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FINANCIAL PLANNING FOR BANKS AND BANK HOLDING COMPANIES IN A CHANGING ECONOMY

Address by

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Banks have seldom been subjected to the kinds of pressures we have witnessed in the past year and a half. Over the course of 1974, inflation surged to 11 percent, the prime rate hit an unprecedented 12 percent, loan demand increased at a time when the Federal Reserve had moved to a restrictive monetary policy, several large banks here and abroad failed, adding to all the other nervousness in financial markets, and towards the end of the year prospects for large loan losses increased as the economy moved steadily downhill.

We are currently in the midst of the most severe recession since World War II. Unemployment reached 8.2 percent in January and, according to some, will top 10 percent by summer. Industrial production declined 3.6 percent in January which, as pessimists were quick to point out, was the largest monthly decline since 1937. Consumer prices are still rising at a rapid rate, although the second consecutive monthly decline in wholesale prices holds promise for some significant easing in inflationary pressures by year-end. A tax cut now appears certain as does the largest peacetime deficit in the Federal budget. This deficit, estimated at $35 billion in fiscal 1975 and $52 billion in fiscal 1976 by the Administration and even higher by others, will place a heavy burden on the financial system in the months ahead. While the recession has already led to a precipitous decline in loan demand, thus ending the liquidity squeeze of last summer and fall, it is likely that more and more of a bank's existing loans will become delinquent or pose special problems, at least until the business cycle turns upward once again. In short, banks will continue to experience pressures and strains during 1975, albeit somewhat different ones from those they experienced in 1974.

Present-day financial planning for banks can be traced back to 1961, the year a secondary market was established for negotiable certificates of deposit. That event was significant because it marked the realization that as long as banks continued to limit their activities essentially to the traditional ones of accepting demand deposits and making short-term commercial loans, they would continue to lose ground to other kinds of financial institutions. The growth in demand deposit balances was just not sufficient to finance the loan demand generated by the booming post-war economy. Increasing interest rates made depositors more conscious of the fact that demand deposits bear no interest and many strove to invest excess balances in interest-bearing assets. For a while, banks held their own by converting their large holdings of U.S. Government securities, accumulated during World War II, into loans. However, by 1961 securities holdings had been reduced, especially in the larger money-center banks, as much as then seemed prudent.

Thus, it became incumbent for commercial banks to seek new sources of funds if they were to retain their position of prominence in the economic life of the country. The search for funds, pursued in ever more imaginative and aggressive ways as each year passed, has punctuated developments in our financial system over the last 15 years. It led banks to expand branching systems, where permitted by law, in order to obtain consumer savings deposits. Increased lending services to consumers followed naturally. Negotiable CD's were used to retain or attract commercial deposits that once would have been held in demand accounts.

During the 1966 credit crunch, market interest rates rose above the Regulation Q ceiling rate for CD's. This caused banks to lose substantial amounts of funds and forced them to liquidate securities at painful losses in order to meet loan commitments. This experience persuaded bankers of the need to develop alternative sources of funds that were beyond the reach of Regulation Q. Simultaneously, bank attempts to expand into areas "closely related" to banking met increasing opposition and delay in court cases brought under the "incidental powers" clause of the National Bank Act. The one-bank holding company, which could get around both problems, was promptly pursued as an industry-wide response. Even after one-bank holding companies were subjected to regulation by the 1970 amendments to the Bank Holding Company Act, expansion into new areas of the country, promotion of new types of financial services and creation of new financial instruments proceeded at a very fast pace.

While the developments of the last 15 years have resulted in a much more competitive and innovative banking system capable of responding to the demands of a complex, prosperous and expanding economy, these achievements have not been obtained without cost. In an aggressively competitive environment, poorly managed institutions, such as Franklin National, are more likely to get into trouble. However, even well-managed institutions can be enticed into taking imprudent actions by the euphoric spirit of the times. Thus, the precipitous acquisition of real estate lending subsidiaries by bank holding companies has become a general embarrassment to the industry and has been nearly disastrous in a few isolated instances. Similarly, the rapid and pervasive buildup of foreign banking operations by U.S. banks has caused significant difficulties for some.

Until 1974, many banks embraced the philosophy of liability management believing that funds could always be purchased for a price. Last year's liquidity squeeze coupled with the nervousness generated by a few spectacular bank collapses around the world resulted in the inability of some banks to purchase money at any price, while still others were compelled to pay a premium that adversely affected their profit margins. Lending policies which had been built around the expectation that money could always be acquired when it was needed were thrown into disarray and a number of banks were forced to make painful adjustments in the face of unhappy customers.

Now there is evidence that bankers, smarting from the experiences of 1974, may have overreacted in the other direction by stressing more retrenchment and greater liquidity than may actually be required to pursue prudent and sound bank management policies. At a time when the economy is declining, the reluctance of the commercial banker to grant loans adds to the contractionary forces in the economy and will delay or retard our overall recovery from recession. Bankers can perform a needed public service now by resisting overly conservative inclinations and by moving aggressively to respond to the needs of credit-worthy borrowers.

I would like to take the next few minutes to consider in greater detail some of the management issues bankers currently face and will be facing in the coming months and years. I plan to follow this discussion with a few observations about the economy and how banks might prepare themselves to meet possible future developments.

First, I want to address the issue of bank acquisition and expansion policies. In recent years, these policies have been influenced by the desire to expand markets, both domestically and internationally, to extend product lines beyond traditional banking services and to gain easier and cheaper access to the money and capital markets.

Rapid expansion places two strains on a bank. One strain concerns financing. As a general rule, it is usually impossible to finance a high rate of expansion with retained earnings and additions to reserves. This means that the bank, or the bank holding company, must sell new stock, subordinated debentures, capital notes, short-term money market instruments such as CD's or commercial paper, or it may obtain the needed funds through additional deposits. There is a tendency to shun the sale of equity capital because such sales can dilute the earnings performance of the bank, because of high investment banking fees when the issue is publicly underwritten, and because many bankers have felt that the intrinsic value of their stock is a lot greater than the market is willing to pay. The fact of the matter is that most banks have issued no new equity in years. Rather, they have resorted to leveraging through issuing debt. The advantage of debt is that its cheaper cost raises the rate of return on equity <u>provided</u> that the rate of return on assets does not decline. However, falling margins on assets have accompanied increases in leverage in many of the larger banks so that the rate of return on equity has risen little, if at all. On the negative side, substitution of debt capital for equity capital reduces the cushion for absorbing loan losses.

Financing of bank holding company acquisitions has raised considerable criticism. One observer has reported that ". . .a high proportion, and in some cases virtually all, of holding company non-bank assets have been funded with short-term debt -- primarily commercial paper. . . ." Another observer recently predicted ". . .that managements at large banks around the United States will find it necessary to bite the bullet on the equity issue within the next year or two."

In the face of declining capital ratios, the Federal Reserve shifted its policies last summer toward discouraging the rapid rate of expansion of the previous three years and toward encouraging an improvement in equity capital ratios in bank holding companies. Even without significant new acquisitions, the pressure for increased equity capital in most bank holding companies will undoubtedly continue as emergency measures to stimulate the economy bring on a new and rapid growth in bank deposits.

Thus, banks should prepare plans now to meet the demands of future expansion on their financial resources. Lack of planning often forces heavy financing at unfavorable times. Furthermore, plans need to be sufficiently flexible so that they can be adjusted to a changing economic environment.

Rapid expansion places another strain on a bank. Because of limited management time, attention tends to be concentrated on arranging acquisition terms and developing expansion plans while insufficient attention is devoted to assimilating the new enterprises or branches and establishing adequate internal controls. When a bank or nonbank subsidiary is acquired or established, it is generally agreed by experts that internal examination and audit procedures should commence as soon as possible. Other control procedures can be perfected later, but questionable investment policies and ill-advised management practices cannot be tolerated in the interim.

Most bank holding company managements have performed admirably; some have not. The failure to exercise proper control over the lending activities of its affiliates caused the failure of Beverly Hills Bancorp a year ago. Volume lending, neglect of loan quality and absence of control procedures led to substantial loan defaults in First Wisconsin Mortgage Trust and caused its parent, First Wisconsin Corp., acute embarrassment and lower earnings. Franklin National's inadequacies are, of course, the best known of all.

While there is a pause in expansion, banks and bank holding companies which have expanded rapidly in recent years would be well advised to turn their efforts towards integrating their acquisitions into a well-managed and controlled organization. In the future, I suspect as much care will be given to the demands of expansion on managerial resources as on the organization's financial resources and to the impact these managerial demands will have on existing operations.

Another important management concern at the present time should be a review of bank lending and investment practices. Risk, cost, price and liquidity are all involved.

Risk taking is one of the functions of banking, but some banks and bank holding companies need to reaffirm their commitment to an evaluation of the credit-worthiness of individual borrowers. When bank growth and higher loan volume became the guiding beacons of a number of bank managements, customer evaluation too frequently was downgraded and the cost of that kind of risk taking is now being paid in significant loan loss exposure and reduced earnings as higher reserves are set aside. Banks should be sure that default of a particular loan or category of loans will not be debilitating and should exact a price commensurate with the degree of risk assumed.

Customer risk is frequently minimized by requiring the loan to be collateralized. But there can be additional risks in overvaluing collateral. This has happened especially in real estate lending where overbuilding in areas of limited popular appeal has led to defaults in which the collateral was marketable only at a substantial discount from its originally anticipated value. Careful analysis of demand and supply will often indicate whether there is a real need for a real estate development. Banks should require feasibility studies from reputable experts or assure themselves that their own analysis has been sufficiently thorough when loan requests are for large amounts.

Diversification can reduce both lending and investment risk, if carefully implemented, but many bank holding companies are finding to their dismay that imprudent diversification into nonbanking activities can also increase their risks. A substantial loss incurred in one subsidiary might affect the external borrowing power of the holding company, for example, and force the untimely sale of other holding company's assets, consisting mostly of the common stock of affiliates. While forced sales of affiliates have been relatively rare, many bank holding companies have nevertheless found that their nonbanking affiliates have not contributed at all to the greater stability in earnings performance they had expected.

Another kind of risk, interest-rate risk, becomes increasingly important when interest rates are unstable and maturities are relatively long. Regrettably, volatile interest rates have fostered imprudent management practices by some bank managements. Some, speculating that interest rates would fall, have loaded up heavily with long-term bonds in order to reap sizable capital gains. The Parsons group followed such a strategy to an extreme, thereby contributing to the failure of Birmingham-Bloomfield Bank and to the FDIC's emergency loan to Bank of the Commonwealth when interest rates rose instead of falling. Playing the interest rates is not characteristic of prudent management practices and should obviously be avoided when the sole motive is speculation.

Costs and prices are also important considerations in any discussion of lending and investment practices today. When the cost of funds is changing almost daily, profitable pricing policies depend upon an adequate understanding of the ties between specific uses of funds and sources of funds. Many bankers have become skillful in utilizing modern cost accounting techniques as an aid to understanding their costs. Yet, many others continue to apply uncritically the "pooled" cost of funds concept when setting prices. For example, the average cost of funds might be only 4 percent because of substantial amounts of interest-free demand deposits, while CD's are selling at 9 percent and Federal funds at 11 percent. It may be possible to finance new loans or calls on approved lines of credit only by purchasing high cost money. The banker who then prices such a loan at his average cost of funds almost certainly will lose money. Franklin's poor earnings prior to its failure can be traced, at least in part, to inappropriate pricing policies.

Although interest rates have fallen sharply, making uncritical pricing less of a problem at the moment, bankers should improve pricing techniques now in preparation for future periods of high interest rates and high loan demand. Furthermore, the declining rate of return on assets experienced by most large banks since 1970 suggests that these banks should be looking for ways to control costs more effectively or to set prices that are competitive but guarantee an adequate rate of return.

As to liquidity, the banking industry has struggled through liquidity crunches three times in the past decade, and each time banks were hard pressed to meet lending commitments. Traditionally, banks maintained liquidity by matching asset maturities with deposit and liability maturities and by practicing asset management. When loan demands increased and deposits were difficult to procure, the bank simply met its commitment by selling off a short-term security. Deposit withdrawals theoretically, according to the asset management philosophy, could be met by maturing short-term, self-liquidating loans.

In practice, asset management never worked as well as it did in theory. Short-term loans often were not self-liquidating and by the early 1960s, banks had already sold off as much of their short-term securities as they considered prudent. Furthermore, during the 1960s, the need for funds led many banks to offer lending services to consumers which tied up funds in long-term mortgages and medium-term installment loans. Increasing competition for corporate accounts compelled more and more banks to extend term loans. As the appetite for funds continued to grow, more and more banks, particularly large banks and holding companies, increasingly relied on market sensitive funds, such as large denomination CD's and Federal funds.

Thus, asset maturities lengthened while deposit and nondeposit liabilities became less reliable sources of funds, reducing a bank's ability to respond flexibly to a liquidity squeeze. The response of many banks and bank holding companies has been to disgard asset management for liability management, as to which I shall offer a few comments shortly. Suffice it to say at this point that, in my judgment, prudent management demands that asset management principles be exercised in coordination with liability management principles and not be ignored altogether. In the future, more attention will undoubtedly be paid to loan and investment maturities. Short-term loans that are long-term loans in disguise and loans and securities having no organized secondary markets should not be expected to provide liquidity in an emergency. Consequently, many banks are striving to reduce their dependence on such assets, to increase their holdings of short-term, highly marketable securities and to shorten somewhat their loan maturities.

The last management issue I wish to talk about concerns deposit and nondeposit liability management practices. I suggested at the outset that many of the fundamental changes we have witnessed in banking over the past 15 years came about because banking, in its desire to maintain its primary position in the financing of American business, was forced to seek new sources of funds. The quest accelerated each time the Federal Reserve tightened monetary policy and each time market interest rates exceeded Regulation Q ceilings.

In this climate liability management was born. Liability management, as it has been practiced, is the technique of purchasing funds in the money market whenever they are needed for lending purposes. Since funds, at least until 1974, were always presumed to be available, there was a tendency to minimize holdings of short-term securities and to relax asset liquidity standards. Banks have learned, however, that liability management can become a high risk policy during tight money periods when the borrowing power of individual institutions can change abruptly and no alternative sources of funds have been planned.

Money market funds are not always reliable. Publicity about Franklin's management problems sparked a savage withdrawal of money market funds. Furthermore, in the nervous environment of last summer, many other banks lost access to money market funds or were required to pay premiums, as unfounded rumors about their financial condition circulated throughout the country. Large money-center banks received preferential treatment while many of the fast-growing regional banks were penalized.

The obvious solution is to reduce the dependence of most banks on the money market. A look at the statistics will show that, while this dependence has grown steadily, it has always been much greater when the Fed was pursuing a restrictive monetary policy which pushed up interest rates. At these times, market interest rates tend to be substantially above Regulation Q ceiling rates. This has fostered widespread efforts on the part of the average saver to evade Q ceilings with the result that much of the public's money goes into the more volatile money market instruments. Banks and bank holding companies outside the nation's money market centers would undoubtedly be better off competing for relatively more stable deposits at market rates rather than having to rely on the vagaries and prejudices of the money market.

Regulation Q exists principally to prevent the destruction of earning power in thrift institutions which are locked into long-term, low-yielding mortgages. Each time Regulation Q ceilings have been exceeded, deposits pour out of thrifts and banks and find their way to the money market. The money market lends on a short-term basis only. Thus, Regulation Q serves to draw away normally stable deposits which can fund long-term loans and to allocate it to other uses. The result is periodic full-scale depressions in the housing market. The havoc Regulation Q wreaks on housing and the instability it perpetrates on banking activities, not to mention the discrimination it exercises against small savers, are now abundantly clear. It is for these basic reasons that the Hunt Commission, the Administration and many others, myself included, believe the time has come to phase out Q in an orderly manner. Housing goals and viable thrift institutions can surely be achieved in better ways than Q, and the sooner we get on with that effort, the better. Whether Q remains in effect or not, however, the nation's banks must seek to lengthen deposit maturities and to reduce their reliance on the volatile money that courses through our financial system.

One of the management fundamentals implicit in my remarks is that bankers should not just slavishly follow the fad of the moment or react to events as they occur; bankers should take pains to plan ahead, to set goals and long-run policies, and to be prepared to adjust to future changes in the economy with a minimum of disruption. To do this successfully, bankers not only must know and understand their bank, their community and their customers, they must recognize how economic events affect their bank, community and customers.

We are all painfully aware of how imprecise economic forecasting is. Nevertheless, an understanding of how economic events are shaped will help a great deal in preparing to respond to an uncertain future. Generally speaking, economic developments are shaped by the formulation and application of public, fiscal and monetary policies in the pursuit of the broad goals of full employment, growth in real output, stable prices and national security in the long run and stability in the short run. The impact of these policies is modified by the way in which individuals, industries, financial institutions and other segments of society respond to them. When so many elements are involved in shaping economic events, it is not surprising that economic forecasting frequently misses the mark, often by wide margins.

In developing economic policies, difficulties arise because policies used to achieve a particular goal may prove counterproductive to the attainment of other goals. For example, policies designed to fight inflation often lead to greater unemployment. Difficulties also arise because the interactive effects of public, fiscal and monetary policies are not generally understood and the diffusion of power to administer these policies does not promote coordinated efforts. As a consequence, the administration of policy tends to focus upon short-run solutions to problems without a clear understanding of long-run effects.

At the moment, the President and the Congress are wrestling with various suggestions to stimulate the economy and to control energy usage, while the Federal Reserve has been moving steadily to ease the monetary restraint it was pursuing with such determination last summer. Predictions may be foolish, but several things are certain. Taxes will be cut, unemployment benefits will be extended, public employment programs will be enacted and the Treasury will be required to finance an enormous deficit. Less certain is whether individuals will respond to the tax cut by increasing spending, whether businesses will regain optimism and step up production, whether banks will encourage business and consumer borrowing and whether the Fed will pursue policies to facilitate Treasury borrowings.

Although all of this will affect banks, the exercise of monetary policy by the Fed will have the most immediate impact. The Fed influences bank behavior by controlling bank reserves, which determine the ability of banks to extend loans and create deposits. Presently, the Fed is increasing bank reserves but, to a large extent, these increases in reserves have been offset by bank repayment of Fed discount window loans which were originally taken out to meet reserve deficiencies.

In a fractional reserve banking system such as ours, changes in reserves can cause much greater changes in the money supply and loans. Increases in reserves, however, do not automatically lead to increases in the money supply and loans. This depends on bankers and their customers. At the moment, individuals and businesses are paying off past loans. Bankers may be adding to this decline in loans through more restrictive lending policies instituted in an attempt to improve their liquidity. The current spread of nearly 2 1/2 percentage points between the prime loan rate and the CD rate, as opposed to the more customary 3/8-point spread, is evidence of current conservatism in bank policy and of current efforts to improve both liquidity and profitability. Thus, even though the Fed has increased bank reserves in the last few months, currency and demand deposits have actually declined.

As a result, the Fed's more recent monetary posture has not yet been effective in stimulating loan growth and, hence, it has not yet been effective in slowing the decline in the economy. In coming months, the Fed will be called upon to provide reserves so that the huge anticipated deficits in the Federal budget can be financed more easily. If it supplies enough reserves by purchasing some of the Federal debt, interest rates will not increase, at least not in the short run. However, if the Fed sticks to its determination to bring down the rate of inflation, significant pressures may develop in our security markets and interest rates may again go up. The Fed has a neat tightrope to walk if it is to avoid laying the foundation for future inflation.

Henry Kaufman of Salomon Brothers believes that the maintenance of the prime rate well above other short-term market rates will induce the best customers of banks to borrow in the commercial paper market rather than at commercial banks. Further, he believes that the slack that this creates will enable banks to finance a large share of the anticipated deficits. However, when economic recovery begins to gain momentum, banks will be able to convert this large accumulation of liquid assets into loans and this may very well precipitate a new round of inflation, tight monetary policy and high interest rates. Milton Friedman fears that the Fed may be pressured into expanding reserves too rapidly and that this will lead to ". . .accelerated inflation in 1977 and beyond. . . ."

As always, the exact future is unclear, but the various possibilities are known with reasonable certainty. Thus, even as banks cope with recession-induced problems, management should be planning ahead and preparing for the possibility of renewed growth, inflation, tight money and high interest rates as well as the possibility of slower growth, prolonged unemployment and moderate interest rates. By watching Administration, Congressional and Federal Reserve policies closely, a sense of the general course of future events should emerge. Those who believe they are especially talented may go ahead and predict individual, business and financial institution response to these policies and make their plans accordingly. The course for the prudent banker, however, is clear. He should implement sophisticated and balanced managerial and financial policies and prepare his plans carefully for the limited range of inevitable changes that will occur in our economic environment.