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FINANCIAL LESSONS OF 1974

Remarks of

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Financial Lessons of 1974

Reviewing developments in banking and finance during 1974, one must be impressed by the diversity and intensity of problems the industry faced and the generally appropriate and timely responses which financial institutions made to these problems. The majority seemed to have learned rather well from some of the pitfalls which developed in prior periods of monetary restraint even though there were significant differences in the 1974 version. On the other hand, at a few banks, aggressive managements, eager to accommodate all would-be borrowers, overstretched their capacities so that illiquidity and heavy use of purchased money dominated their positions. Obviously any listing of bank problems would rarely be applicable to all banks and might be important to only a few. In general, the smaller banks held more conservative and appropriate policy positions than a number of the larger banks. Nevertheless, I think we can all learn from the mistakes of others and where the problem fits your bank, a more direct impact should be evident.

As some of you may remember, I have attempted to point out some of the problems of the financial institutions in their responses to credit restraint in years past and find that I am repeating myself in much of this speech. But perhaps the repetition is worthwhile for the evidences of overcommitment of funds, excessive short-term borrowings, shortages of capital, inadequacies of management, and competitive excesses have repeated themselves time and time again.

So today I start a two-part series of financial lessons of 1974. As is usual this is entirely my own opinion and should not be attributed to others on the Board of Governors, nor any other associates in the Federal Reserve. In this first part of the lessons of 1974, I wish to speak about the banking excesses and responses to the problems of 1974 viewed from a regulator's standpoint. In a later speech I will do a little self-analysis to see what the regulators should have learned from the problems of 1974.

It is agreed that the economy of 1974 and the financial problems, therefrom, were of a highly unusual nature. We were responding to the changes in the energy situation and the sharply higher prices for oil, natural gas, and their products. And these responses brought even more rapid rates of inflation throughout the economy. The construction industry fell to quite low levels as prices of houses rose rapidly and credit became less available to home buyers in this period of high and rising interest rates reflecting again the disintermediation of funds from thrift institutions. The international developments reinforcing inflationary trends include the coincident cyclical positions of the industrial countries, the pressure for recycling petrodollars, and the uncertainties originating in the changing international monetary reaction to floating rates. There were rapid and wide gyrations of exchange rates which kept the markets off balance and increased the uncertainties for dealers in exchange and for the exporters and importers of goods throughout the world.

The instabilities in our domestic economy were accentuated by the political problems of the year and by the shortages of basic raw materials early in 1974 with the subsequent over-ordering which created a massive inventory buildup. Recognizing these and other major difficulties in the economy, I want to speak about the responses of the financial institutions in meeting these problems.

In evaluating the responses, I intend to appraise four areas which I will call the four "C's"--Conceptualization, Control, Constraint, and Caution. Conceptualization represents planning--the need for careful planning of forward actions by managements of banks to the changing economic and financial conditions of an economy in transition is a clear lesson of history. It seems to me that most of us, including bank managements, spend too much time reacting instead of planning. Without carefully conceived plans and programs to meet changing situations, bank managements are constantly fighting fires and adjusting policies to the day-to-day situations.

By April of 1974 it took no special insight to know that the banking system was going to have to respond to another period of monetary restraint. Some banks were able to plan their programs in such a way as to be able to respond appropriately when excessive demands for credit hit their banks and a rising proportion of outstanding credit commitments were drawn down. In too many banks, planning ahead to conceptualize the framework within which they must operate was merely a day-to-day response of business as usual and meet all the demands possible by borrowed funds, issues of new CD's, purchase of federal funds, or even Eurodollar acquisitions. Too many banks relied too heavily upon an upward ratcheting of interest rates to control credit extensions, without giving sufficient thought to the type of credit commitment they were extending nor the type of borrower who was being accommodated. Planning for future acquisitions by holding companies both in foreign operations and domestic additions was also often inadequate and inappropriate to the developing situation and its problems. It almost seemed that some bankers cared little about or understood the necessity for the internal balance of assets both in maturity and product mix.

Planning for additions to capital was especially weak. Now, I grant that markets were poorly placed to accommodate new capital issues, but few banks took actions in the areas where they did have control, such as voluntarily retaining earnings to boost capital and limiting asset growth until capital and liquidity became sufficient.

The first step in adequate bank management response to a developing situation should have been for planning and conceptualizing the salient features of the economy to which it must respond. But often a satisfactory response in this area was counteracted by a poor response to the second "C," that is in their follow-through in controlling the activities of the banks. Bank after bank found itself in a position heavily funded by short-term funds because it did not adequately review and limit the extensions of credit or the commitments made by its management to would-be borrowers. I know that many bankers would respond that they were merely accommodating the credit needs of their regular borrowers and that credit commitments were made in past years when expansion was the rule of the day. But I submit that a careful well timed management response to the situation would have curbed credit commitments and found ways to curtail them in the face of a reduced supply of credit and a period of monetary restraint.

Control was insufficient in the area of foreign activities where banks, particularly subsidiary banks of some of the large bank holding companies, permitted officers to engage in foreign exchange operations with neither controls nor adequate caution as to the type of currencies being acquired nor the open positions to which the bank might be exposed. It is probably true that the weaknesses of any organization and especially one so highly service oriented as banking become evident largely in periods of stress. However, I believe that such periods of stress in the past have shown these same weaknesses, and yet some bank managements have been slow to respond to such developing problems and have failed to provide adequate controls or place limits on their positions.

For a few banks, even the control of day-to-day operations seems to have slipped this past year and some of their control procedures seem to be inadequate for modern day banking. The sheer growth of banking operations, the increased check processing, cash handling, credit commitments, and repayment schedules have not been adequately supervised. It is just not sufficient to develop a control program and walk away from it without careful supervision and external audit checks. In a period of rapid changes in banking and of changes in the market places within which banks must do business, controls must be enforced with great diligence and control procedures continually updated to maintain efficiency and effectiveness, and to permit management supervision of a growing institution. The need for continued attention to the adequacy, effectiveness, and enforcement of controls is a lesson which banks should have learned from prior periods of stress but certainly from the pressures of 1974. Hopefully some will learn in rapid fashion for there are still banks presently in need of the development of such controls to correct back-office problems.

Our third lesson from the 1974 textbook of banking and financial developments can be represented by the word constraint. Constraint in the context used here means public service constraint. It means self restraint for the economic statemanship required of the banking industry and it may mean limiting profits, interest income, and even operating revenues to contribute to the higher goal of economic stability in the nation.

Now I recognize that the individual banker seeks a bottom line maximization and I recognize that the banking industry is now moving largely from owner operators to professional managements. But I also know that the banking industry is one of the most visible and highly public service oriented industries of our nation. Its public responsibilities far exceed that of the normal profit oriented business, and may exceed those of other regulated industries. If banking does not live up to its responsibility then the nation as a whole will suffer. Under the pressures of competition, many banks have been unwilling to constrain their profit-making activities for the benefit of the nation as a whole and have operated business as usual with growth and bottom-line expansion as the sole targets.

Constraint is difficult but it is one of the hallmarks of an enlightened banking management and a public service oriented institution. One can wonder aloud about those banks who rely excessively on purchased brokered funds or the banks on the other end of the transactions who sell most of their surplus funds into the federal funds market with too little regard for adequate servicing of local credit needs. Constraint means saying no to some borrowers for the benefit of the nation and the banking institution.

In another context, constraint means careful response to the problems of banking. Far too many bankers become back yard gossipers about the alleged problems of other banks or bank customers. Time after time the difficulties of a particular bank were exacerbated by the Monday morning quarterbacks and the gossipy old hens of the banking industry. The efforts of the regulators to aid in the correction of individual bank problems have been partially frustrated by the public gossip of other bankers. It is long past time when bankers should recognize that the problems of one unit are the problems of the industry and that the failure of one compounds the difficulties of all. I cannot say in too strong terms that gossip has no place in a responsible industry of professional leaders. It is demeaning to the industry and all within it to gossip about the problems of individual units.

Finally, it seems to me that another lesson not well learned by bankers in 1974 was the need for caution. It would have seemed logical to me that banks and bankers would have injected a considerable degree of caution into their operations and handling of borrowers and credit extensions this past year. But insufficient caution was exercised by too many with a result that expansions of credit in both over-all totals and in specific areas became a nationwide problem. It is of course easy to generalize the headline problems of a few banks and certainly the banking industry as a whole is not in the kind of operational or credit condition that these banks represented. But there are a number of other banks whose positions need strengthening and they should learn from the troubles experienced by others.

There are likely to be large loan losses recorded as banks report their year-end data. It is also apparent that a good many of such losses will be coming from the real estate and construction industry. One can sympathize with those banks who sought to help the construction industry of their communities and extended credit for back-up lines of commitments, only to find that financial conditions beyond their control caused cash flow problems or even failures. But it is hard to extend much sympathy to the bank who merely accepted the credit appraisal of another financial institution and made no effort to cross-check the validity of those appraisals or to review and reappraise them as changing conditions impacted upon the construction industry. A generous measure of caution would have brought bank managements into a posture of checking, double checking and rechecking every major line and assuring themselves that bank funds were being adequately safeguarded with additional collateral as needed and take out commitments reinforced.

Another type of credit problem surfacing too often these days is the self-dealing loans to directors and shareowners. It would seem to me that such loan activity should have been limited severely in the difficult times of recent years. Excessive credits to directors and their industries can only bring grief to the bank if nothing else than by the appearance of self-dealing. Similarly, over-concentration of credits in a particular industry was a special problem for some banks this past year. A balanced portfolio of loans is still a desirable objective and one particularly appropriate in periods of economic stress.

In still another area it would seem to me that adequate caution would have required directors of banks and other financial institutions to insure that their managements were on top of all situations and preparing reasonable forward plans to meet developing contingencies. Perhaps as a fallout to the shift from owner-management to professional-management, some bank directors do not seem to have adequate control, interest, or even information to appraise the adequacy of their managements and assure themselves that management is doing a proper and responsible job. It has been, and continues to be axiomatic in banking that management is the critical key to the progress, safety, and prosperity of the institution. Meeting the economic, financial and organizational pressures upon the institution and its policies are the tests of management and too many managements had low scores on these tests in 1974. In fact, management development is a key problem of banking as it faces the challenges in the decades to come. In my opinion, the training of new and competent management has not been given adequate attention by the banking system, and will need a great deal more attention in the future.

Perhaps of even greater importance was the needed attitude of caution respecting management competence. Continuous appraisal of management capabilities and performance is a characteristic of an enlightened board of directors and action to remove an incompetent or hazardous management is the true test of such a Board. Unfortunately management removal is such a traumatic experience that Boards of Directors are loathe to take the action. Moreover, with directors largely selected by management and listening to the explanations of management, the directors' loyalties and lack of independent information or appraisal interferes with their handling of director responsibilities. With the very public examples of the past year where bank managements were kept on the job long beyond the time when incompetence or unsound banking practices were evident, one could hope that every board of directors would look carefully at their own managements and bank condition.

In summary, conceptualization, control, constraint, and caution are synonyms for policies which should have been exercised to a high degree by banking in 1974. To those of you who did the job, my sincere congratulations. To those who did not, I hope you have learned these lessons just as we in the regulatory agencies will need to learn them. We are all involved in maintaining the ongoing health, vitality, and progressiveness of this highly public-service oriented industry and for the benefit of our nation let us resolve to learn from our mistakes of past years, and repeat as few as possible in coming years.

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