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IS THE LIQUIDITY OF YOUR BANK STILL ADEQUATE?

Remarks of C. Canby Balderston,

Vice Chairman,

Board of Governors of the Federal Reserve System,

Before the Seventy-first Annual
Kentucky Bankers Association Convention,

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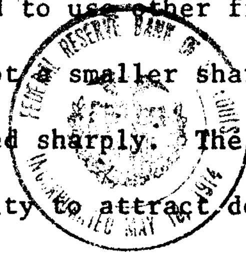
IS THE LIQUIDITY OF YOUR BANK STILL ADEQUATE?

It is prudent for bankers to inquire, especially in good times like the present, whether they have made adequate provision for adversity. A bank's primary protection, in addition to its capital, centers in its liquidity. What has been happening to bank liquidity? Ten years ago the ratio of total loans to total deposits at all commercial banks was about 43 per cent; now, it is 64 per cent. Excluding security and non-bank financial loans, the ratio ten years ago was about 38 per cent; now, it is 58 per cent.

These bare facts point to the old, old problem of balancing risk and safety. To fulfill their role in our society, bankers must take risks in lending and investing to serve their communities and to earn dividends for their stockholders. On the other hand, they must also keep constantly in mind that loans and investments of greater risk call for commensurate protection against the unforeseen.

To assess whether bankers are still keeping risk and liquidity in balance requires first a look at changes in the banking industry, in both deposit and portfolio structures. Not all of the implications of these changing structures are yet clear.

During the 1950's, bankers complained about restrictions that reduced their ability to compete for their raw materials--deposits. They faced the increasing growth of competing nonbank financial institutions. They faced the accelerating tendency of businesses to reduce their holdings of cash and to use other financial assets for liquidity purposes. And so banks got a smaller share of a growing pie. Also their liquidity was reduced sharply. The credit demands placed upon banks exceeded their ability to attract deposits, and so they were forced to sell Government securities in order to make loans.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During the 1960's the competitive stance and rate of growth of the banking system were altered dramatically. The causes were rise of the negotiable CD--and the increases in Regulation Q ceilings. For at least 25 years banks' acquisition of deposits had been rather passive. To be sure, service, information, understanding, and creative lending were all considered to be important competitive tools. But in the last five years, banks have been stressing price competition for deposits, not only in dealing with the small saver, but also in dealing with the giant industrial enterprise.

By offering higher rates, banks began to attract an increased flow of savings that had once been placed in savings and loan associations and mutual savings banks. Competitively priced CD's began to bring in and hold in deposits funds that had once been placed in Treasury bills and other forms of "near money". Moreover, as research of the Board's staff indicates, most of the continued growth in these interest-bearing deposits has come out of new savings, from deposits of nonbank competitors, and from the money markets, rather than from the transfer of demand balances. Banks found, contrary to their fears, that they could gain new--and larger--deposits by competing for them at market prices instead of merely inducing a shifting of interest-free demand balances into interest-bearing savings and time deposits and certificates of deposit. Banks, in short, began to get a bigger share of the savings pie; their deposits rose twice as rapidly between 1961 and 1965 as in the 1950's.

As liability structures of banks changed over this period, there was some realignment in their assets. All sectors of earning assets, other than U. S. Governments, rose more rapidly than during

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the 1950's. This was true especially of real estate loans and municipal securities. Over the 1961-65 period, mortgage loans rose at an annual rate of almost 12 per cent, while State and local security holdings rose at an annual rate of 18 per cent, which was twice as fast as total earning assets.

It is likely that three factors were at work here:

First, banks were capturing a larger share of the public's financial savings by issuing new types of instruments and by paying attractive rates. Having more funds to invest, they allocated them somewhat differently. Indeed, at least until late 1964 or early 1965, it is likely that some part of the portfolio realignment of banks was caused by deposit growth in excess of loan demands. For example, during the first three years of the current expansion, business loans grew at a 7.3 per cent annual rate; in 1964, at almost 12 per cent; and in 1965 to date, at almost 21 per cent.

Second, and related to my last point, banks felt that with higher deposit costs it was necessary to recast their portfolios by increasing the proportion of higher yielding assets.

Third, this changing portfolio structure may reflect the perennial desire of banks to maximize profits through aggressive policies. A 6 per cent tax-equivalent yield on a municipal bond is a very good return regardless of whether all your deposits are demand balances or one-half of them are time balances; and whether you are paying for time deposits 2 per cent or 4 per cent. In short, yields affording higher profit-margins played a part, along with availability of larger sums in interest-bearing deposits, in propelling banks to increase their municipal security investments and real estate loans.

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It is within this framework of increasing competitiveness, larger loan-investment-deposit growth rates, higher deposits costs and increased profit consciousness, that bank liquidity must be examined. Traditional analytical ratios indicate a considerable deterioration in bank liquidity.

The loan-to-deposits ratio of commercial banks continues to show a persistent rise. From an abnormally low level of 18 per cent at the end of World War II, this ratio has now advanced to a postwar high of 64 per cent. Previously the ratio tended to rise rapidly only during business upswings, when loan demands were strong and the Federal Reserve System was restraining monetary and credit expansion, and to recede during periods of recession.

Another indicator of bank liquidity is the ratio that bank holdings of U. S. Government securities of one year or less bear to total deposits. Even without much monetary restraint during this cycle, this ratio has declined quite sharply from the levels in the early 1960's. It has not, as yet, however, breached the lows of previous expansions.

So far this year--a period marked by rapid economic growth and increased credit demand--the decline in bank liquidity has accelerated. Over one-third of the increase in the loan-to-deposit ratio during the past four and one-half years of business expansion has occurred in the last nine months. This trend, with attendant declines in holdings of short-term Governments, appears to be continuing as the year progresses.

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Certainly by any of the old standards, bank liquidity is considerably less. But do old standards give an accurate reading of bank liquidity?

Some people feel that the true state of bank liquidity may not actually be as low as the standard ratios indicate. This group argues that more bank liabilities are in the form of savings deposits that have less volatility than demand deposits. Consequently, banks require fewer assets that can be liquidated quickly, and without loss, in order to meet deposit withdrawals.

This group suggests also that, within the realignment of their portfolios, banks have changed the form of their liquid assets. Thus, banks are holding more security loans, more short-term loans to financial institutions, and more short-term municipals and Federal agency issues.

It is argued that although these assets produce a somewhat higher yield than short-term Treasury issues, they can be liquidated almost as rapidly. Traditional bank investment policy called for relatively uniform spacing of municipal maturities over the entire portfolio. But with the recent trend toward the use of municipals for liquidity purposes, some banks concentrate their holdings in either very short or very long maturities, and hold few in the medium-maturity range. Another source of liquidity is the greater volume of assets that are amortized over their life--mortgage, consumer, and term loans. These produce a steady cash inflow.

Finally, according to those who feel that current liquidity is not as low as the ratios indicate, banks now have available to them new means for gaining additional liquidity. The principal sources are the markets for Federal funds and CD's.

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There is some merit in these arguments. However, I am not as positive as their proponents that the decline in traditional liquidity ratios is not a cause for concern--particularly when appraising developments in 1965. I am also not as sure it is a completely new development,--witness the 1920's.

The tendency for banks to be more aggressive, more willing to compete, and more adept at seeking out higher yields is all to the good in developing a stronger and more flexible banking system. But I have the uncomfortable feeling that perhaps caution is being neglected. Many businessmen and bankers seem to be acting as if expansion can never abate. The mental state often called ebullience is catching. Businessmen tend to copy the decisions of others to increase inventories, plant capacity, and higher-yielding earning assets.

As the expectation of continued good business feeds on itself, there is a tendency to underestimate increasingly the risks of adversity. It may also be noted in passing that the number of decision makers who learned the hard lessons of the early 1930's has been reduced markedly. Consequently, there are fewer voices of caution to be heard. I am *not* suggesting that a repetition of the 1930's, or even a mild recession, is just around the corner; rather, I *am* suggesting that caution should not be cast aside.

It is not at all clear that banks will be able to liquidate municipals or mortgages as readily as they might desire. Moreover, savers, who have learned to look for the best yield, may not be willing to keep their deposits with banks if a better yield develops elsewhere. Even disregarding Regulation Q, corporate deposits may not be gained

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when needed just by raising yields, especially when corporate liquidity is low. In short, sources of liquidity available to a few banks may work out less well when many banks attempt to tap them simultaneously.

The adequacy of liquidity can only be determined on a bank-by-bank basis. The following questions may serve to point up the <u>need</u> for liquidity:

1. Do you really know your depositors, their needs for funds under various economic circumstances, and the way they would adjust their balances in response to possible changes in their circumstances?

2. Have you a heavy exposure owing to a concentration of deposits of a potentially volatile sort, either because they are held in a few large accounts or are drawn from depositors living outside the community and having no other significant customer relationship with your bank?

3. Have you made a careful estimate of the "hard core" of your deposits, both demand and time, that you can count on keeping in your bank?

4. Have you recognized all risks of being unable to retain funds acquired through the issuance of CD's and unsecured notes?

5. Have you attempted to ascertain the size of the unexpected loan demands from your large customers in an emergency situation?

Assuming you have reached a judgment as to how thick the liquidity cushion should be, what further questions will serve to appraise its dependability?

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Are you satisfied that the assets in your liquidity cushion are truly liquid? To what extent might they become unmarketable if many sellers tried to liquidate them simultaneously?

To what extent are you relying, to meet future liquidity needs, on the issuance of CD's or unsecured notes?

Are you counting on the run-off of assets for which there is substantial risk that repayment at maturity might not be realized?

Are you placing undue reliance on emergency borrowing, considering the possibility that some of those sources might dry up?

Banking remains a business extremely sensitive to shifts in demands, yields, and the business cycle. To achieve flexibility in providing required reserves, banks may borrow from their Federal Reserve Bank if they are members of the System. One of the Federal Reserve tasks is to help banks provide bank liquidity. But resort to the discount window cannot liquefy bad assets. To have enough readily marketable assets is the responsibility of each individual bank. Only then can it have a sound defense against adversity and contingencies.

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