.

BANK BORROWING. While the success of commercial banks in attracting and holding short-term funds has helped to create the gratifying record of meeting credit needs, it has also raised questions about the appropriateness of the various forms of short-term bank indebtedness. There is not much difference in substance between a demand deposit and a loan to a bank by a customer for a day or two. Nor is there much difference between a thirty-day certificate of deposit and a thirty-day promissory note. Yet, only deposits, because of their legal form, have been subject to statutory restrictions on the payment of interest, to reserve requirements, and to FDIC assessments. Since the effect is the same, whatever the form, the Federal Reserve Board has proposed that short-term promissory notes be treated the same way as certificates of deposit. The Board has published its proposal in the Federal Register and has asked for comments by February 25.[4]

BANK CAPITAL. Of course, a bank should also maintain a sound capital structure as its business expands. Bank capital accounts increased in 1965 by about $2.5 billion, or by roughly 9 per cent, compared with less than 7½ per cent on average in the four preceding years. We should note, however, that a substantial portion of the increase in the last two years took the form of capital notes and debentures. Indeed, the rise in borrowed capital from $150 million at the end of 1963 to $1.6 billion at the end of 1965 has accounted for more than 30 per cent of the rise in capital accounts over the period. The increased use of borrowed capital apparently reflects the belief among a number of bankers that capital notes and debentures are a relatively inexpensive way to raise capital; not only do they bring tax advantages, but they provide through greater leverage the possibility of increased earnings for stockholders.

While this leverage is favorable to stockholders when bank earnings are rising, the effect may be adverse when earnings are falling. And it is important not only for stockholders but also for depositors and the general public that borrowed capital not be excessive. It seems to me that debt capital should not exceed a reasonable percentage of a bank's total capital funds; that the debentures should be amortized over a reasonable period; that the bank should be able, on some reasonable basis, to call the debentures for payment before their stated maturity; and that upon the retirement of the debentures there should be a corresponding increase in the bank's permanent capital, e.g., by a transfer from undivided profits to surplus. As a starter, I would suggest that the debentures not exceed 25 per cent of the bank's total capital funds and that there should be provision for complete retirement out of earnings over a reasonable period, say, twenty-five years.

SELF-RESTRAINT IN MAKING LOANS

As bankers see the likelihood of strong loan demand continuing or perhaps intensifying, there is a natural inclination to raise the rate of interest they pay on time deposits in order to assure themselves against a runoff of such deposits and to pick up some additional deposits. As competing banks take similar steps, the rates can ratchet upward without producing a substantial amount of additional deposits to satisfy the strong loan demand.

In the present situation in which the economy is operating close to capacity ceilings and credit cannot be expected to grow at the extraordinarily rapid rate of last year, the individual banker will have to be more selective in meeting loan requests. He will have to exert ingenuity in paring down loan demands. And in making loans he will have to consider more criteria than merely the creditworthiness of the borrower. He will have to apply some order of priorities. For example, in a period of inflationary pres-

[3] *Report of Advisory Committee,* page 4.

[4] 31 Federal Register 1010 (January 26, 1966).

sures a so-called nonproductive loan, such as a loan to purchase an additional plant or company where no over-all increase of production would result, or a loan for speculative investments or purchases, would generally have a much lower priority than a loan for the production or distribution of goods.

JUDGMENT OF INDIVIDUAL BANK

The proper structuring of loans and investments and of their maturities is, of course, a problem for the individual bank. Each bank must judge for itself the degree of vulnerability to sizable deposit drains and whether its portfolio is appropriate to the risks. The need for this self-appraisal does not imply that a bank should stop seeking new ways to accommodate loan demands or the needs of its depositors. But the employment of these new techniques should be consistent with the time-honored necessity of serving the public interest and of balancing the interests of the bank's customers, its depositors, and its stockholders. The primary responsibility for this balancing rests on the management of the bank.