

SOME BANKING PROBLEMS AND TRENDS

Address of

Chester C. Davis, Member,
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Those of you who have once lived in this Northwest, and have returned to it after prolonged absence, know what I mean when I say that I am genuinely glad to be here today. I spent 15 very lively years in the Ninth Federal Reserve District, and it is a real privilege to be able to be back here for a month this summer.

My satisfaction is sharpened by the fact that climatic conditions seem to be turning favorable after a period of extremely trying years. Most of the citizens of this district draw their income directly from the ground, or from beneath it. Economic and climatic disturbances affect them directly and powerfully. It is comforting to realize, however, that this is just as true on the up-swings as on the down.

In addressing you this afternoon, I realize that there is just one question which is present in everyone's mind. How is it that we, with our vast human and material resources, have permitted our economic machine to falter and slow down? What can we do about it? The question has a peculiar interest to an association of bankers. Because, given good management, a bank doesn't get in trouble unless the community is in trouble. Its state of health is directly affected by the economic pulse of the community it serves.

There are so many lines open for us to explore this afternoon that we cannot go into them all. We have to pick and choose. Particularly, I should get into difficulties if I attempted to analyze the causes of the present phase of the depression and the remedies that are possible.

It would take so much time that I would never get to the real subject I want to discuss with you. Let me only mention the broader question, therefore, with the observation that its elements are not simple, but complex. There is no single cause, and no single remedy. Underlying it all is the fundamental question of how we can arrange our complicated system so as to make the maximum use of our unrivaled resources -- both raw materials and man and machine power -- in the production of useful things and services which the people need and should enjoy. How can we develop and maintain our ability to buy and consume at a rate that matches our ability to produce?

The American people will not be satisfied until we have made more progress toward the answer than we have made to date. There can be no real contentment as long as unemployment and under-consumption go hand in hand. No matter what administration may be in power, it will be forced to grapple with that question, and in doing so it will attempt, you will find, things which many of us will not like.

If, as a people, we will only recognize this, then perhaps we can approach the problem in a spirit of good-humored tolerance and understanding of the other fellow's point of view which will enable us together to work out a program through coordinated action on the part of government in all its branches, and of employers and labor, and agriculture. If we fail in this attitude and viewpoint, then we will find ourselves blundering along in a cloud of animosities, going at things the hard way.

I am particularly interested this afternoon in narrowing our discussion to a line which concerns you, as bankers, and us who are

temporarily in positions of responsibility in the money and credit field, very vitally indeed.

Speaking as a representative of the Federal Reserve System, I want to say that we are interested, as you are, in doing what we can to make sure that the country in all its parts is adequately served out of the vast reservoir of credit that exists, and is served through the private commercial banking system.

I know you will understand that in what I have to say I am not speaking from long-time experience in the banking field. My comments are based on observation gained during the past few years at the nerve-center of money and credit policy in the United States.

I think it may be useful at this time to ask ourselves a few searching questions: What are banks for? Why do they exist? Do they earn their keep? and then: What must they do in order to be worth preserving as a part of our economic machinery? For one thing is certain: in the long run, only those institutions can survive that serve a real economic need and do so with reasonable efficiency and at reasonable cost to the community.

First, let us analyze the purpose that the banking system serves.

Sighting back along the path that credit institutions in the United States have traveled, it is clear that the commercial banking system as we know it has developed for three general reasons: it provides depositories for the liquid and transferable funds of the country, making these funds much more efficient than currency for the vast bulk of business transactions; it provides the facilities, through extension of credit,

for converting future returns into present funds; and finally, as an agency for handling community savings, it plays an important part in the process of capital formation.

We could perhaps transact our business by using currency instead of bank deposits. Many countries do, to a much greater extent than we. But our system is more efficient. It saves the business community hundreds of millions a year by making funds instantly transferable all over the country. Our economy has become adapted to this way of doing business and therein lies one ~~worth~~ while function of the banks.

In connection with its second principal function of converting future returns into present funds -- the function of extending credit -- fundamental changes have occurred in the country's life that vitally affect the methods by which banks must serve their communities.

The integration of industry has opened up capital markets to lines of business that once depended on banks for loans. In addition, corporations in a growing number provide their own financing from funds accumulated out of current receipts. Short-time commercial loans are becoming less and less available to banks as a means of extending credit.

Investments in bonds and other securities have become increasingly important as the opportunity for normal loans has diminished, and as the Government has borrowed heavily to finance its recovery and relief program.

The continuance of the growth of the American banking system in its present form depends to a considerable degree upon the efficiency

with which banks are able to adjust themselves to these changed conditions.

We are all concerned now with the statements so frequently heard, that the banks today are not fully and courageously meeting the credit needs of business — particularly of "small business" of which so much has been said and written in recent weeks. Probably the picture as many present it is overdrawn. But enough is being said to indicate that all of us -- you who are on the credit firing line, we who are entrusted with responsibility in government or state supervisory and examining authorities --- should re-examine and re-appraise our policies to make sure that the vast credit resources of the nation are being efficiently used to meet the country's needs through the banking system.

It seems to me that every force and influence that affects the banker is pushing him to extend credit where credit is needed, and where it can safely be granted -- the control of a vast reservoir of lendable funds, the desire to replenish earnings, and the banker's natural ambition to assist in the smooth functioning of the national economy.

The banks must not only serve the credit needs of the country efficiently, but must convince the country that they are doing so, if they are to escape a continued limitation of their lending field due to increasing competition of public or semi-public agencies.

It is the concern of the Federal Reserve System and, I believe, of the other supervising and examining agencies, to help the banks function freely and effectively in performing these services. That is the

motive which has led the three Federal agencies recently to study their own policies, particularly in bank examination, to try to find out whether there is anything in bank examination policy that unnecessarily restricts banks from making sound loans. And if you bankers, individually or through your associations, have ideas and suggestions on that subject, the people in Washington would be very glad to hear from you.

The changes in bank examination procedure that have been agreed to in Washington are considerable. Time will tell how they work out. I cannot refrain from comment on one feature of the news stories that have appeared in the West during the past few days. They give the impression that the Federal Reserve System favors letting the bars down, depending on Federal Deposit insurance to protect the depositors. That is simply not true. I sat in all the preliminary conferences as a representative of Federal Reserve. Our position was that regulations and criticisms that unnecessarily restrict banks in making sound loans should be done away with. I have talked with enough country bankers on this trip to have my conviction strengthened that changes in old procedure are desirable, even necessary, if banks are to be freed to serve the credit needs of the country.

Perhaps some further modifications may appear to be desirable after we have worked under the new regulations for a time. If so, the authorities should not hesitate to make them. And now, let me get back to the main track of my discussion.

The past decade has seen radical changes in the composition of

assets of commercial banks. Customers' loans at the end of 1928 comprised 45 percent of all assets of Federal Reserve member banks. They are now less than 30 percent. On the other hand, during the decade Government security holdings of member banks have increased from 9 percent of total assets to 26 percent. More than one-fourth of banking resources has been lent to the Government to be passed on to trade and industry through public activities.

Most of these funds borrowed by the Government have been spent for general recovery and relief purposes and have not competed with banking activities. Only to a small extent have these funds been re-lent by the Government.

Government intervention in emergency conditions, when private credit was all but non-existent, was inevitable and essential. But now that private credit is once more restored, are there not fields where banks could take over the lending from the Government, for example, in intermediate-term advances to industry for capital purposes? If such fields are found, and some banks are finding them, then the Government will be relieved of a part of its debt -- and the banks will profit both by the growth of their business and by the increased rate of return.

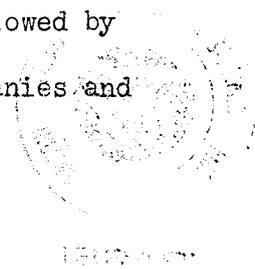
There is little reason to expect a large increase in the demand for short-time commercial loans. If banks are to employ the funds entrusted to them in productive uses and are to make the earnings necessary for their profitable operation, then banking practices will have to be modified and adjusted to different standards. This does not

mean lower standards, for emphasis should always be put on high quality and soundness.

I am not sure how much of the problem has been solved, but many banks, instead of requiring that loans be limited to short-term working capital and repayable in 3 to 6 months, are finding a more lucrative field among long-term borrowers whose loans can be amortized and paid back over a period of years.

Others have entered the field of personal loans and consumer credit, a small loan business heretofore handled largely by a specialized type of financial institution. In certain parts of the country commercial banks are now finding this a substantial outlet, so that both they and the small borrower stand to profit by this new development. In the past, the banks' participation in this field has generally been indirect and at small profit, that is, through middlemen who were in a position to shop around and secure credit at wholesale rates.

As loans of banks have declined in volume, the importance of bank investments has been increasing. Banks are more influential in the bond market than ever before. For their own good, as well as the country's, banks must develop a wise investment policy. Instead of considering bonds as something to be held only temporarily and sold at a profit, commercial banks are coming to recognize that to an increasing extent they are in part investment institutions, and should handle investment accounts according to the principles that are followed by other investment institutions, such as life insurance companies and trust accounts.



But some of you will say that banks are not the same as these other investment institutions, that they have liabilities payable on demand which they must be prepared to meet. In this connection there have also been important changes in the past decade or two which may justify a deviation from the standards and principles of the past. Certain important changes in our financial organization make it far safer than it formerly was to invest in long-term assets.

For one thing, over the past 20 years the banks have acquired a vast volume of time deposits which represent savings and are not generally subject to abrupt withdrawal, so long as faith in banks persists.

Second, deposit insurance safeguards banks against runs, particularly by small depositors. The bulk of time and savings depositors is fully protected.

Third, the Federal Reserve has liberalized its credit facilities. You may recall that Regulation A has now been made so comprehensive that it permits a member to rediscount paper for almost any legitimate credit need. Moreover, as long as a bank is sound and has sound investments, it can always borrow at the Federal.

Some of the restrictions of a more or less technical nature imposed by law on banks ten years ago have now been removed. It may be necessary to revise some of the existing restrictions in order to encourage the banks to become more active parts of the country's mechanism for financing commerce and industry. It seems to me that the supervisory agencies are going to have to study their own practices carefully to see what they can do to assist banks in adapting themselves to the long-time

changes I have spoken about, while at the same time safeguarding the public interest, in this process of adjusting banking practices to changed economic conditions.

To sum up: the economic need for banks is clear. Banks began because they were able to meet certain needs of the community. These needs have changed and are continually changing. In order to continue successful operation, they must accommodate themselves to these changing requirements of the community.

The prospects are that banks will do those things and that, in return, society will be glad to have them earn a fair return on their capital.

It is a great privilege to get away from Washington and exchange views with men in different parts of the country and different lines of work. It is very easy for a man in Washington to get insulated in his office. But contacts like this, to be fully worth while, ought to open up two-way lines of communication. It doesn't do much good for me to stand up here and talk unless you have a chance to talk back. I ought to be able to get at what is in your minds and take it back with me to Washington. So, if your program and your time permit, I hope you will express yourselves on any of the points I have raised this afternoon -- perhaps ask questions on things you are interested in. I may not know the answers but it will be interesting to have the questions raised, nevertheless.

And now in conclusion -- it is great to be back here, and to see the country looking as well as it does. If I were to express one wish

for the Ninth Federal Reserve District, it would be that you may soon enjoy production and its returns in a measure that matches the courage and toughness of your citizens.

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