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"BANK LIQUIDITY AND THE CHALLENGES OF 1974"

Before the

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Nineteen seventy-four has been a difficult year for the banking industry. During the months of August, September and early October a genuine sense of crisis prevailed, and, more than at any time since the thirties, confidence was shaken.

There has been ample reason for concern. We have never experienced inflation at the current rate and certainly not when combined with a recession. Moreover, such factors as the protracted ordeal of Franklin National Bank, interest rates unprecedented in the history of modern American banking, the sudden demise of American Bank and Trust in South Carolina, notoriety given recent bank failures in Europe, shocks in the foreign currency markets, and enormous flows of funds to the Middle East could hardly help creating an air of uncertainty.

Fortunately, the atmosphere of doubt with respect to the banking system has abated in recent weeks. The fact that interest rates have diminished as a result of the slackening demand for business loans and the Fed's signalling of a moderation of its policy of monetary restraint has served to relieve some of the stress that has been placed on the system. At the same time, resolution of the problems of Franklin and American Bank and Trust served to demonstrate that the insolvency of a major banking institution can be managed in such a way that needed banking services are not interrupted and confidence in the troubled institution's brother and sister banks is unaffected. Moreover, even in the face of strains unlike any experienced since the Depression, there has not been a rash of failures or the hint of any panic. Finally, there are significant indications that bankers are prepared to follow the policy of caution and restraint which the times demand. In short, the stresses of recent months have themselves produced concrete evidence of resiliency and strength in our banks and the framework of regulation.

Because liquidity--both of individual banks and the system as a whole--lies at the heart of problems which have plagued the industry, it serves as a useful focus for discussion of some of the adjustments in industry practice and public policy, which, in my judgment, are required by prudence and present economic conditions.

I approached this subject with some trepidation because, though at the very core of the business of banking, it is a difficult one. Part of the difficulty in defining the term with great precision lies in the fact that it may be used to describe the condition of an asset, a group of assets, a single institution, the banking system or the economy generally.

For example, in their recent article, "The Painful Squeeze on Bank Liquidity," George W. McKinney, Jr. and John McCracken of the Irving Trust Company stated:

> In recent years, total credit has expanded at an explosive pace. Since the end of the 1970 recession, the combined obligations of

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consumers, business and government have soared almost 40% to a currently estimated $2 trillion. Yet in the midst of this liquidity explosion, we are faced with the anomaly of a liquidity shortage. Record interest rates and growing fears of credit shortages attest that even this massive increase in liquidity has been insufficient to meet demand. Rapid liquidity expansion has now been swamped by an inflationary demand for credit of even greater momentum.

Here the term "liquidity" is used with reference to the financial system taken in the aggregate. In this sense, "liquidity" is substantially determined by the level of reserve requirements and by the efficiency with which those reserves are put to work. When the authors refer to a "liquidity shortage" they mean the shortfall between the demand for credit and that which is available.

With reference to an individual bank or other financial institution, liquidity has been defined as the "... ability not only to meet possible deposit withdrawals, but also to provide for the legitimate credit needs of the community...." The first purpose is "defensive" and suggests a cushion for the impact of a reduction of a bank's liabilities, while the second is "aggressive," involving capacity of the bank to acquire earning assets. Liquidity has also been defined as "the ability to raise cash on short notice with small risk of loss."

There are two sources of liquidity for an individual institution. The first is its assets. Certain assets are highly liquid. Cash and U.S. government securities are traditionally viewed as the "liquid assets" of a bank. In many instances, however, these may be of no use in satisfying a bank's liquidity needs. The cash account of a bank is usually held at an irreducible operating minimum and, to the extent that it is held for required reserves, it is available for liquidity purposes only to a limited extent. Similarly, government securities are not liquid if they are pledged against public deposits or otherwise committed within the bank. A bank's assets are also a source of liquidity in that the maturing of loans or other investments and the receipt of interest give rise to liquidity. The second source of liquidity lies in a bank's ability to borrow or purchase funds.

Traditional banking practice viewed a bank's assets as the primary source of liquidity. Borrowing either from the Federal Reserve System or other banks was used to meet emergency requirements or for last minute reserve adjustments. The level of deposits was, in essence, taken as given and the volume and cost of credit supplied by a bank adjusted in response to that level and to reserve requirements. Liquidity was dependent primarily upon the maturity schedule and the salability of the assets and the income stream generated by those assets.

In the late fifties and early sixties banks departed from this traditional

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approach. In order to meet the credit demands of a booming economy, banks tapped, in dramatically increasing amounts, the second source of bank liquidity--borrowed or purchased funds. The basis of this approach to banking is, of course, known as "liability management." It was aptly described by L. G. Gable, Vice President of the Federal Reserve Bank of Minneapolis, who stated:

> The term "Liability Management" as a bank-management philosophy relates to bank liquidity. More specifically, it relates to the source of funds.... In a simple sense, the philosophy of "Liability Management" means to create, (i.e., accept, locate, and purchase) additional liabilities to meet loan requests, commitments and depositor-creditor demands.

The history of liability management should probably begin with the rejuvenation of the federal funds market in the 1950's. A second major discretionary source of liquidity was made available with the development of the negotiable CD. It has been noted that "[W]hile the [Federal Funds] Market gave large banks discretionary access to the liquidity of the banking system, the negotiable CD gave these banks discretionary access to the liquidity of the nonbank sector of the moving market...." The liquidity of this instrument was greatly enhanced with the development in 1961 of a secondary market for negotiable CD's and later with the removal of Regulation Q ceilings on large CD's.

In essence, liability management meant that banks were no longer substantially limited in their sources of funds. The new view was described by Lehman Brothers economist Leonard Santow when he stated:

> The pragmatic view of banks is that you can't look at the old ratios. They don't apply any more when people can buy all the liquidity they want in the market place if they are willing to pay the price.

Among the sources added to these two were Eurodollar borrowings, repurchase agreements, commercial paper and finance bills. The importance of these instruments is reflected in the fact that the ratio of purchased funds to assets for larger banks grew from 7.8% in 1965 to 14.3% in 1970 and to 26.5% in June 1974.

The benefits of this approach were substantial. The development of liability management as a tool for enhancing bank liquidity allowed money center and regional banks to respond to a rapidly expanding economy. It also allowed regional banks to achieve or begin to realize national and international ambitions. The phenomenon paralleled the holding company movement, expansion abroad and a chipping away at restrictions on branching, facilitating

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the most innovative and exciting period in banking history. Smaller banks benefited as well since many profited handsomely as net lenders of federal funds.

Notwithstanding its benefits, the practice of liability management is not without perils. These were highlighted by events in 1974, including the failures of Franklin and American Bank and Trust and the stresses caused by the liquidity squeeze engendered by tight money and unprecedented business borrowing from banks, which through the summer had been growing at an annual rate of more than 25%.

One difficulty with the view of bankers that they "can buy all the liquidity they want in the market place if they are willing to pay the price" lies in the fact that access to the money markets can be lost. And, as the Franklin and American Bank and Trust experiences suggest, once the liquidity provided by the access to such markets is lost, it is difficult if not impossible to regain.

Indeed, what occurred in these two situations was a modern kind of "run" on the bank. A setback which otherwise might not have been proven disastrous led to a loss of confidence and the outflow of "hot" funds. While deposit insurance seems to have maintained the confidence of most small depositors in the face of the worst sort of adverse publicity, willingness of the lender of last resort to provide funds and the stabilizing efforts of other agencies did not stimulate the confidence of large individual and institutional depositors. Thus, it would appear that the greatest danger to a financial institution today lies not in a loss of confidence by the public at large, but rather illiquidity resulting from the mistrust of providers of money market funds. It is even conceivable that a relatively sound institution which had relied heavily on purchased funds could be brought to its knees by an unwarranted loss of confidence resulting from rumor or a well-publicized but not otherwise crippling setback.

Another pitfall was reflected in recent months' earning performance of a number of institutions whose rapid growth was based on purchased funds which supported medium or long-term assets. As a result of record interest rates their earnings declined while banking earnings generally stood at high levels. This problem was particularly acute among those banks with a high proportion of real estate related loans. Similarly, those banks which had invested heavily in securities found themselves with depreciated assets yielding significantly less than the cost of funds. Such conditions were exacerbated by the appearance of multi-tiered markets, penalizing institutions which only months before had been respected as innovative, aggressive and especially well-managed.

Other effects should be noted as well. First of all, there can be little doubt

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that the rapid decline of capital relative to either assets or deposits is due in part to the availability of money market funds. Second, some critics have attributed a decline in credit quality, as reflected by an increase in loan losses, to laxity induced by the easy availability of funds. While I doubt that most banks have eased standards, there can be little dispute that the assumption of unlimited liquidity caused a relaxation of discipline in some banks. Finally, it is probably also true that the same assumptions led to loan commitments that are now proving embarrassing or inconvenient.

As I have already indicated, it seems to me that our system of banking and bank regulation has performed remarkably during this period of special stress. Nevertheless, the strains of liquidity have crystallized the need for bankers, the regulatory agencies and Congress to come to grips with certain basic issues and to do so without delay.

Bankers should immediately move to apply the lessons of the past year. It seems clear that some institutions have relied far too heavily on purchased funds as a basis for growth. This has proven unwise; instead, expansion should be more nearly equated with the natural growth of deposits, addition of capital, and concrete expectation of income. Long range planning balancing present and future credit demands with anticipated resources must be implemented. Bankers should no longer respond to credit needs on a day-to-day basis nor make loan commitments assuming the availability of virtually unlimited liquidity in the money markets. Moreover, with the unsettled state of our own and the world economy, I suspect that in the medium run at least, bankers should no longer expect the luxury of relatively stable conditions.

For example, most analysts agree that a period of recession is required to bring inflation under control. Indeed, unemployment climbed to 6% last week, a figure reached only once in the last decade. And, while many economists are optimistic, all recognize the danger of a recessionary phase more severe than that projected by Administration economists. In this climate, it is only reasonable to expect that in many areas of the country, businesses will experience their own liquidity problems and that loan losses and delinquencies will increase. Bankers should not be caught unprepared if this occurs. Anticipating this, bankers should focus on credit and investment quality, avoiding the risk associated with high yielding but speculative ventures. At the same time, emphasis should be placed on shoring up liquidity by moving to lengthen liabilities' maturities. The introduction of floating rate instruments might accomplish this. Certainly, volatile money should not be used to fund essentially long range commitments of resources.

I should reiterate that many bankers are already moving rapidly and effectively to make such adjustments. Bankamerica's president A. W. Clausen's announcement of a formal policy of restraint represents a dramatic indication that this is the case. In part he stated:

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> Economic growthmanship--without equal concern for quality and staying power--has always been a faulty philosophy. Today, more than ever, it is a philosophy at odds with the economic needs and financial realities of this country.

and:

> Given these difficult financial times of high interest rates and unprecedented loan demand, we are convinced that shareholders, depositors and the public at large all are better served by a policy that gives the quality of assets and the stability of earnings higher priority among corporate goals than size alone.

This approach must be applauded and might well serve as a policy statement for the industry.

At the same time, bank supervision must adapt to the present economic environment. It may be true that some bankers were "careless" in their pursuit of growth at any price; certainly that would be an accurate, and probably charitable, characterization of the management of Franklin National Bank in the years immediately preceding its demise. It also must be frankly acknowledged that the philosophy and practices which have characterized banking during the past dozen years took place under the close supervision of the regulatory agencies and was, by and large, not inconsistent with the monetary policies pursued by the Federal Reserve System.

There is a fine balance between vigorous but appropriate exercise of supervisory judgment and the unwarranted substitution of supervisory opinion for the business judgment of management. I personally favor a minimum level of regulation. At the same time, I recognize that the agencies may not have been sufficiently vigorous in checking practices which they thought to be unsound but which seemed to be working in a booming economy. Congress has given the agencies adequate power to act expeditiously to remedy banking practices which they deem to be "unsafe or unsound" and have sought to buttress that power by granting the Fed "cease and desist" authority with respect to bank holding companies. It seems to me that we should not be timid in its exercise.

With a policy of restraint in the granting of credit goes a large measure of responsibility for the shaping of the face of the community which a bank serves--whether it be a rural farm community or the world wide markets of our money center banks. The assumption that virtually unlimited liquidity is available, which pervaded the philosophy of liability management, allowed bankers to avoid difficult choices. In announcing Bankamerica Corporation's policy of restraint, Mr. Clausen recognized that a rationing process necessarily flows from such a policy. He stated:

> Clearly we cannot meet all the credit demands we now receive.

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> We shall continue to honor the normal essential credit requirements of established customers. But, as we continue to serve their needs, other borrowers may find it difficult to obtain all the funds desired.

The fact that hard choices must be made in the coming months has been reflected in the growing debate over the issue of credit allocation. Some Congressmen and respected economists have argued with force that a mandatory federal system aimed at directing the flow of funds is required to insure the proper allocation of credit and, ultimately, all real resources in the society. To date, the Fed has rejected the notion that it should implement mandatory credit allocation guidelines. Rather the Board has emphasized bank cooperation with voluntary guidelines.

In its press release of September 16, 1974, the Board of Governors summarized the conclusions of the statement of the Federal Advisory Council to the Board in this respect. The release stated:

> The Board regards restraint in lending policies as essential to the national effort to control inflation. Restraint best serves the public interest when limited credit resources are used in ways that encourage expansion of productive capacity, sustain key sectors of national and local economics, provide liquidity for sound businesses in temporary difficulty and take into account legitimate needs of individuals and small as well as large businesses.

Even within the parameters of the Fed's guidelines difficult choices are posed. A banker must necessarily face hard questions which pertain not merely to an analysis of the yield and credit risk of a given asset but to what is good or bad in the long run for the communities served by their banks. I do not pretend that the answers will be easy or even that there will be a right answer in each case. I do believe, however, that such questions must be faced and answered--either through the voluntary exercise of responsibility by bankers or through credit allocation policies implemented at the federal level.

In addition to the challenges facing bankers and bank supervisors, events of the past year underscore the need for Congress to give serious attention to certain questions. In conclusion, I would like to touch briefly on three issues which will probably be the subject of Congressional scrutiny in the coming months.

First of all, Congress will undoubtedly examine very closely the actions of each of the banking agencies involved in the Franklin matter and the insolvency of American Bank and Trust in South Carolina. While these cases were resolved expeditiously and with a minimum of ill effects, they provide informative case

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studies which reflect the options and procedures presently available in dealing with failing and troubled banks.

Among the issues which Congress might address are division of responsibilities and tasks among the agencies, the rigidity of the statutory options available to FDIC under Section 13(c) and 13(e) of its Act, and the disadvantaged position of state non-member banks with respect to emergency access to short-term liquidity.

In raising these questions, I do not mean to suggest either a personal position or the inadequacy of the present framework. However, in times of economic uncertainty including the possibility of future liquidity strains, prudence would seem to require careful consideration of the tools available to the responsible agencies for dealing with troubled financial institutions and indeed with other institutions essential to the public.

Secondly, the depression in the housing industry and the substantial disintermediation from the thrifts which occurs in times of high interest rates insures that Congress will once again address the recommendations of the Hunt Commission. Predictably, vested interests are already jockeying to lobby for that portion of the package which appears favorable to them and against that which does not. In light of the seriousness of the strains which the system has felt the past few months, it seems to me that we cannot afford a business-as-usual approach to this piece of legislation.

It has been demonstrated time and again that Regulation Q ceilings are inefficient and cause severe dysfunction in the operation of our money markets. Moreover, and to my mind, even more importantly, the Q ceilings constitute a subsidy or shelter to the housing and thrift industries which is funded by what constitutes a tax on low and middle-income savers. In times of inflation with interest rates at present levels, this tax is unwarranted and unfair.

I am well aware that abrupt elimination of Regulation Q without significant measures to avoid dislocation would be grossly irresponsible. Yet those measures have been defined and some of them require state legislative action. All of them deserve our support. The time has come for Congress, the agencies and the various industry groups to confront and resolve this question.

Finally, there is some indication that Congress will give consideration to the subject of regulatory reform. Unlike the matter of Regulation Q, we are only beginning serious consideration of this subject. The range of solutions is broad, the questions complex and the interests conflicting. The process will require careful thought, compromise and a willingness to forego narrow vested interests. I have not resolved in my own mind some of the most basic questions and certainly have not begun to address the multitude of lesser considerations, but I am convinced that the time has come to address and resolve these questions.

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In surveying the fifteen months of my tenure at the FDIC, and particularly the last six months, I am reminded of the Chinese curse, "May you live in interesting times." Well, we do live in interesting times. Yet, I am just enough of an optimist to believe that rather than cursed, we are challenged. I am confident that we will respond.

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