CREDITS: BANK LOANS

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The topic on which I have been asked to speak today and tomorrow is "credits". The word "credit" and its plural, "credits", may be used to cover almost everything that has to do with banks and also a great deal that has very little to do with banking. Moreover, when the word "credit" is used in connection with banking it is often used ambiguously. Every business man knows the difference between his assets and his liabilities. If he does not he soon finds himself in trouble. Each of you, as a banker, knows instinctively the difference between the assets and liabilities of your bank: If you do not, I am sure you will not remain a banker very long. But ~~in Washington where economists and other government officials talk a great deal about bank credit,~~ when people talk about bank credit, they frequently do so in such a way that it is impossible to determine whether they are talking about bank assets, or about bank liabilities, or both of them.

In my talks today and tomorrow I am going to try very hard to avoid this ambiguity. Today I shall talk about bank credit from the point of view of the assets of banks, and particularly about bank credit in the sense of bank loans. Tomorrow I shall talk about bank credit from the liabilities side of bank operations, paying particular attention to the deposit accounts of business enterprises and individuals, which constitute the dominant aspect of bank credit from this point of view.

At the Federal Deposit Insurance Corporation we are now completing our tabulation of the assets and liabilities of all operating banks in the United States as of June 30. Our figures for the entire United States are not yet available but we have those for Tennessee, and

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the Federal Reserve staff in Washington have made some estimates for all banks in the United States. In taking a look at the figures for June 30, we should keep in mind the fact that they are not affected by the business upsurge which followed our participation in the Korean war. They do, however, reflect the moderate upswing in business which had been under way for nearly a year.

As of June 30 of this year the banks of Tennessee reported total loans of $672 million. This was 15 percent more than they reported for the same date in 1949 and 20 percent more than for mid-year in 1948. It was more than double the amount of loans which Tennessee banks had outstanding on June 30, 1945, at the height of our participation in World War II. To describe these changes in a slightly different way, the 15 percent increase in bank loans in Tennessee during the year ended on June 30 may be compared with a 4 percent increase during the preceding year, and with an average of 23 percent per year increase from the middle of 1945 to the middle of 1948.

Bank loans throughout the entire United States have not increased quite as rapidly as in Tennessee, but the changes in the rates of growth have been somewhat similar. From mid-year 1945 to mid-year 1948 loans of all banks in the United States and possessions increased by 17 percent per year, from mid-year 1948 to mid-year 1949 by 4 percent, and from 1949 to 1950 by about 11 percent.

These rates of increase in the amount of bank loans differ substantially from the growth in total bank assets. In Tennessee total bank assets increased only 4 1/2 percent during the year preceding June 30, 1950, and less than 2 percent during the year from June 30, 1948, to June 30, 1949.

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During the three years from 1945 to 1948 the increase in total assets was only 1 1/2 percent per year. That is, the rate of increase in loans has been far higher than the rate of increase in total assets.

This great difference between the rates of increase in bank loans and total bank assets is also reflected in the proportion of total assets which consist of loans. Five years ago bank loans in Tennessee constituted less than 17 percent of bank assets. By mid-year 1948 loans had become 29 percent of total assets; at the end of June 1949 they were 30 percent of total assets, and by the middle of this year 33 percent. However, loans are still not as high in proportion to assets as they were prior to World War II, for on June 30, 1941, they comprised 37 percent of all assets of Tennessee banks. Obviously, as the banks have made new loans they have used most of them to replace other assets, such as United States Government obligations, which were being redeemed or which the banks were selling.

Let us now take a look at the kinds of loans which have been made by the banks in Tennessee. On June 30 of this year, 38 percent of all loans were in the category "commercial and industrial," and 7 percent were loans to farmers. Loans on real estate were about 20 percent of all loans, and loans to individuals 30 percent of all loans. These types of loans, taken together, account for all but 5 percent of all the loans of Tennessee banks. The proportions of total loans in the various categories in Tennessee differ somewhat from the distribution of loans for all banks in the United States. Tennessee banks have about the same proportion of commercial and industrial loans as do the banks in the nation as a whole, but they have relatively smaller amounts of real estate loans, and relatively larger amounts of loans to individuals.

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Some types of bank loans increased much more rapidly than other types. In Tennessee loans to farmers, excluding those on stored crops guaranteed by the Commodity Credit Corporation, are about twice the amount five years ago, business and commercial loans nearly three times as large as in 1945, and real estate loans three and a half times. But the highest rate of increase is in the case of instalment loans to individuals, which are eight times as large in amount as in 1945.

With this brief resume of the growth and character of bank loans in Tennessee, I want to turn to some comments on the outlook for the future. In looking ahead, we must distinguish clearly between the short range outlook and the long range. For the short term, that is, for the next six months or year, the outlook for bank loans depends almost exclusively upon developments resulting from the Korean war and our rearmament program, particularly upon the financial policies adopted by the government in Washington.

During the eleven weeks which have elapsed since the outbreak of hostilities in Korea and the decision of the United Nations to intervene, there has been a tremendous sweep of opinion throughout the country that the situation must result in strong inflationary pressures. The basic reasons for this opinion appear to be two: (1) The experience of the last World War, with price controls and rationing and the rapid rise in prices at its close, which is still fresh in our memories; and (2) A prevailing belief that the increased defense expenditures mean a government deficit and that a deficit means an expanding flow of money meeting a contracting supply of goods available for business and personal use. As a result of this belief in the inevitability of strong inflationary pressure, speculative

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forces have already pushed the level of prices, particularly at wholesale, upward, and Congress has granted the President extraordinary powers of allocation of goods and control of prices, wages, and certain types of loans. It seems to be generally understood that restrictions on real estate loans and on loans to consumers will be put into effect quickly. How drastic these regulations will be, or how much they will effect the loan operations of banks, can not now be forecast with my confidence. I can only surmise that the regulations will be strict enough to prevent much further expansion of real estate or consumer loans, but that they will not be so stringent as to produce a marked decline in the amounts now outstanding.

With respect to other types of loans, it is even more difficult to look ahead. Our defense activities and the impulse they are giving to business will stimulate the demand for three sorts of business loans: (1) loans needed by firms accepting contracts for military equipment and supplies; (2) loans desired by other enterprises attempting to increase production to meet the upsurge of demand; (3) loans desired for the purpose of holding inventories or building up stocks of scarce goods as a precaution against shortages and price rises or with the expectation of reselling them later at higher prices. Bankers, we believe, should scrutinize their applications for loans very carefully. They should make those which really contribute to increased production, but should decline so far as possible to make loans which merely enable business men or others to hold stocks of goods unused. They should take particular care to avoid loans for the speculative holding of commodities which have been purchased at the rising quotations of the past

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few weeks or are to be purchased at prevailing prices. Such loans not only impede the meeting of military and civilian needs, but are also unduly risky. While further pushing of the price level upward is possible, there is not as much liklihood of rising prices in the coming months as has obviously been assumed. In fact, it is quite possible that prices will soon start to fall back. I hope that your banks will not be caught with speculative loans if this should occur.

The short range outlook for bank loans is affected not only by the prospect of credit restrictions, but also by the outlook with respect to change in total bank assets and the outlook for United States government obligations. The cash deficit of the Federal government may not be very large during the rest of 1950 and the first half of 1951, but will probably be sufficient to require some increase in the outstanding public debt. For this reason the banks will have less opportunity than they have had during the past five years to reduce their holdings of United States government obligations. At the same time, if the present policies of the Federal Reserve System remain unchanged, commercial banks will not be able to enlarge very much their total assets. This combination of circumstances would tend to stabilize bank loans not far from their present volume.

Regardless of whether bank loans, under the impact of a wartime situation, expand further or whether they do not do so, the earnings of banks from their loans may be expected to increase. For the calendar year 1949, insured banks in Tennessee earned 10 percent more from interest and discount on loans than in the previous year though the average amount of loans and discounts outstanding was only 6 percent larger. A further rise in the average rate of income on loans appears to be in prospect, even

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though there are restrictions on loans in some of the categories which bear the highest rates of interest.

The long-range outlook for bank loans is quite different from the short-range outlook. Except for the contingency of another major war, banks should have an opportunity for a substantial expansion of their loans during the next decade. The principal reason for this opportunity is the need for a larger money supply or circulating medium to accompany the normal growth of population and increase in productivity. Our estimates indicate that to provide the needed additional circulating medium, bank deposits ought to grow at a rate of approximately 5 percent a year. This is the rate of growth which analytical studies of our past experience indicate is needed to maintain full employment and prosperity and at the same time to prevent price inflation. Tomorrow I will discuss more fully the reasons why we need this rate of growth of bank deposits.

If bank deposits are to grow at the rate of about 5 percent a year bank assets must also increase at approximately the same rate. In fact, bank assets must increase more rapidly if banks strengthen their capital position, as I believe they should. At the present time the banks of Tennessee have about $2 billion of assets; the banks of the entire United States about $180 billion. If these assets are to grow at 5 percent a year, the banks of the United States should acquire $9 billion of assets a year, and the appropriate portion for the banks of Tennessee would be about $0.1 billion, or $100 million.

If we avoid a major war, and balance the budget of the Federal government, there will be no additional amounts of Federal government obligations available for acquisition by the banks. We should anticipate,

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therefore a much higher rate of expansion of loans than of total assets. In fact, a growth of 5 percent a year in bank assets for the next decade, if it were concentrated wholly in loans, would mean an annual increase of 15 to 20 percent in their loans. This would apply both to banks in Tennessee and in the entire United States.

The question of how large a part of such an increase in total bank loans might reasonably consist of the various types of loans is not readily answered. Certainly it should not be assumed that all types of bank loans could well be increased in approximately the same proportion. The asset side of the operations of the nation's banks, and particularly their loan operations, are intimately associated with the aspects of economic activity on which the people of the nation are placing emphasis at a particular time. It is the new industries, the new things which people want, and particularly the new structures and new durable goods which they wish to acquire, that create the need for bank loans. Economic activities which have become well established and are no longer expanding, though current purchases continue year after year, require much less credit financing than do the expanding segments of the economy.

During the past few years replenishment of consumers' stocks of durable and semi-durable goods, such as automobiles, kitchen and laundry equipment, and household furnishings, was a natural and appropriate part of our national output, and loans to facilitate acquisition of such goods were an appropriate phase of the adaptation of banks to the needs of the economy. While this phase of economic activity still continues, the need is now not so pressing as at the close of World War II. Our needs for new houses and other new structures have not been met so adequately. This is

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now the chief segment of the economy which needs credit in a large amount. True, we have also had a housing boom, but houses and other structures are among the things which have not yet been produced in sufficient volume to meet the nation's needs; and many other types of goods and services, such as medical care and education, the production of which needs also to be expanded, are not likely to require credit financing to a similar extent. If we look at the various types of goods and services produced for the people and business of the nation--food, clothing, shelter, recreational facilities and services, educational and medical facilities and services, household equipment and furnishings, the varied assortment of items of jewelry, personal adornment and works of art, and business equipment--there appears to be no field in which wants are so largely unsatisfied and the satisfaction of which would require so much new credit as in the field of housing and other structures.

As a class, real estate loans have long been considered more hazardous than most other types of loans which banks habitually make. Real estate lending is in fact subject to special hazards of its own. Real estate loans, as is amply proved by the experience of bankers in the United States, may appear to be based upon adequate tangible security and yet entail large losses to a bank. If banks make large amounts of real estate loans during the next few years, as appears to be a reasonable expectation, they should give close attention to the peculiar hazards in this type of lending.

For the difference in risk between real estate and other types of bank loans there are good reasons, chiefly resulting from the fact that real estate loans are generally granted for longer periods of time than

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other business or personal loans. Obviously, the risk of something unusual or unexpected happening to a person who has borrowed the money, or to security which has been pledged, is much greater over a period of several years than over a period of a few months or a single year.

One factor in the riskiness of real estate loans, operating only over a period of time, is the possibility of developments affecting particular neighborhoods or particular properties unfavorably. The changing values of real estate in various neighborhoods should be watched carefully at a time when there is a large volume of new construction and a large number of applications for real estate loans--both in the areas where new construction is going on and in areas already built up. It will, of course, be difficult in the case of new areas to judge accurately which ones will in the future be subject to special unfavorable circumstances, but careful appraisals of the probabilities will aid greatly in minimizing the risks incurred in banks. In the case of loans on older properties the problem is largely that of avoiding excessive loans on properties now showing good income in the form of rentals or otherwise which may not be continued after new construction in other areas has been brought into use.

In the case of amortized loans on residential properties repayment in accordance with the terms of the loan depends more on the continuity of the income of the occupants than upon the current sale value of the property. This may also be true in the case of some business properties. The attention given in recent years to the incomes of prospective borrowers for the purchase of residences has been and will continue to be of great advantage in reducing the riskiness of particular residential loans.

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The last comment which I wish to make on bank loans is to suggest that bankers should review rather thoroughly the rate of interest or discount which they charge and the terms of repayment which they customarily require. There is a lot of tradition in the bankers' way of doing business, and this results in terms of repayment which may not adequately meet the borrowers' needs and in charges for the making of loans which are not consistent with each other relative to the riskiness of the loans, and which seem unfair to borrowers. One of the banks in Washington, for example, and I think this is typical of banks throughout the eastern part of the United States, makes short term unsecured personal loans, nominally for 90 days, but with the understanding that part of the loan may be renewed, provided that the entire amount is repaid in a year, at a customary rate of 6 percent. The bank also makes monthly instalment personal loans, running for a year, at the same rate, that is, at 6 percent, payable monthly on the outstanding balance. On monthly payment automobile loans running for two years with a chattel mortgage, the rate is 4 percent discount per year on the original amount of the loan or the equivalent of nearly 8 percent on the outstanding balance. On a monthly payment loan for an equal length of time, which the same customer may need for repairs or improvements to a house in which he may have a large equity and which will be guaranteed by the Federal Housing Administration the usual rate is 5 percent discount per year, or the equivalent of nearly 10 percent on the outstanding balance. But the bank will also make a monthly payment loan for a much longer period of time secured by a first mortgage on the house itself and guaranteed by the Federal Housing Administration, at a rate of 4 1/2 percent, plus the 1/2 of 1 percent premium, making the cost to the borrower 5 percent on the outstanding balance. Or it will make a 3 or 5 year mortgage loan, without amortization, at 4 1/2 percent. Do these differences in rates

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really reflect differences in the costs of making the loans or in the risks attached to them? Similarly, when the rates charged on these various types of loans to individuals are compared with the rates charged on loans to various business enterprises, do the differences in rates and terms reflect the differences in costs and risks?

In closing I might summarize my comments regarding the outlook for bank loans. During the coming year I do not expect much change in the amount of bank loans, but there may be some changes in the character of the loan portfolios of the banks as they meet the credit needs associated with more production of armaments. Looking farther ahead, and assuming that we avoid a third World War, I expect to see a relatively large expansion in bank loans as banks reduce their holdings of United States government obligations and meet the credit needs associated with prosperous times and an expanding economy. If bankers are to meet these needs in the most adequate fashion, they should give much thought to developing a consistent set of interest rates and terms which are adjusted to the needs of borrowers.

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