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BANKING IN THE SIXTIES

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of the

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BANKING IN THE SIXTIES

It is a privilege for me to be with you today and I am grateful for your invitation.

As you might know, I have been -- until a little over a year ago -- an average American citizen in the business world. The U. S. Navy kept me busy for four years during World War II and, although I thought I would prefer to be at home in my native Louisiana, in retrospect I can see that the Navy furnished me a large part of my formal education. I say formal because the following twelve years were quite informal. They were spent working in partnership with a man of much common sense and patience -- my father. He tried to teach me the lumber business, but I'm afraid I had my mind on other things. Some inner desire kept alive my earlier dreams of owning a cattle ranch. I had always been told that the West was the only place for such an undertaking, but my roots were so deep in the South that I decided to give it a whirl in Mississippi.

My progress as a Hereford breeder reached its peak when my firm produced and exhibited the champion Hereford bull at the National Western Livestock Show here in Denver in 1957. Since then I haven't made much progress as a Hereford breeder. But I do have an alibi. In 1956 I was appointed as a director of the New Orleans Branch of the Federal Reserve Bank of Atlanta and in 1959 found myself on the Board in Washington. So my lack of progress as a Hereford breeder during these years is clearly the fault of the Federal Reserve System. Accordingly, I <u>could</u> join the chorus of those who blame the Federal Reserve for all the ills of America. But since it is <u>eventually</u> necessary to face facts in all situations, I know that such an attitude on my part would be as unreasonable as many charges leveled at our central bank.

Before my appointment to the Federal Reserve Board, my experience with banks had been mainly as a depositor and a credit user. I have seen at first hand how vital credit is to a growing business. While many industrial enterprises have been built mainly out of retained earnings, this method of growth, if relied on entirely, would seriously retard industrial progress. Much of our technological advancement as a nation has been due to the existence of a highly developed credit and banking structure to mobilize financial resources and direct them to those who can use them profitably.

The availability of credit for meeting seasonal needs is a factor of great importance to most businesses. The contribution of such seasonal borrowing to efficient business operations is often overlooked or underestimated because it is so commonplace.

Even more important is the contribution which credit can make to economic growth and technological advance. If any of us is inclined to the conclusion that our economy is getting old and losing its momentum, he need only be reminded of the meteoric rise in the last few years of many dynamic new businesses, particularly in electronics, to realize how important to our progress is the man with a new product or process and the courage of his convictions. In order for the potential of these budding entrepreneurs to be realized, access to outside funds is a necessity.

Since assuming my Federal Reserve duties, the position from which I observe banks and appraise their actions has been greatly altered. Naturally, I am still concerned with the problems of the individual borrower and with the manner in which the banker manages his business. But as a public servant, my present concern with bank credit and bank deposits is with their influence on the over-all functioning of the economy and on the economic welfare of all our citizens.

As you are aware, the major function of the Federal Reserve System is to influence, through regulating the availability of bank reserves, the capacity of the banking system to create bank credit and money -- and through this to promote high and growing levels of employment and production, relatively stable prices, and a stable currency. This requires that the creation of new credit and money be kept in balance with our nation's capacity to produce. Experience has taught us that excessive credit expansion leads to inflation while too little would hamper our growth and our prosperity.

The principal function of commercial banks, on the other hand, is to allocate the available supply of bank credit among the various competing users. Under our competitive free enterprise economy, we rely for the most part on changes in interest rates on borrowed funds to bring the demand and supply of loanable funds into balance, and to allocate that supply among the various potential borrowers. In effect, this means that funds generally get allocated to the most profitable uses since they will go to those borrowers able and willing to pay the rate that brings supply and demand into balance.

In many markets, including the market for bank loans, we are all aware that prices are not completely flexible but are characterized by rigidities which limit their effectiveness in performing their economic function. In the market for bank loans, some of these rigidities are institutional in nature, reflecting possibly the banker's reluctance to depart from traditional rates, individual customer relations, or his desire to avoid the administrative complications of frequent rate revisions. Some of these rigidities, particularly at current rate levels, also result from usury law ceilings and other statutory limitations. As a result of these rigidities, the banker exercises considerable discretion in allocating funds among the various applicants for loans. Decisions as to which potential borrowers will be able to obtain funds and in what amounts are matters not solely of price but also of human judgment.

As you know, you bankers, therefore, have a great responsibility. How you carry out this responsibility has a great deal to do with the amount and direction of growth in our national economy and the vigor of the competition among its component free enterprises. In recent years, this responsibility has grown. The amount of discretion exercised by the banker has increased. For in this period, there has been a substantial reorientation in the lending position of most banks. Unlike the situation generally prevailing since the early 1930's, when banks had abundant funds to lend, the available supply of bank credit in the last year or so has fallen considerably short of the demand at prevailing interest rates.

Two related developments underlie this dramatic shift in the availability of bank credit relative to continuing strong demands. One of these is the continuing exercise by the Federal Reserve of effective control over the creation of bank credit, particularly since the "pegged" Government bond market ended with the Treasury-Federal Reserve Accord of 1951. From 1932 until the time of the Accord, bank credit increased at an average annual rate of more than 7 per cent as a result, first, of anti-depression actions and later as a result of heavy deficit financing of the War through the commercial banks. In contrast, credit growth since the Accord when monetary restraints have been flexibly applied has been at an average annual rate of less than 5 per cent.

The other major development has been a sharp drop in bank liquidity as banks have adjusted to monetary restraint by disposing of a large part of the vast accumulation of U.S. Government securities which they held at the end of the War. During most of the postwar period, commercial banks have had available for loans not only a large part of the new deposits generated during this period, but also the proceeds of an extensive liquidation of their Government securities holdings. As a result, banks have had sufficient funds to meet the demands of most of their creditworthy borrowers.

In the process of reducing holdings of Government securities and expanding loans, commercial banks have raised substantially their ratios of total loans to total deposits. While great significance should not be attached to any single ratio, it is interesting to note that the loans-to-deposits ratio has risen rapidly over the postwar period -- from a wartime low of 17 per cent in 1944 to a high of 56 per cent at the end of April. At New York City banks, this ratio has moved close to 70 per cent for the first time in three decades, and is now approaching the average of the 1920's when loan ratios were relatively high. The ratio for country banks, which is the lowest of any class of member banks, is now above 50 per cent, a level considered relatively high, even by many city banks just a few years ago.

At these levels, many banks have reached or are rapidly approaching what they regard as their loan ceilings -- a point at which they consider themselves "loaned up" and beyond which they are no longer willing to expand loans at the expense of further liquidation of investments. Many other banks, if recent rates of loan expansion continue, will doubtless run into loan ceiling problems in the foreseeable future.

We are all aware that many banks in recent years have revised from time to time their standards of an appropriate ceiling on loans in relation to their other assets or to their deposits. Further revisions could be made in the future; but I would like to emphasize the fact that within the limits set by liquidity needs and prudent regard for the safety of the depositor's funds, these standards cannot be stretched indefinitely. At some point, there is an ultimate limit. On the basis of the information available to us, there is reason to believe that such a limit already has become a reality for a large number of commercial banks.

As banks have reached or approached this limit, they have been forced to reorient their loan policies and to revise their procedures for loan administration. With loan demands continuing high and available funds short of the amounts needed to meet the requirements of all creditworthy borrowers, banks have found it necessary to establish priorities on types of loan demand they will try to satisfy, to establish new standards for determining borrower eligibility, to select measures for restraint on lending appropriate for each type of loan, and to tighten internal loan administration to insure that these policies are made effective.

Over the past few months, holdings of real estate loans at weekly reporting member banks have declined moderately and holdings of loans to brokers and dealers other than Government security dealers have declined by one-third. Although some banks have been de-emphasizing consumer loans in their advertising and have become more selective in extending consumer credit, the volume of consumer loans has continued to rise, but at a somewhat slower pace than last year.

Meeting the legitimate credit needs of commercial, industrial, and agricultural customers, however, apparently continues to receive top priority among commercial banks. The extension of short-term credit to finance the flow of goods through the various stages of production and distribution traditionally has been a major function of commercial banks. In recent decades, banks have also extended moderate amounts of credit on somewhat longer maturities to finance investment in plant and equipment where regular amortization of the loan out of income or alternative financing was reasonably assured. This source of credit is particularly important to smaller businesses whose alternative sources of long-term financing are much more limited than those of larger businesses.

In reappraising loan policies and in reshaping loan portfolios, it is natural to expect that bankers will give primary consideration, as they have in the past, to safeguarding the funds of their depositors and realizing a satisfactory level of earnings for their stockholders. Their responsibilities, however, extend beyond these traditional lines. Bankers also have a responsibility to allocate credit equitably and constructively so as to promote the growth and prosperity of the country as a whole.

The way in which you carry out this responsibility may have as great a bearing on the growth, prosperity, and vigor of our economy as the total volume of credit made available. As funds for loans become limited, you will undoubtedly tend to give first consideration to the needs of old and established customers. But let us not forget the man who is willing to risk his ability and his capital for the prospect of successful enterprise and fulfillment of an economic need. Out of such beginnings has come the drive which has contributed so much to the industrial pre-eminence of America.

In the past, we know of many instances where the banker has provided important assistance to relatively new ventures to help them through the difficult early stages of growth until they became established. When funds available for loans were plentiful, as they have been over most of the past three decades, bankers had appreciable incentives to undertake the additional effort needed to make bankable loans to new and sound businesses -- and to provide the advice and counsel needed to launch them on the road to a healthy growth and development.

When the demand for credit is high relative to the supply, the incentive to take these risks and make these additional efforts naturally tends to diminish. This I hope you resist within the limits of sound banking. It is important that you continue to reserve a part of your available funds to meet the needs of promising new enterprises and feel responsible for seeing that these funds are wisely used. This is especially true for the members of this group who, because of their size and their status, are in such an excellent position to make contact with promising young businesses and to appraise their prospects on the basis of direct knowledge and experience.

In the decade ahead, the challenge to you in fulfilling this responsibility will be even greater than it is now. If our country experiences the growth that many now foresee, credit demand will continue to rise. In the vigorously expanding economy we confidently expect, growth in bank credit and money must continue to be kept in balance with our productive capacity. The supply of bank credit will continue to require careful and judicious allocation, and the way in which you allocate that credit will influence economic growth.

Our gross national product, which now is at an annual rate of about $500 billion, is expected to reach $750 billion at present prices by 1970. The surge in births during the War and the immediate postwar period will result in expanding our labor force at an annual rate of 1.5 million in the latter half of the present decade compared with a recent growth of 800,000 per year. The stock of plant and equipment required for each person in the private labor force, which now averages about $10,000, might rise by 25 per cent over the decade. This would mean an increase of more than 50 per cent in total domestic investment. Thus, there is every prospect that in the decade ahead, the administration of bank loan portfolios in the interests of the whole economy will require greater wisdom and courage than at any time in the past.

How can commercial banks best prepare themselves to meet this challenge? It seems to me that bankers will need to take a careful look at themselves and at their institutions, and re-examine all they do and all for which they stand. The responsibility lies with the banker to see that his institution is in step with the times. Specifically, the following appear to be important steps in such a review.

First, commercial banks should re-examine their goals and objectives. We could ask the question: Are the traditional commercial bank goals of sound assets, good earnings, growth, and prestige adequate for this critical era of international competition, exploration of outer space, and concern for full employment and high living standards? Perhaps not. Bankers might set their sights in relation to a wider horizon, taking account of their broad responsibilities to their communities and to the national economy. Of course, many already do this. I believe it is desirable for all bankers to take this attitude because it is only to the extent that private enterprise continues to demonstrate its superiority in satisfying the wants of mankind that the demands for a greater role of Government in the economy can be successfully resisted.

Second, commercial banks should give increased attention to the grooming of future officers. The future, I am confident, will place a premium not only on intelligence but also on the ability to see the broader issues facing our society.

Finally, it will continue to be important in the future as in the past that commercial banks make adequate provision for their own liquidity and provide a strong capital base that will justify and support the continued assumption of risks.

I feel confident that if the American commercial banking system gives itself an objective review, grooms farsighted executives, and equips itself with adequate capital and liquidity cushions, it will not only be able to meet the great challenge of the decade which lies ahead, but will keep the faith with those who laid the foundation for our United States.