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Bank Lending Practices and Changes in the Monetary Environment

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Bank Lending Practices and Changes in the Monetary Environment

In the past 15 years or so, the senior lending officers of American banks have endured no less than four bouts with monetary restraint. Their reactions, as heard on Constitution Avenue, have been indicative of extreme frustration and even agony. This is understandable, because, while monetary restraint is not their doing, almost without exception their institutions, their industry, their leaders and spokesmen have, on each of these occasions, supported Federal Reserve use of monetary restraint to curb inflation and defend the stability of the dollar.

I assume that all of us accept the possibility of periodic monetary restraint as a fact of life, but loan officers are asking increasingly whether the banking industry can be successful as an aggressive lender one year and indifferent or hostile to the credit needs of the same customers in the next? Others wonder if as loan officers they must permit the productivity of their professional careers to be retarded because of the changes in pace ensuing from alternating periods of monetary ease and restraint. The plight of the industry and the loan officer is a real one, indeed, but your customers stand to suffer still greater inconvenience and loss than you do--if that is any consolation. And if your inclination is to blame it all on monetary policy perhaps you should reconsider that judgment.

I am indebted to Joseph Burns, Economist in the Board's Division of Research and Statistics, for assistance in preparing these remarks.

I have always thought a loan officer was paid to screen and select loans--not to sell them--a view I am sure borrowers generally have of lenders. This view follows not merely from the fact that institutions that invest other peoples' money must constantly guard against lending exuberance when it can entail undue risks. In a prosperous and growing economy, it seems to me that the conditions for access to credit, including its price, must of necessity be used as selective deterrents simply to contain, within supply constraints, the massive demands for credit that are so pervasive in our economy.

Economic developments in the postwar years and especially the 1960's have changed attitudes gradually but drastically with regard to creditworthiness. Fewer and fewer loan officers give much weight to the likelihood of a major economic recession. The past decade of expansion in markets, employment and earnings of business and workers alike, has upgraded the performance and debt service capacity of borrowers in all sectors of the economy. While we often view the larger and more pressing demands for credit as the consequence of expanding capital requirements in our economy, we could also view them as the creation of lending officers--for it is the lending officers who have discovered that, given conventional lending standards, the changes in economic environment through the past decade have greatly extended the creditworthiness of consumers, businesses and State and local governments. It may be argued that the latent demand for credit has been there all along but that it is the steady and prolonged economic expansion of our times that has made it an effective demand.

Since there has been no proportionally large flow of funds to credit markets and institutions your job is becoming more and more that of selecting the best credits and developing standards or pricing policies to bring the flows of resources and the flood of demands into approximate balance.

This is a point in time when I believe an inward look at your own operations is more productive than venting frustration over monetary policy. Moreover, considering the commitment to price stability that all of us have, I believe we can and should develop lending techniques that accommodate and even enhance the effectiveness of monetary policy. This responsibility rests most heavily on those of us whose institutions deal in money or fixed money claims rather than equity instruments--for here the essentiality to our overall interest of a stable dollar is especially apparent and vital.

Let me now examine recent experience in matching up the banking system's resources with the demands of its customers.

The Changing Economic Environment

The period from mid-1968 to date is illustrative of a situation in which the flow of banking's resources shifted markedly relative to the loan demands of its customers. The supply of lendable funds at banks was adequate to meet demands until late in 1968 because of a corresponding rise in deposit resources. In this period banks extended more than 50 per cent of the total increase in net credit extensions. Total member bank deposits, for example--the bank credit proxy--rose at an annual rate of more than 13 per cent during the second half of 1968. But in 1969, with loan demands still strong, member bank deposits declined at an annual rate of about 5.5 per cent over the first nine months of this year. Banking's share of the increase in credit flows during the first half of the year dropped to approximately 12 per cent and in the third quarter it was significantly negative!

Management of Liquidity Positions

The oldest and most conventional means by which banks have reacted to a faltering supply of funds relative to demand is through an adjustment in holdings of impersonal money market assets. I refer to their impersonal character to imply a lack of customer relationship or solicitousness which might serve as a deterrent to the sale of such assets. Of course, this is not entirely true even for Treasury securities and Federal funds. In any event, such assets are frequently used as a buffer to insulate loan customers from unexpected--and sometimes even expected--variations in flows of loanable funds, or loan demands. During periods of excess supplies of funds, these balances usually are built up, and in periods of excess demand they usually are drawn down.

During the latter half of 1968, commercial bank holdings of securities rose by nearly $9 billion, on a seasonally adjusted basis. Moreover, the greater part of this increase represented acquisitions of short-term securities. Holdings of Treasury bills at large banks more than doubled in this period and holdings of short-term Treasury notes and bonds, as well as short-term municipal obligations, rose sharply. Very short-term loans such as those to brokers and dealers and to other domestic banks also rose markedly, though in part seasonally. Nevertheless, the rise in most of these items was larger than in comparable periods of recent years and the nation's larger banks entered the period of monetary restraint with a considerable quantity of liquid assets at their disposal, relative to their liabilities.

The most immediate reaction on the part of banks to the reduced availability of funds that set in towards year-end was the liquidation of some of these holdings of liquid assets. Holdings of securities at all commercial banks, for example, fell by $8 billion during the first nine months of 1969, in spite of the fact that banks underwrote several rather large Treasury financings during this period, mostly after midyear. Initially, this liquidation consisted largely of U.S. Government securities. But as time passed and holdings of these securities began to reach minimum working balances around midyear, banks also began to run off other securities in volume.

At the large banks, holdings of Treasury bills were reduced by nearly two-thirds during the first half of the year, but have generally remained unchanged, on balance, at this low level since that time. On the other hand, holdings of short-term Treasury notes and bonds and short-term municipal issues fell somewhat more rapidly after midyear, after having declined only moderately earlier in the year. These banks also cut back on very short-term loans such as those to brokers and dealers. By midyear liquidity positions of the larger banks had fallen below the lowest point reached in the period of monetary restraint in late 1966, and remained at this low level in the ensuing months.

Management of Sources of Funds

The "in" thing now among intermediaries who must maneuver to match resources and commitments is liability management. Initially--that is, in the early Sixties--in banks it took the form of intermediation on a more diversified scale than had ever been tried by the banking system. The variegation in the transformation of short debts--in the form of time and savings deposits--into long-term loans and investments worked miracles for intermediaries and their customers and no doubt made a major financial contribution to the halcyon days of the early Sixties. But in recent years intermediation has turned into disintermediation as market interest rates rose so sharply that the yields on long-term loans and investments with non-negotiable interest terms were insufficient to cover the interest cost on competitively priced short-term deposits And to make matters worse, the monetary authority used rate ceilings to limit the banking system's access to time deposits even when it was, in a market sense, prepared--and increasingly able--to pay a competitive short price.

However, liability management is not, as we have been learning, limited to deposit instruments. It can be done with other direct debts, such as Federal funds purchased or Euro-dollars borrowed, or with contingent obligations arising out of agreements to repurchase assets, or indirectly through sponsorship or guarantee of the obligations of others.

In the sequence of events in 1968 and 1969, intermediation, using large denomination CD's, added substantially to resources of the larger banks in the second half of 1968. But banks could do little, given the rate ceilings in effect, to stem the CD attrition that followed in 1969, and by the end of the third quarter of this year the total of outstanding CD's at weekly reporting banks was less than half that outstanding at the end of 1968. And in spite of heavy promotional campaigns by banks, consumer-type time and savings deposits at large banks also began to decline in the spring.

Consequently, banks turned their efforts towards developing new, or more fully utilizing existing, nondeposit sources of funds. For example, banks with foreign branches borrowed heavily in the Euro-dollar market, pushing rates up sharply. By the end of July, U.S head office liabilities to their foreign branches were in excess of $14 billion, or more than double the amount outstanding at the end of 1968. Totals have changed little, on balance, since that time, however, probably, in part, because of the increase in the effective price for these funds that resulted from regulatory changes introduced during the summer. Moreover, banks in need of funds increased their borrowing in the Federal funds market, and the volume of these funds traded in New York, for example, rose from a daily average of about $7 billion in the fourth quarter of 1968 to nearly $10 billion in the third quarter of 1969. The interest rate paid on Federal funds also rose fairly steadily from around 6 per cent in the latter part of 1968 to more than 9 per cent in recent months.

Banks without European branches or a Nassau shell--the "poor man's London office"--borrowed Euro-dollar funds from brokers and dealers or directly from foreign banks. However, the volume of funds borrowed in this manner has not been particularly large--about $1.2 billion--and has shown no tendency to rise in recent months. In addition, banks began to sell loans under repurchase agreements in increasing amounts, until funds obtained from such sales were made subject to reserve requirements and Regulation Q ceilings in August. By the end of September, outstanding funds obtained in this manner had dropped back to only about $500 million. Banks also gained indirect access to the commercial paper market through the issuance of such paper by their holding company or other affiliates. By mid-October the total of funds acquired in this manner was approaching $3 billion. Other somewhat more esoteric devices for acquiring non-deposit funds also have been employed, including the sale of "ineligible" bankers' acceptances and the placement of customers' paper subject to payment guarantees through the bank's letter of credit.

Despite all of these liability management techniques, total lendable funds of banks have fallen since the end of 1968, as the growth in these sources of nondeposit funds has failed to offset the decline in bank deposits. Member bank deposits for the year through September fell by about $12 billion, seasonally adjusted, or by $16 billion unadjusted. This compares with inflows of funds from nondeposit sources of only slightly more than $11 billion.

Management of Lending Terms and Conditions

As I indicated earlier, banks might find monetary restraint less frustrating if they could adopt or adjust their lending terms and conditions to a more realistic evaluation of their own prospective loan capacity in light of financial trends in the economy. This method of adjustment is much different in its implications from the management of liquidity and liability positions. Those techniques attempt to alleviate an excess demand impasse by increasing the supply of lendable funds, essentially at the expense of other potential lenders in the economy. Management of lending terms and conditions, on the other hand, aims at constraining customers' demands for accommodation to a level consistent with a projected flow of funds from reasonably certain and stable sources.

The conventionally preferred way in which banks curtail borrowing is by increasing the rate of interest charged customers either explicitly or implicitly. The explicit cost of bank loans has risen sharply since late 1968. The prime lending rate, for example, has been raised five times since the end of November, from a level of

6.25 per cent at that time to the current 8.50 per cent. As we all know, however, the true price of bank credit has risen considerably more than would be indicated by this stated rate because banks commonly have raised compensating balance requirements as well as enforcing such requirements more strictly.

After taking these steps in 1969, many banking institutions were still in an over-committed condition and have had to engage in some form of nonprice rationing. Most have raised their standards of creditworthiness. Preferential treatment is accorded to established or local customers as opposed to new or non-local borrowers. Customers' deposit balances relative to their use of banking services in past years has become an important measure of the relative profitability of an account relationship and, therefore, a top criterion for loan accommodation.

It is difficult to determine the relative importance of these actions, i.e., the increase in effective lending rates or the various forms of nonprice rationing, in contributing to the observed slowing in the increase in bank loans. The record shows that the rate of growth in loans at all commercial banks has slowed considerably since the end of May. This slowing followed an increase in the prime lending rate by a full percentage point to 8.50 per cent early in June. On the other hand, with liquidity positions at extremely low levels and only limited success in obtaining nondeposit sources of funds, banks may have begun to employ nonprice rationing devices on a more serious basis at about that time. Of course, some faltering in the underlying demand for bank loans--aside from that due to the increase in the lending rate--could have been a factor, too.

Summary and Conclusions

What can we say about the relative merits of these three means of adjustment to monetary restraint from the point of view both of banks and of the monetary authority?

Recent experience emphasizes the need for a re-evaluation of the various methods banks can use to adjust to monetary restraint. What techniques are most effective and profitable for banks and also consistent with the national interest? While I would be the first to admit that it is bankers who should do this re-evaluation, I cannot resist the temptation to indicate the priorities and possibilities as one would see them from my position.

Of prime importance is the fact that banks should not base their adjustments on the assumption that they can predict the time, the duration and the intensity of monetary restraint. Nor should they assume that periods of monetary restraint will always be relatively short-lived. Changes in the structure of the economy, the political environment, and in consumer, business and investor expectations can alter both the intensity and duration of the monetary action required to curb inflation. The slower than anticipated response of the economy to monetary action in 1969 bears ample witness to this statement. The relatively taut and uncomfortable position in which the banking system currently finds itself reflects overcommitment based on the earlier expectation of many bankers that this period of restraint would be over by now.

Even though "second guessing" the Fed is done with confidence in some quarters I wouldn't recommend it or do it myself, even as an insider, given the uncertainties in the timing of responses to monetary actions. The vagaries of the response of economic activity to monetary restraint are simply too great. But if the urge to predict the speed of this response is irresistible, it is better to err on the side of anticipating a long period of restraint rather than a short one because the consequences of conservatism will be less painful to the bank and probably to its customers. If restraint turns out to be short lived the worst that can happen is that banks find they can make more loans and commitments than they had initially expected. It seems to me that this is more consistent with an image of financial strength and soundness than an obviously hectic scramble to obtain funds to meet an over-extended position. Some will say that a conservative assessment of a liquidity squeeze will run the risk of antagonizing customers unnecessarily, with the possible loss of accounts. But in a capital-short world toward which we seem to be heading customers may think twice before deserting an institution whose assurances are conservatively realistic.

How a firmer commitment policy ought best be implemented would undoubtedly vary from bank to bank. Some may wish to tie their commitment policies to liquidity positions or projected deposit flows, tightening policy as these become more adverse. They may find it necessary to adjust their commitment policies in light of estimation errors regarding movements in these variables in the past. Thus, if a banker finds he has underestimated deposit outflows in recent months, it would seem prudent to tighten his commitment policy to hedge against the possibility that he may also be underestimating future deposit outflows. Some sort of public information campaign could make firmer commitment policies somewhat easier to swallow from the borrower's point of view. That is, if these firmer policies were couched in terms of a conscious effort by banks to comply with the spirit of monetary restraint in the fight against inflation, consumer resistance and alienation to these policies might be minimized.

From the central bank's point of view the most orderly and effective passing along of monetary restraint occurs if the terms, availability, and price for new commitments are modified as early as possible. One might have expected that in 1969 banks facing falling liquidity positions and the prospect of much reduced inflows of funds would have curtailed commitment activity quite early in the year. However, such limited data as is available on commitments suggests that this did not happen. In fact, the dollar volume of new commitments made in the May-July quarter--the latest period for which data are available--still showed little tendency to moderate.

Returning to other methods of adjustment, it seems clear that dependence on liquidity and nondeposit sources of funds has indeed become more risky and potentially unprofitable than formerly appeared to be the case. There certainly are limits to the practicable swing in liquid asset holdings. At one extreme, these limits are set by the amount banks can afford to hold while taking care of the normal needs of their loan customers. At the other extreme, there is some positive minimum working balance which banks must prudently maintain. Intermediate security holdings add some flexibility to portfolio swings but if the initial yield prospects are attractive the loss from liquidation may become prohibitive.

Nondeposit sources of funds have been imaginatively used--in some cases, to the point of abuse--to provide significant supplementary flows to meet excess demands at some banks. But the markets tapped by these devices are characterized by very volatile supplies, which at critical times may prevent banks from obtaining all of the funds they desire, except at extremely high rates of interest and with negative margins. Moreover, as recent events have indicated, regulation of some nondeposit sources of funds by the monetary authority--which I personally believe to have been unnecessary--has limited the scope and flexibility for defensive action by banks.

Given the shortcoming of the conventional means of adjustment, it would seem reasonable from the banks' point of view to increase reliance upon changes in lending terms and conditions particularly with respect to policies concerning new commitments. This would avoid a situation such as the current one, where liquidity is cut to the bone, nondeposit sources of funds have been all but cut off, and yet banks face a large overhang of unused commitments. As these commitments are drawn down in volume, banks are indeed placed in an extremely uncomfortable--and probably profitless--position.

From the public point of view, more reliance on this latter method of adjustment has great merit. Clearly, a financial crisis in the banking system is less likely during a period of monetary restraint if banks manage their commitments so as to keep them in line with their lendable funds. Moreover, it is possible that if banks began to ration credit earlier in a period of monetary restraint, rather than waiting until liquidity and liability positions forced them to do so, the degree and duration of monetary restraint required to do the job might well be moderated.