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MANAGEMENT, CREDIT, AND PUBLIC CONFIDENCE

Address of

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Washington, D. C.

before the

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of the
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MANAGEMENT, CREDIT AND PUBLIC CONFIDENCE

Recent events once again have focused the banking industry's attention on the cost-earnings squeeze. The pressure not felt during the war years has built gradually to become a major fact of life.

The existence of this squeeze is of primary concern to every credit man in the audience, because in the long run the credits you make and manage will play a major role in assuring the success of your banks in meeting this problem. For that reason a brief review of why and how that squeeze exists seems appropriate.

The recent events to which I have referred were the increase in the discount rate by the Federal Reserve Board, and the increase in the permissible legal ceiling of interest paid on time and savings deposits jointly authorized by the Fed and by the Federal Deposit Insurance Corporation. These two actions had the net effect of increasing the cost to bankers of their basic tool of operation, money.

At the same time the President strongly suggested that the banking industry maintain existing loan rates, when he expressed apprehension that banking generally might increase rates. The excess of funds in the market -- at a price -- at the present time supports the President's request; this excess has become so apparent that some of your savings and loan competitors have stated publicly that they do not want any additional funds because they cannot safely place them. Additionally, some sectors have shown a weakening in loan demand, most notably the housing sector.

Actually, the average rates on all loans have remained remarkably stable from the 1960 midyear. This has been true for all classes of loans, large and small. If anything, there has been a slight easing of rates over the past few months.

Back in the 1950's the banking industry was confronted for the first time with a tremendous increase in costs, generated not only by the increase in wages and other costs prevalent throughout the country but also by a tremendous increase in paperwork. To a large extent the industry met this problem with internal economies, including automation.

For the past three or four years there has been superimposed upon this problem another problem. While the cost of money has gone up (and money is still the basic raw material of any bank) the earnings generated from use of that money have not gone up proportionately. One figure makes the point perfectly clear. Net current operating earnings, as an amount per hundred dollars of current operating revenues, have declined from about 35 percent as of 1960 to 28 percent as of 1963. The result has been for many banks to compensate by shifts into new types of loans, or into higher earning areas, and, in many instances, into service type earnings which do not require the use of large amounts of money as a raw material.

The cost of money is up. From December, 1961, to October, 1964, all short-term money market rates had advanced about one full percentage point; during the same period the rates paid on time and savings deposits have gone from the 1-2½-3 percent basis to the present 4-4½ percent basis. There have been other equally important developments, including a restructuring of deposits.

Corporate treasurers and others who control demand deposit balances have become more skillful and more careful in the use of their funds. They too have had to trim costs as the first flush of prosperity after the end of World War II gave way to a more competitive environment. As the rates on Treasury bills and other alternative short-term investments inched upward, corporate treasurers have turned to these markets as places to invest their short-term funds. And they have restricted their demand deposit balances, seeking more and more services for less and less in the way of hard cash.

Thus the banking industry's ratio of "free" funds has dropped. Actually, of course, these funds are not "free" even though no interest is paid on them, because maintenance of demand deposits represents one of the major costs of doing business. From December 1961, through June 1964, total deposits of the banking industry rose dramatically, but the actual amount of demand deposits adjusted in the commercial banking industry for the same period actually declined slightly. At the same time, time and savings deposits in the commercial banks rose some 44 percent. These, of course, are funds upon which interest must be paid, in addition to which there are some of the same expenses to a bank in maintaining these accounts as there are in demand deposits.

The deposit mix has changed drastically, and the change has been a factor in increasing costs.

There have been other peripheral changes which have had the net effect of increasing the cost of money to banks. The time lag represented by "float" has been reduced a good deal as banks have introduced new, streamlined methods of presentation and collection. New lockbox services, new 24-hour collection procedures, armored car runs, automated clearance of checks, and other methods of responding to customer desires for speedy collection have proved the banking industry's ability to offer better service. The net result has been also to trim "float" time and eliminate to a large degree the short term earnings which "float" may produce. Additionally, while demand deposit velocity has increased many times during the past ten years, that increase seems to be slowing up somewhat as the system probes ever closer to the outer limits.

Some bankers have sought answers to the cost problem by increased volume of activities, perhaps somewhat analagous to the "supermarket" thesis that profits are built up not on the markup as such but on the volume of business generated and the turnover of inventory. This seems to be a solution not available to all institutions, and there may be questions as to just how far this volume answer can be carried.

With strong pressures sending the costs of money up, both through a shift in the deposit mix and through national policy which encourages higher short-term rates as a tool in holding down balance of payments deficits, banks under normal circumstances might be expected to raise rates on loans. Yet this has not happened. It has not happened for several reasons, among them being a policy of credit ease, and the related adequacy of funds available, the sharp competition between banks and other lending institutions, the more sophisticated approach of corporations, together with better than average retained earnings for corporate investment needs, and continued and sometimes open pressure on the part of the Administration. Additionally, bank rates always have had a tendency to be "sticky" in movement, both in interest paid and rates charged for loans. Bank rates have a strong tendency to become "institutionalized." This inertia has also played its part in the present rate structure. There is a strong tendency on the part of the public and banks alike to treat maximum permissive rates as the going rate.

The result of all this has been a squeeze on earnings.

Banks have been meeting this pressure through an increase in loans, a percentage of assets, and also through a shift in the types of loans made. The loan mix has increasingly emphasized the higher yielding, and generally more risky, areas.

Again the figures tell the story. While assets have gained somewhat over 16 percent from December 1961, to June 1964, loans were up 32 percent. The loan to asset ratio for commercial banks over the same period moved from 45 percent to 51.2 percent, and appears to be continuing upward. At the same time the holdings of U. S. Governments dropped, while tax-free municipal holdings were up.

The composition of the loan portfolio tells the same story. All the major categories of loans were up, but the greatest gains were shown in the higher yielding areas. The lowest gain was shown in the agricultural loans category, followed by commercial and industrial loans. Within that latter category, increases were posted by such industries as construction, trade, and petroleum. Much of the over-all increase here was in new types of term loans, developed for the first time in recent years as attractive alternatives to the conventional short-term business loan.

Agricultural loans gained 19 percent, and commercial and industrial loans 22 percent. However, instalment credit loans were up 35 percent; real estate loans, 36 percent; loans to brokers and dealers, 38 percent; and loans to other financial institutions were up 43 percent.

Interestingly enough, the extensions of consumer credit loans are broadening to the point where extensions of such credit are far outstripping repayments. The net change in such loans in 1960 was negligible, but in 1962 extensions moved ahead of repayments, a trend which has been gradually accelerating. The gap is now at about $5.5 billion, and about $500 million a month is being added to the figures. The gap between extensions of new credits and repayment of existing ones is widest in auto paper, widening slightly in personal loans.

There is no panacea for the cost-earning squeeze confronting industry today. Some bankers are finding answers in increased non-deposit services to the public. Some bankers are seeking an answer in further increases of volume. Many bankers are devoting a sharper attention to cost reduction in their institutions. And, of course, many bankers are re-shaping portfolios and loan policies to maximize earnings as far as possible.

All of these approaches are valid, and taken together, they offer a constructive program. The important point remains that these pressures are a fact of banking life today, and that nothing on the horizon suggests any new pattern, at least in the near future.

I would like to suggest that it is precisely in times like these that the banking industry must be on its guard against excesses generated to respond to earning pressures. It is precisely at times like these when management must be at its sharpest and soundest in handling credits, when management must resist temptations to lower standards, and, in the long run, to risk forfeiting the high confidence the public has today in banks and bankers.

Over the past thirty years the public's confidence in the banking industry has gradually risen from the depths to which it sank during the Depression years. Thirty years of safe operation, buttressed by the formation of the Federal Deposit Insurance Corporation, with its guarantee of bank deposits, has created a pool of public confidence which is now one of the greatest assets the banking industry possesses.

This confidence is a fragile thing. It is not to be tampered with. It is not something with which to take chances. And, to a very large degree, its maintenance is in the hands not only of senior management but of the credit men whose individual and collective judgments decide just what kinds of loans are to be made. In the long run the soundness of a bank's loan portfolio governs the soundness of the bank -- and you credit men decide the soundness of the loan portfolio.

In a large sense, when a bank is under a cost-earnings pressure to increase loan portfolio amounts and yields, the first line of defense against any unsound approaches which might weaken the bank and the public's confidence is the credit man.

In recent months several banks have failed, and back of each failure among many other problems was the problem of unsound credits. Some of these cases involved men not trained as bankers, but in some instances which have shown up in bank examinations, trained bankers have made some credits with equally poor standards. I should like to emphasize that this is not a universal problem. Indeed, the great majority of bank credits are sound. But these fringe problems do exist.

Some examples of these borderline -- or worse -- credits follow:

Mortgages have been based on highly inflated values, or upon questionable appraisals. Mortgages where the actual cash equity of the borrower is non-existant or marginal. Mortgages advanced on properties on the basis of projected earnings, where there is no earnings history, and expectations are promotional.

Loans to out-of-territory interests, unless backed by full, accurate, and impartial credit checks and a high degree of credit skill on the part of the lending officer.

Term loans not supported by adequate collateral, nor by adequate income schedules from which payments will be met.

Loans to corporate interests which have not been checked thoroughly, and which actually turn out to be a corporate "shell" through which promoters divert funds to other interests.

Otherwise questionable loans which are accepted because of so-called "compensating balances," actually placed in a form of link financing, affording no assurance that the balances will not be removed. These loans often may be brought in by so-called "finders," and may bear attractive rates to the bank. All too often this means a loan which should be unacceptable under normal circumstances.

Loans on collateral which may be forged. The answer is obvious, but not always simple: Investigate collateral carefully -- do not assume that what is presented for collateral is always what it is represented to be. Some borrowers, under pressure themselves, may offer supposed collateral which either covers non-existent assets, or which may be forgeries of documents, the originals of which are sound.

Unsecured loans based on statements so good as to raise doubts as to why a loan may be necessary in the first place. Too often beautiful statements of net worth, or company balance sheets, may be presented, which have no more truth to them than the latest bestselling novel. The answer to this, or to the other problem loans we have outlined, is adherance to well developed credit standards.

Loans made without regard for the fact that <u>no</u> loan is safer than the borrower. Too many bankers have made loans on the strength of excellent collateral, forgetting that in many instances that collateral continues sound only if the borrower maintains its value. For example, there have been several loans -- too well known by us -- which were collateralized by bank stocks. When the borrowers committed actions which destroyed the banks, I suspect there were some rather agonizing reappraisals of collateral, and some interesting discussions between a lending officer and his front office.

Basically, the answer to these problems is adherance to well developed credit standards.

Now is the time for bankers to redouble their vigilance against unsound loans, and unsound borrowers. Now is the time to resist competitive pressures, and to maintain sound credit operations. There are perhaps two key rules which can help every banker to resist such pressures, no matter how tightly he may be squeezed by the cost-earnings pattern prevalent today.

In the first place, it is not sound banking to let credit standards be set by a competitive bank, or by a competitive non-bank institution. The banker who lowers his own standards to match some other banker's, or the standards of some mortgage lender or other non-bank lender, all too often is surrendering his own judgment and jeopardizing his institution. The only sound operation is still that operation which makes its own judgments as to the safety of the credits it advances, its own judgments as to the recoverability of the funds advanced, and which tailors its loan portfolio to its needs, management skills, and its ability to absorb losses.

In the second place, making credit advances on the basis that continued expansion in the economy, or in an industry, will cover unsound approaches, is a positive danger. No banker should count on the future to bail him out of risky situations. There are times when a banker may want to lend on future prospects, but there should be a sound, legitimate analysis that the operation is geared to succeed in the forseeable future, withoutthe necessity of continued economic advance, or of inflation, to push it along.

Public confidence in the banking business is based on the public's belief that the banks of the nation are sound, with competent managements, and prudent, workable credit policies. This is a priceless asset, perhaps the single most priceless asset the banking industry can have. Every bank manager, every bank credit man should do all in his power to maintain a sound operation which justifies the public's confidence now and in the future.

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