SECURITY-FIRST NATIONAL BANK OF LOS ANGELES

LOS ANGELES

CHESTER A. RUDE
CHAIRMAN
OF THE
EXECUTIVE COMMITTEE

March 1, 1950

Mr. Marriner S. Eccles
Governor, Federal Reserve Board
Washington, D. C.

Dear Marriner:

Because there has been some press comments concerning my talk to the National Credit Conference of the American Bankers Association on "Factors to Consider in Establishing a Sound Loan Policy", which in some instances have given a wrong inference, I am inclosing a copy of my remarks, together with a copy of a Bulletin from the California Bankers Association on "Consumer Credit" which was recently sent to all of our members.

In the installment and mortgage loan fields in California we have been going entirely too far in the extension of credit, in my opinion, and it is for that reason some of us in banking out here have been trying for some time to put on the brakes, and I might add without too much success.

Kindest regards.

Yours sincerely,

Inclosures 2

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Bulletin
CALIFORNIA BANKERS ASSOCIATION • MILLS BUILDING • SAN FRANCISCO

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OSCAR R. MENNENGA, EXECUTIVE MANAGER
ALLEN J. ZAHN, ASSISTANT MANAGER

BULLETIN NO. 36 - SERIES 14
Subject: GENERAL
DECEMBER 23, 1949

CONSUMER CREDIT

Statement By
CBA Commission on Lending Practices

Consumer Credit May Be Either A Constructive Or Destructive Force in Our National Economy

Consumer Credit based on the needs of the individual borrower and his ability to repay without sacrificing essentials to normal living is a constructive force in our national economy. Credit of that type has placed millions of Americans in the market for consumer goods with the effect that we have unmatched power to produce and an unequalled standard of living. A continuation of sound policy in this field of credit will advance the gains already made.

One of the prime purposes of consumer credit is to enable individuals to purchase consumer goods on the instalment plan out of spendable income. Should lenders and merchants and manufacturers lose sight of this fact and increase their loan volume or sales, as the case may be, by lowering credit standards and terms to levels which would encourage overbuying unfortunate results would surely follow. Under such circumstances consumer credit would be a destructive force bringing delinquencies, repossessed merchandise, depressed sales, lower production, and unemployment in its wake.

Terms

The following schedule of consumer credit terms (minimums and maximums), which is considered by many lenders to be sound under existing conditions, is presented as a guide to banks that wish to appraise their own lending policies:

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Class of Business	Minimum Down Payment	Maximum Maturity
1. Automobiles		
A. New Cars	33 1/3%	24 months
B. Used Cars (1949-1950)	33 1/3%	24 months
C. " " (1946-47-48)	33 1/3%	18 months
D. " " (1942 or older)	50%	12 months
2. New Household Appliances		
A. (Refrigerators - Ranges - Washers, etc.)	15%	24 months
B. Furniture - Radio - Television	20%	24 months
3. Personal Loans		
A. Unsecured	None	12 months
B. Secured (Auto., Furn., etc.)	"	18 months

Schedules of this kind should not be applied indiscriminately. As in other types of credit, each risk should be considered on its own merits. Since every individual will not fit the average economic pattern, some borrowers may be injured by strict adherence to a fixed formula. The lender's policy while geared to current conditions should be flexible enough to accommodate in a proper manner each worthy applicant for a loan.

The fundamental function of credit, in any form and in good times and bad, is to help qualified persons and firms acquire goods and services and thereby contribute to the growth and stability of the national economy. Credit practice on availability and terms which acts as a stimulant to produce or sustain a temporary false prosperity or which is depressive when business activity is declining defeats this fundamental purpose.

Stated positively, credit practice which encourages cash purchases and calls for substantial down payments and short maturities when employment and income are high or rising and which displays confidence in the future of proven borrowers when the trend is downward helps stabilize business conditions, aids worthy persons and firms, prevents injury caused by overextended debt positions, and makes credit serve its proper function. This principle applies with equal force to all merchandisers of credit, including retailers of commodities on credit terms.

The Trend in Terms

The bulk of consumer credit extended by all lenders is being made on a reasonably sound basis but there is evidence that terms are softening. This is particularly true at the retail level. Competition for customers in both the merchandising and the lending businesses is likely to ease terms still further unless some voluntary action is taken to extend credit on terms and under contitions which will not encourage unwise spending by the consumer public.

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The Banker's Responsibility

As the supply lines become jammed with consumer goods it may be expected that sales efforts will frequently be augmented by attractive purchase plans of the "dollar down and dollar a week" variety. If history repeats itself, lenders outside the retail field will follow the trend by lowering their standards at a time when business activity is at or near a peak. In the long run such credit practices will not help to maintain the high level of employment and income. Instead, they will create excessive debt positions, curtail normal buying, and eventually bring about a period of debt liquidation during which all business will suffer from lack of sales.

Bankers can make a substantial contribution to the Country's economic welfare by doing these things:

1. Follow a flexible credit policy which will enable the bank to fill every legitimate credit need and which will not encourage excessive debt accumulation by any individual.

2. Become familiar with the retail credit practices of the bank's customers, and work closely with those customers. Encourage the selling of merchandise and discourage the selling of credit terms. Discourage advertising of terms which are not only unsound but usually of such a generous character that they are available only to customers of the highest credit standing. Encourage resistance to factory and jobber pressure for more sales when filling quotas can be accomplished only by relaxing credit terms to unsound levels.

As specialists in the extension of credit and as the principal source of credit, banking has a responsibility to take the lead in encouraging sound lending policies and sales terms. This responsibility extends beyond the walls of the individual bank; it includes its whole sphere of influence.

COMMISSION ON LENDING PRACTICES
Chester A. Rude, Chairman

William M. Hale	J. C. Ralphs
A. P. Holm	Frank A. Rees
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A. E. Oliver	P.H. Van Horsen

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FACTORS TO CONSIDER IN

ESTABLISHING A SOUND LOAN POLICY

By C. A. Rude, Chairman Executive Committee
Security-First National Bank of Los Angeles

at the

National Credit Conference
American Bankers Association
Chicago, Illinois
January 25, 1950

* * * * * * *

In covering this subject today I have in mind the responsibility of the banker to his community and how it fits into the economy of our country as a whole. The extension of credit is a grave responsibility. It has an important bearing on the economic health of the country. If we withhold credit unwisely, business suffers and so do the people in our respective communities. If we extend credit too freely, over-expansion takes place and ultimately there is great suffering.

We are now, and have been since the war, financing a boom by liberal terms in every field of credit. This during a period of shortages of all kinds of goods and services, at the very time when credit should be sparingly used.

We are helping to build the ground-work for future repossessions and foreclosures which will cost us more in the long run than the money we receive in interest for a long time to come.

It is therefore vital for us to examine our loan policy closely to find out what is sound for us as trustees - not of our funds but of the communities funds.

The loan policy of each individual bank must take into consideration its capital funds in relation to deposits, the character of its deposits, and

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the diversification of its deposits and loans.

My remarks are intended for banks doing a retail business; for banks operating in small, medium and large cities, handling commercial and savings deposits for the individual and for the small, medium and large businesses for that community; for the bank that helps the young couple buy a home, an automobile, or an appliance; that assists in emergencies such as sickness; for the bank that takes care of the sound credit needs of the territory it serves.

One industry or one crop areas call for a much more conservative loan policy than areas with a vast diversification in agriculture and industry. This same reasoning should apply in determining the percentage of risk assets to capital.

How should we measure the amount of loans for each bank?

Some bankers measure their loans against deposit liability and feel that loans up to 50% of deposits should be considered a safe yardstick. With the tremendous increase in deposits caused by deficit financing, a major war, and inflation, the percentage of loans to deposits is only a partial guide. The character of loans and the ratio of loans to capital would seem to be a safer guide, considering the way in which our deposits have been created. The figures and percentages for all of the banks in the United States are as follows:

	6-30-39	6-30-49	% Change
Total Loans	$21,320,000,000	$47,076,000,000	120.8%
Total Capital Accounts	8,156,000,000	12,845,000,000	57.5%
Total Deposits	63,856,000,000	156,470,000,000	145.0%
Loans as a % of Deposits	33.4%	30.1%	
Ratio of Loans to Capital Accts.	2.61 Times	3.66 Times	
Capital Acct.as a % of Deposits	12.77%	8.21%	

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I think it is always unwise to make rules as to what percentage of deposits should be in loans, or how many dollars of capital there should be for a given number of dollars of loans. Although loans are actually somewhat lower in relation to deposits than was the case 10 years ago, there has been a sharp increase in the ratio of loans to capital accounts.

It is interesting to observe that the ratio of loans to capital accounts has increased 40%, or another way of saying it, capital has 40% more assets at risk than 10 years ago. Likewise there is 35% less capital to protect deposits.

For a number of reasons there is little we can do about increasing capital except to earn it, but there is a lot we can do about our risk assets - namely, loans - because we can control our loan policy.

Assuming that the averages are a fair guide, then if your loans exceed the average of loans to deposits perhaps you are too liberal with your loan terms. If the percentage of loans to capital is likewise higher than the average, there is further reason to scrutinize the loan portfolio and re-examine your loan policy. It might mean a fine earning record on capital, but it might also mean an investment in risk assets which is out of proportion, thereby risking future dividends and possibly some capital.

Having decided for your individual bank how much you believe your total loans should be, or let us say 'should not exceed', some of the factors to study for your own loan policy can be considered.

Effect of Economic Conditions

Where are we in the economic cycle? Our loan policy can never be static. It must change as economic conditions change. We have had a sustained period of prosperity since 1935, much of it artificial. When we speak of prosperity let us remember deficit spending, World War II, foreign

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gifts through the Marshall Plan, the costly foreign rearmament, and Veteran refunds now in progress. All have an important bearing on our so-called prosperity. We deal in dollars so we must measure our risk in dollars. Prices have declined and in many lines must go lower. How much we can only guess, but it might be enough to endanger a good many customers. Brakes on lending have been more and more desirable since the middle of 1946.

It is good policy to hold down loans during prosperous times in order to have ample leeway to take care of the credit needs of our customers when conditions are uncertain. Stock Exchange collateral loans have been taken care of for us through Regulation U. Very little loaning ability is required to take care of these loans with safety to the bank. Commodity, installment, agricultural, livestock, mortgage, and open credits are still within our responsibility and must be scrutinized with more than usual care. Our terms the past two years should have been on the cautious side. It is not safe for the bank or customer to grant liberal credit at the top of a business cycle or sustained full employment. Economic foresight is most important when considering loan policy.

We must be fully aware that as our loans increase, our risk and loss potential increases. It is natural to have few losses in a rising economy and larger losses as the supply of commodities becomes readily available. For the sake of the borrower and ourselves we must re-study our existing loans. Then we must look at loan applications to make sure the borrower is on safe ground and that we are not contributing to his downfall financially. In other words, we must be more than careful when conditions are good and liberal when conditions are bad. This means following every possible business index, nationally, and tying in local trends to fit an individual bank's policy. You will never know within months when the top

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or bottom of a cycle is reached - possibly not for a considerable period of time. However, with care you will not be too far out of line for your customer, the bank, or the community. Your headaches will be fewer, your loan policy sounder, and your depositors safer.

Each day since the war risks have been greatly increased due to strikes, the inadequate flow of materials, and increased loans for unbalanced inventories. The warnings have been clear - high prices, buyers resistance, high inventories, and business failures. Commercial loans are for the purchase of raw materials or finished products, to pay for labor and other expenses, to carry receivables from the sale of the product. In other words, to assist in providing working capital. Watching the inventory figure, frequent discussions with the management so that price fluctuations and obsolescence do not endanger the borrower, is important. Likewise the credit policy of the borrower and terms of sale should be carefully watched.

There has been plenty of time since 1946 for the average commercial borrower to get his house in order. Plant modernization should be completed; sales and credit policies should be well established. Concerns which are still limping along financially are in for troubles which credit probably will not cure.

Let us not make the mistakes now of the early 1920's, which are so vivid in some of our memories, when too liberal credit brought about the commodity bust which broke many companies and banks; the liberal credit for stock speculation of the late 1920's; the very tight credit of the early 1930's. We as bankers should have reversed our loan practices in those periods. In order to avoid the same mistakes, our credit terms should be strict now, and I don't mean a sudden turning down of loans. The vast majority of borrowers don't want to go broke. Loans can be controlled by terms and rate.

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Another reason for a careful loan policy at this time is that the interest rate on loans of all kinds has never been lower in our history than now. There isn't the interest return today to justify the same risk as 15 to 25 years ago. Losses must come from earnings. Increased capital funds to protect increased deposits must, in the main, come from earnings. After reasonable compensation for officers and employees, and a reasonable dividend to the stockholders, the amount left for losses and increased capital funds is relatively small. The stockholder today is getting half what he received in purchasing power as compared with ten years ago. This amount should certainly not be put in jeopardy. Let us always keep this in mind when we speak of loan policy.

Appraising the Risk

The basic fundamentals of lending money are an appraisal of the ability and experience of the borrower, the importance of determining the asset value which is the cushion behind a loan, and the earning possibilities of a particular transaction. Let us not be lulled into making loans based upon security alone. The reason for the use of credit is that the individual or company thinks a profit can be made through the use of borrowed money. Earnings must ultimately pay debts. Assets should be a cushion in the event of unforeseen difficulties. That is, the ability on the part of a borrower to perform the task for which the credit is needed, and the knowledge of how the loan is to be paid, are fundamental. To determine these facts, good accounting records must be maintained, complete audits by outside accountants are essential, and above all, the very best tax counsel should be used. This hidden liability can become a very real one and has caused the failure of many business enterprises in recent years, with loss to everyone concerned.

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The important thoughts we must keep constantly in mind are to try insofar as possible to fit our requirements to the needs of the borrower, and to be realistic. If a farmer needs credit and has just one type of produce to market once a year, the credit must be for a longer period than 90 days. If a manufacturing concern requires more machinery, or is in need of plant expansion, and a loan for this purpose will take five years to repay, there is little use to place this type of credit on a 90-day or year-to-year basis.

Legal Limits

Corporation Treasurers are flattered by the bank which grants its legal loan limit, and officers of banks are proud to show their confidence in a given company by giving their legal limit. This is bad loan policy. For the protection of the company they represent they should not accept legal loan limits. This same reasoning applies as between banks. If conditions are good and a company needs more credit, they must seek other and new banking connections. This might be difficult even when conditions are good. If conditions are bad, and the borrower's credit is strained, the legal limit bank can do nothing, even though it should, to protect themselves, and it is a certainty new bank lines are not going to be granted to bail out a competitor. Unnecessary failures were caused in the early 1920's and '30's on this account. It could happen again. (1)

Getting the Facts

Competition from government agencies and insurance companies is not an excuse on our part for making or not making certain types of loans. Politicians make a lot of fuss about 'small business'. Government regulations, red tape, and controls are one of the biggest handicaps that small business must meet. (2)

Banking, in the main, throughout the United States is small business. The substitution of loans for capital in any kind of business

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is unsound. Individuals and businesses rarely go broke if their indebtedness is not out of proportion. Unwarranted expansion through bank loans, or any type of debt, is rarely justified. On the other hand, you and I know too many loans are made or are turned down because of lack of information, which usually means laziness on the part of the banker. Ratios are a valuable guide and are important to consider in granting credit, but they shouldn't be the final guide. Intelligent loaning of money means getting the facts - all of the facts. Above all, know your customer and how he performs. Then, and only then, will intelligent judgment be used. Laziness means getting part of the facts. It is a good plan before turning down a loan application to take an extra look at it by visiting the plant or business. Find out the merits of the product and the type of customers. Maybe a loan can be made on warehouse receipts and/or receivables, or both. It will take lots of time, and maybe some trouble, but we build our banks by building customers. Know all about the company and the industry before deciding a loan. It is much easier to say - "The Loan Committee would not approve the application." Passing the buck to a committee is psychologically very bad for the bank. Good news for customers should be from the bank committee, if you prefer. Unpleasant things, such as a loan turndown, should be by the officer handling the loan. There is a fine difference in the mind of the borrower between the bank and the individual officer. (3)

Insurance Competition

Many bankers feel the insurance companies are encroaching in the commercial banking field. Term loans are being made for a period longer than would be wise for banks. There is still plenty of room for banks to handle the shorter maturities of term loans. The typical insurance loan is the kind that used to be handled by investment bankers - subordinated debentures,

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long term open credit, equipment certificates, which were purchased by the public in years past. It is cheaper for the borrower to go the insurance route, and less complicated.

Installment Credit

It has been only a relatively few years since the majority of banks entered the installment loan field. They always made small personal loans but even these were not installment loans. Most were for 90 days, with many renewals, and sometimes a nominal reduction. The automobile and finance companies, and the appliance manufacturers, taught us how to make these loans. We should have made them from the beginning. Our depositor is entitled and has the right to expect his credit needs to be taken care of by his bank, for an amount and on such terms as are sound for him and the bank. Installment credit, like other types of credit, serves a useful purpose and a public service when it encourages a sound growth of industry by reason of its stabilizing effect on purchasing power. It is strange that any banker would encourage constantly more liberal terms at the very time there was a shortage of automobiles and appliances, and almost immediately after the expiration of Regulation W. Liberal terms should be reserved for the time when there is a surplus of automobiles and appliances and the purchaser needs more extended terms.

Good loan policy is not trying to see how much money can be loaned. Good loan policy is trying to see how wisely money can be loaned. Making credit too easy, spreading it around too far, must inevitably create higher peaks of prosperity and lower and longer valleys of depression. It is not inconceivable to think that the next depression could be touched off by the excessive use of installment credit. This is being brought about by over-selling the individual on every form of commodity which satisfies the human need or luxury, far in advance of the monthly paycheck.

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Prudent lenders should not lose sight of the fact that only credit which is good for the borrower is, in the long run, good for the bank. That test should dictate their policy. Banks should strongly oppose the return of government policing and be prepared to build a record which should help prevent any such development. Too many bankers and large corporations are building a record which is hastening the return of Regulation W. Unemployment insurance when used will probably go for food, not for payments on homes, automobiles, or appliances. (4)

Mortgage Loans

In the fields of mortgage lending, for the sake of some immediate interest on loans, the banker has been and is now tearing down the goodness of his mortgage loan portfolio. There seems to be no intermediate ground between a housing shortage and a surplus. Obviously the period of acute shortage is well behind us and we are in the selective buying period. The surface appearance of the housing shortage is caused by artificial factors, such as rent control. Undoubtedly some time during this year it will be recognized that we have a surplus of housing. The G.I's purchased a cheap house for too much, and everyone connected with the construction of his house made too large a profit. Banks encouraged rather than discouraged the G.I's to invest in something that within a short period he could have gotten for 20% less money. To the extent the banker was responsible, it was not constructive banking or good policy. At this very time mortgage lending agencies of all kinds are financing large housing projects, not with the idea of retaining the individual mortgage, but to make a few points on a quick turnover on the individual mortgage which finds its home with a government agency - The Federal National Mortgage Association.

This agency started out as a means of providing small lending agencies an outlet for mortgages where the demand for housing in certain

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localities exceeded their ability to furnish the necessary funds. The Association was authorized to issue and have outstanding at any one time notes and other obligations in an aggregate amount sufficient to enable it to carry out its functions under this Act or any other provision of law. The total amount of investments, loans, purchases and commitments made by the Association shall not exceed $2,500,000,000 outstanding at any one time. Prior to July 19, 1949, the authorized maximum limit was approximately $1,500,000,000.

It doesn't seem to me it was intended to provide a means for large lending institutions to use their credit for the construction period and charge the borrower 3 to 8 points bonus for making mortgage loans which would be sold to The Federal National Mortgage Association, a subsidiary of R. F. C. This must certainly be considered to be making direct loans by government with the active cooperation of lending institutions. Why talk about a free enterprise if, for a little profit, we ourselves put government in business? This practice, in addition to hastening an overbuilt situation, is building up one more government agency to compete with us, in addition to the many others.

When credit distress comes again, which is inevitable, don't be surprised if we have an epidemic of moratoriums on mortgage loans, installment loans, and other types of credit. We might not even get to the moratorium stage in the financial field. Borrowers with no equity and a possibility of a debt exceeding the value of the security will feel no compunction on letting you have the security. The sense of moral obligation is not as great as it was a few years ago. The sense of financial responsibility is becoming more and more the other fellow's.

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Here is a quotation from a recent Bulletin from the Board of Trustees of the Banking Research Fund of the Association of Reserve City Bankers:

Subject: "Commercial Bank Experience in Urban Mortgage Lending"

> "The economic conditions under which the loans were made appear to have been the most important factor affecting their ultimate repayment or foreclosure record. Loans made in the years of highest real estate values and activity - 1925-29 - proved in the end to have the highest foreclosure rates. Loans made in periods of depression have a better record, in the end, as regards foreclosure rates."

Recent experience in Los Angeles County illustrates this conclusion very definitely. A study of recent foreclosures reveals that 96% of them are on loans which were originally made in the years 1946 and 1947. 1946 was the peak year for both real estate sales activity and prices.

Danger Signs

The danger signs of over-extended credit in this country are, and have been, numerous, and have been ignored for too long a period of time. They are:

1. Strikes and inadequate flow of materials.
2. Unemployment.
3. Price cutting and slowing up of sales.
4. Rapid increase in installment credit.
5. More liberal credit terms, and no down payment.

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6. Greater emphasis on credit terms than quality of product.

7. Increased repossessions.

8. More "For Sale" and "Rent" signs on real estate.

9. Increased foreclosures of real estate.

10. Less money spent for luxuries and entertainment.

11. Business failures.

We must all agree that government spending is at too rapid a rate. It is hastening the liquidation of our economy. We must think carefully about the bankers responsibility in this liquidation. If we cannot stop it, we can postpone it.

Conclusion

The banks have the surplus funds of this country on deposit. If we loan them unwisely we add to our national problems.

While the over-extension of credit in the stockmarket has been given as the cause of the depression of the early '30's, I believe the over-extension of credit in construction and consumer goods was equally responsible.

Today we are using a good many government crutches, and that which government doesn't finance directly or indirectly some bankers are taking care of by financing the individual for his home and all that it contains, with no down payment; and his motor transportation on practically the same basis. From whom have we received such a mandate? I don't believe we are performing our duty in taking the lead in economic thinking and the welfare of our customers by deliberately encouraging them to mortgage their future for the rest of their lives.

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There seems to be a race between government credit agencies and banks to see how fast the credit energy can be disposed of. A debt ridden country, whether by public or private means, or both, cannot be a happy forward-looking people. There is no mystery about sound loan policy. It is just plain, ordinary common sense.

* * * * * * * * * *

(1) While our legal limit is $6,000,000.00 we have no lines or loans of that amount. We have only two lines of credit approaching that amount, which is $5,000,000.00. All other lines are substantially less.

(2) New commercial loans made in 1949 numbered 150,821, of which 144,573 were $10,000.00 or less - or 96%. New real estate loans made in 1944 numbered 4035, of which 3564 were $10,000.00 or less - or 88%.

(3) Lets remember there are not too many officers loaning money today who were in the policy level of the early and middle 1920's. It hasn't required too much loaning skill from 1935 to 1946.

(4) To be consistent with my remarks, I should add that our installment credit outstanding on December 31, 1949 was 17% less than on December 31, 1948.

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March 8, 1950.

Dear Chet:

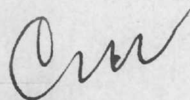
I was pleased to receive with your letter of March 1 the copy of your talk to the National Credit Conference of the American Bankers Association on a sound loan policy. Your discussion of this problem was so frank and penetrating that I wish to congratulate you for its preparation and delivery. Even though you may not have the success that you would like, and I can fully appreciate why, it is good to know that an outstanding leader in the banking field like yourself is advocating a constructive credit policy in these times.

Very sincerely yours,

M. S. Eccles.

Mr. Chester A. Rude,
Chairman of the Executive Committee,
Security-First National Bank of Los Angeles,
Los Angeles, California.

CM:am



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