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FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D. C. 20429

Telephone: 393-8400
Br. 221

FOR RELEASE AT 10:00 A.M., TUESDAY, JUNE 15, 1965:

MANAGEMENT, CREDIT, AND THE GROWING ECONOMY

An Address By

K. A. RANDALL, CHAIRMAN

FEDERAL DEPOSIT INSURANCE CORPORATION

Washington, D. C.

at the

ANNUAL CONVENTION

of the

MARYLAND BANKERS ASSOCIATION

at

The Homestead
Hot Springs, Virginia

10:00 A. M.

Tuesday, June 15, 1965

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MANAGEMENT, CREDIT, AND THE GROWING ECONOMY

The substantial increase in the private use of bank credit over the past two decades has been one of the distinguishing marks in the continued growth of the nation's economy. The varied forms of credit extended to business, builders and individuals have risen dramatically in recent years, well in excess of the growth rate of total gross national product.

The new uses of credit have required bankers to develop new approaches to credit origination and administration. I would like today to discuss the implications for bank management of a few of these changes. These new approaches and methods have forced bankers to re-evaluate their role. For most bankers, this evaluation has coincided with another problem -- a cost-price squeeze of great concern. The net effect of these inter-acting factors has been to impose considerable burden on the banking industry, and most specifically on bank management. Seldom before have we faced quite such a conjunction of problems, made even more complex by balance of payments considerations, by the foreign aid and military commitments of the nation, and by a growing emphasis on national policies to eliminate as far as possible both unemployment and poverty.

All of this creates an atmosphere that we can expect to live with for many years. The days when the bank manager could expect to operate successfully solely with a knowledge of his own area, and his customers, without attention to the world beyond, have passed. I suspect they will never return. Events in Washington, in New York, and in other money centers or national capitals may influence actions of the local banker. The balance of payments problem, to name one of many, while it may seem esoteric, can affect decisions of bank management. For balance of payments considerations influence both monetary and fiscal policies, and these in turn impinge directly on banking activities, even those of smallest country bank.

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In such an environment, the key to survival of any bank is knowledge and understanding. This is a complex and highly competitive world, and it has become a world where ignorance can mean not just stagnation, but outright failure.

To understand the expanded role of credit in the national economy, and bank management's role in maintaining satisfactory credit standards, let us consider some of the points which we have touched upon.

To a large degree our continued economic expansion has been financed by credit. The conventional uses of savings have been supplemented by techniques enabling us to capitalize future earnings. In a sense, the individual with a steady income may, through the use of bank credit, realize upon his expected income to finance needs and desires immediately.

However, such credit must be advanced wisely and intelligently. Loans cannot be made solely for the sake of putting a credit on the books. They must serve a useful purpose for borrowers, be within the borrower's capacity to repay, and within the credit grantor's capacity to control his risk. There have been new approaches since the end of World War II which have made this increase of credit possible and which have enabled banks to handle successfully these ever-increasing demands.

Perhaps the single greatest change in approach, and the single most important, has been the increasing use of amortization schedules for practically all types of loans. The old-fashioned mortgage, written for a relatively short period, with only interest payments required during its term and with a balloon payment of principal due at maturity, has given way to the new, longer-term mortgage, upon which both principal and interest are payable from the inception of the loan on a regular monthly program. This new mortgage has helped to make home ownership possible for most wage earners, and has in turn contributed to the residential construction boom of the past 20 years.

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Likewise, the old 90-day or six-month note, due in a lump sum, has largely disappeared, to be replaced with a one-, two-, or even five-year instalment loan, but again repayment commences immediately and is spread over the life of the loan, in uniform, budgetable instalments.

These debt servicing concepts are applied to business loans, as well. The term loan to business is a relatively recent innovation, yet many thousands of such loans are written every month. The extension of credit on an open basis, carried for years with periodic renewals and without principal payment, has become less common.

This development has permitted banks to schedule their cash return more accurately, and has made funds for additional loans continually available. In essence it supplies the bank with a built-in source of liquidity. It also eases much of the pressure on the borrower, since this style of loan is not callable, and he is not faced with a demand for payment in full unless and until he fails to meet his regular schedule of payment. The net effect has been beneficial to both borrower and lender.

Such debt service concepts, using amortization, have also been used in the field of credit for the purchase of agricultural equipment. The successful lender to farmers now makes far better use of relating loans to his customer's cash flow, on a definite repayment schedule. Indeed, with rare exceptions, this is becoming more and more true of all bank lending activities. The net result has been in a large sense to improve the cash flow and the liquidity position of the banking industry. The illiquidity formerly associated with an increasing proportion of loans among bank assets has been offset to a considerable degree by these improved cash flows.

One factor of importance, which has been influencing the growth of loan volume, and which seems to be playing a part in shaping loan portfolio structures,

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is the cost-price squeeze that banks are facing. It is real, it pinches, and it requires a degree of management excellence which the period of the late 1940's and early 1950's did not require.

This cost-price squeeze, simply put, means that bank costs have gone up tremendously, while bank earnings have not matched this growth. As a result, the banking industry is grossing more, but bringing less down to net, on an average. For example, net current operating revenues, as a proportion of total operating revenues, declined from about 35 percent in 1960 to about 27 percent in 1964.

In the past ten years, the cost to banks of the paperwork they must handle has gone up sharply, staffs have increased, and salaries and other fringe benefits have risen. The remedy undertaken by many banks to overcome this staff and paperwork cost -- automation -- itself has a very high initial expenditure which makes savings a matter of long-term realization.

The cost of money, a bank's raw material, has also increased. From 1960 to 1964, the average rate paid by insured commercial banks on time and savings deposits advanced from 2.6% to 3.4%. The impact of this increase in rate has been accentuated by the increasing proportion of total deposits held in the form of time and savings deposits. Most of the increase in deposits in the past four years has occurred in the costly time and savings component.

The normal reaction to increasing costs would be an increase in the price of bank services. Though adjustments have been made in some instances, banks have not been completely free to follow this course. The twin demands of national policies designed to stimulate the domestic economy and difficulties with the balance of payments have resulted in a rate structure that limits pricing adjustments. Intensified competition among banks and other financial institutions for sound loans enables the borrower to shop for rates and inhibits increases in interest charges. Greater sophistication of many corporate borrowers, and the

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long-standing tendency of bank rates to become "institutionalized" are also important factors contributing to this problem.

Banks have attempted to meet the cost-price squeeze through relatively greater investment in higher yielding loans, particularly in the development of consumer instalment loans. Moreover, many banks have been moving steadily into service-type operations, where they can generate earnings without the use of their raw material -- money -- on a loan basis. This trend, I feel, will accelerate in the future, especially for those banks which automate and which sell services utilizing their computer systems.

There are dangers inherent in this stretch-out to generate earnings to cover increasing costs. Borderline credits have been made in some instances by bankers in response to these pressures. There have been relatively few of these instances but it is a response which every banker must guard against.

Bank management plays a vital role in this whole area. Management must understand these problems and the means that have evolved to meet them. It is not enough to use tools blindly because other people use them. They must be understood, they must be appreciated, they must be related to the total environment of the bank, and their strengths and limitations must be applied consciously in all bank planning.

Bank management has a duty to its community. It must meet the community's credit and banking needs. If a bank does not meet these needs, then that bank has failed the public trust inherent in acceptance of a bank charter. Bankers fill a quasi-public role, and if they are unwilling to serve their community, they can be destructive of progress just as they otherwise can be constructive when offering complete modern service.

The bank manager needs not only to understand the environment in which he lives and functions, but to act as a teacher for the people who work with him,

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who work for him, and who live in his community. The bank manager should act as a leader in the development of new approaches and should constantly seek their improvement and refinement.

Such developments as the cost-price squeeze should not stampede bankers into imprudent activities. There are classic credit rules -- rules of prudent, sound operation -- rules based on character, capacity to pay, and collateral. Although techniques may change, these rules do not. These new techniques must be blended with these old rules; together they can continue to give us a strong banking system.

The new environment we all inhabit has brought new emphasis to the sensitive and crucial duties of the bank manager. It is not enough now for the manager to merely set formal policies; he must live by those policies and he must assure himself that both he and his credit team are able to function within the framework of the bank's ability to serve. The bank which does not have a well-balanced credit department will find its ability to serve in today's economy has been weakened. The bank manager must make sure that he not only is capable in the field of credit, but that his staff is capable, and that both he and his staff understand and appreciate existing conditions.

Numerous facilities are available for learning. The work of the various state and national banking organizations in the field of credit, especially of the Robert Morris Associates, and the many schools which teach the latest in credit techniques, are all avai· ble to every bank manager, whether his is a large or a small institution. But beyond the technical aspects of credits, there is a philosophy which I would urge upon every bank management.

If I could sum it up in one sentence, I might say: "Management should not be guided in loan policies solely by its <u>loan</u> limits, but by its <u>own</u> limits." It

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is the responsibility of the bank manager to know what he is capable of doing, and what his staff is capable of doing. There is a positive danger in seeking to go beyond these limits. Schooling, the growth through experience, the broadening of staff can inevitably extend these limits, but they should never be extended -- especially in today's complex and sophisticated world -- without thorough training, and without positive assurance that the bank's management and credit personnel are capable of handling any new techniques.

The questions which will help to establish a bank manager's policy for credit administration should be directed to the bank's size, the terms it can handle and supervise, and the area in which it is competent to act. The bank's own competence should be the guiding rule, not the actions of a competitor down the street. What management knows its own abilities to be should be the guide to what management does in its credit operations.

It is precisely because these rules remain true, even in our changing economic system, that management must exercise care in utilizing the new techniques which have been developed in recent years. These new techniques are valuable, and indeed essential, if a bank is to satisfactorily discharge its responsibilities to its community.

But these new techniques we have been discussing are truly workable only if they are developed and controlled with standards of excellence and of prudence. Risk taking is necessary and proper; any bank must accept and take risks if it is to discharge its responsibilities to its community. Knowledge and understanding are the keys to determining the degrees of risk taking, and those keys are the responsibility of and justification for bank management's existence.

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