WHAT DOES A CREDIT MAN THINK ABOUT TODAY?

by

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WHAT DOES A CREDIT MAN THINK ABOUT TODAY?

One thing I'm not going to do is try to tell you how to run your business. Capable credit men need no such advice--and the others wouldn't take it anyway. A good credit man knows the many elements to be considered in granting a loan and he knows that he cannot afford to overlook any one of them in reaching his decision. Something of little importance today may, because of rapid economic and other changes, be of first importance tomorrow.

You members of the Robert Morris Associates are well aware of the need for evidence of the borrower's integrity, for assurance that the money he borrows will be employed for provident and productive purposes, and for reasonable certainty that the loan can and will be repaid upon the terms and conditions granted. You know that your advice and counsel must accompany many loans if the credit is to be used to best advantage. You are aware of the dangers of relying too heavily on the continued success of any one industry or enterprise, and of the need for diversification in your lending activities. In short, you know the many angles to this business of lending other peoples' money to other people, and you are endeavoring to consider all of them in an effort to protect your depositors, to provide a fair return on the investment of your stockholders, and to assure the maximum sound productive use of credit in your community.

It is not my purpose this evening to review the many detailed considerations that enter into the granting of a loan. Rather, as a native of this city and former associate of yours, I should like to discuss some of the broader problems of national and international credit policy with which I have been conversant for the past 16 years. In today's world, the conduct of economic affairs at home and abroad is greatly influenced by considerations of social responsibility. In the interest of the greatest good for the greatest number we as a nation have set ourselves the task of maintaining high employment, stable values, and a rising standard of living.

The attainment of these national economic objectives, in view of the growing complexity of our economy, gives rise to many perplexing problems. Considering the essential role of credit in our highly specialized system of producing and distributing goods and services, it is not surprising that these problems are a matter of concern to each and every credit man in our country.

The Robert Morris Associates deserve high praise for publicizing the essentials of constructive credit policies and for encouraging and facilitating the exchange of information and ideas among credit men. The Associates' financial statement studies, which are continually being enlarged and refined, have provided members with standards of comparison that are extremely useful in analyzing and evaluating particular loan applications, and in detecting changes in business financial structure. Through its Monthly Bulletin and meetings such as this, the Robert Morris Associates are encouraging that sort of thoughtful analysis essential to a sound solution of our many problems and to the realization of our economic goals.

The Role of Credit and Credit Institutions

We all know that an adequate supply of credit at the right place, the right time, the right cost, and the right repayment terms is essential to the smooth functioning of our economy. There is hardly an individual, a business man, a municipal or state government, or a national government that doesn't need credit from time to time. In order to meet these varied needs for credit, different types of lending and investment institutions have been developed. Some, like the commercial bank, evolved in response to a need for short-term business credit; others, such as the savings and loan association, were created for the purpose of supplying special types of longer term credit. Still others, such as mutual savings banks and insurance companies, have, in recent years, turned to lending and investing funds normally supplied by commercial banks. The commercial bank, however, is still pre-eminent in the field of shorter-term credit. It must, because of the high proportion of its demand to its total liabilities, concentrate on shorter-term credit. In contrast, life insurance companies, the majority of whose obligations represent lifetime contracts with policyholders, and mutual savings banks, which hold peoples' savings, are able to extend credit for longer periods through the purchase of long-term bonds, obligations secured by real estate, and other investments of a long-term nature.

While the demand character of much of their deposit liability largely restricts commercial banks to short-term lending, member banks can, if confronted with unforeseen deposit withdrawals, obtain funds from their Reserve Banks. In its capacity of lender of last resort, the Federal Reserve System has introduced a much greater degree of flexibility into commercial bank lending than previously existed. In this respect, the powers of the System were broadly expanded in 1935. Banks can now grant loans without fear that tomorrow or the day after they may be forced to liquidate them on short notice in order to meet depositors' demands. On the other hand, we recognize that certain types of credit extension are not for commercial banks--among them, purchase and lease of business properties and investment in equity shares. In other words, the role of the commercial bank should continue to be largely that of provider of short- and medium-term credit to business corporations, unincorporated enterprises, farmers, consumers, home owners, and all levels of government.

In this connection, I should like to say a word about public lending institutions that provide emergency financial assistance to banks and business. I think most credit men would agree that Government competition in the field of direct lending is undesirable if private lending institutions can provide the amounts and types of credit needed. On the other hand, I think we should have some public credit agency or agencies available on a standby basis to render assistance in periods of financial stress--at least until such time as the commercial lending institutions are able to cope with any conceivable situation. In addition, there may be some remaining gaps in our present structure of financing agencies--for example, agencies that would provide long-term debt capital to small enterprises. Such gaps may have to be filled by new types of private or public financial institutions.

Whether the potential expansion of Government lending agencies poses any serious competitive threat for private credit institutions will depend, in my opinion, on our success in minimizing or eliminating cyclical expansion and contraction of business activity and credit and in filling any gaps with appropriate private lending institutions wherever possible.

The dual responsibility of the commercial banker on the one hand to protect the interests of his depositors and stockholders, and on the other hand to expedite the production of essential goods and services by granting credit, is a difficult one. The desire to protect depositors may cause individual bankers to change their credit policies at the first signs of financial stress. The over-all effect of such action, by sharply curtailing or even liquidating credit lines, might seriously impede economic activity and hurt all bank depositors. Individual bankers might find it difficult to continue granting credit freely when competitors are calling in their weaker loans and tightening up their credit terms.

The only real solution to this problem lies in the prevention, by means of over-all credit and monetary action, and other public and private means too numerous to mention on this occasion, of any economic development that might lead to sharp retrenchment and liquidation of credit.

Role of the Federal Reserve System

The Federal Reserve System, as the central monetary and credit authority, is charged with responsibility for regulating the over-all supply, availability, and cost of money with a view to contributing to the maintenance of high levels of employment, stable values, and a rising standard of living.

In an effort to meet its responsibilities, the System takes positive action to curb or to encourage credit expansion, as circumstances require. It operates by using either quantitative or selective instruments, or both. Quantitative instruments, such as changing the required reserves of member banks or open market purchases or sales of Government securities, increase or decrease the reserve base for credit extension but leave to the individual bank the decision as to the type or types of credit that should be expanded or contracted. Selective credit instruments, such as margin requirements for the purchase or carrying of listed stocks or emergency regulation of consumer instalment credit, apply to a particular type of credit, but impose no direct limit on the total amount of credit outstanding.

Generally speaking, action taken by the Federal Reserve System to influence the expansion or contraction of credit has the primary effect of suggesting, rather than requiring, certain responses on the part of individual lenders. This is particularly true in time of economic recession when the Federal Reserve can enlarge the basis for credit expansion but is powerless to force additional credit into business and trade channels. The latter can be done only by aggressive response on the part of individual banks in extending credit and by willingness on the part of business men and others to utilize credit in expanding their operations. To make this possible, both public and private policies should inspire confidence on the part of business men, bankers, and the general public.

In influencing credit policies in an effort to contribute to monetary and economic stability, the Federal Reserve System must act in the public interest. Oftentimes such actions are unpopular, especially among the banking fraternity. Sometimes central banking officials resign, voluntarily or otherwise, because of the unpopularity of their actions. This is particularly true in periods of inflation, when most people do not want to see business activity curtailed. However, as recently demonstrated in a number of Western European countries, the need for drastic action to ensure monetary stability does arise and the results of such action are beneficial. In the end, most groups recognize the wisdom of action which they at first opposed.

In the final analysis, the major contribution of the System to the smooth functioning of our economy lies in its early detection of undesirable economic trends and prompt action to guide commercial credit policy away from paths that may lead to serious inflation or deflation. Without the understanding and cooperation of the entire banking system and the public much of the effectiveness of Federal Reserve action is lost.

The organization of the Federal Reserve System, with its 12 regional banks and their 24 branches, provides grass-roots information on what our leaders in the fields of agriculture, industry, commerce, and banking are doing and planning. In similar manner, the System obtains firsthand information about economic developments in foreign countries and in the field of international trade and finance through its membership in the National Advisory Council and from various Federal Reserve and other Government missions and representatives abroad. Much of this information is relayed to credit men through the publications of the System so that individual lending policies may be reviewed in relation to national and world-wide economic developments.

The Current Business Situation and Outlook

In the first place, as you know, determination of appropriate credit policies depends in part on our longer-range economic objectives. But it depends also on the present and probable future course of business activity. Between November 1948 and July 1949 industrial production, as measured by the Federal Reserve index, declined roughly 17 per cent; during the same period, wholesale prices, as measured by the all-commodity index, dropped 6 per cent and business inventory holdings declined 5 per cent. These declines in industrial activity and prices, together with smaller business credit demands on banks and other lending institutions, prompted several monetary and credit actions by the Federal Reserve System during the spring and summer of 1949. Downpayment and repayment requirements on consumer instalment loans were gradually moderated prior to the termination of Regulation W. Margin requirements on stock exchange loans were decreased substantially, successive reductions in reserve requirements of member banks were instituted, and a policy of flexibility in open market operations to permit freer play of general credit forces in the determination of market rates and yields was adopted.

The moderate recession in business activity that we experienced during the first half of this year probably reflected inventory and price readjustments, rather than any basic difficulties. Whether the recovery that began this summer may lead to further inflationary pressure or will be replaced by a resumption of the earlier downward readjustment is now a subject of considerable discussion.

Among the various aspects of the present situation that suggest continued high levels of business activity, one of the most significant is the record level of construction activity. In a recent joint report, the Department of Commerce and Department of Labor estimated that the total value of new construction put in place during 1949 would exceed 19 billion dollars, or slightly more than the 1948 total of 18.8 billion. Moreover, these same sources predicted that the total of new construction expenditures in 1950 will equal that of 1949.

Consumer expenditures on goods and services of all types were still running at an annual rate of 179 billion dollars a year in the third quarter of 1949--less than 2 per cent under the peak annual rate reached in the fourth quarter of 1948. Moreover, recent Federal Reserve Board surveys have revealed the existence of continued large-scale demands on the part of individuals for automobiles, houses, and other durable goods. Not only is the demand great, but individuals have cash or other liquid assets, or are able to borrow, to finance purchases of these goods. National service life insurance premium refunds during the winter and spring of 1950 are counted upon to bolster consumer demand, while continued large-scale Government expenditures will sustain a demand for many types of goods and services. The over-all financial position of business is sound, despite a substantial increase in business indebtedness during the past few years. In general, the supply of credit is large and elastic and the cost, both of short- and long-term credit, relatively low. Furthermore there is a marked absence of speculative excess, such as we had in the late twenties, while the great strength of the banking system enables it to deal effectively with any sort of economic development one might reasonably expect at this time.

At the same time, we should not overlook the fact that we have gone a long way toward satisfying the immediate postwar demands for industrial plant and equipment, business inventories, and consumers' goods. Business expenditures on new plant and equipment, which reached a peak of 5.4 billion dollars in the fourth quarter of 1948, are estimated at 4.3 billion dollars for the fourth quarter of 1949--a decline of about 20 per cent. Business inventories, which expanded by 28 billion dollars between December 1945 and December 1948, have since declined by roughly 4 billion dollars. Wholesale prices have continued to fall and at the end of October were about 8 per cent below their level of a year ago. While industrial production has picked up since July, and is admittedly being held back by recent work stoppages in the coal and steel industries, the current level is still some 12 per cent below the level reached in the same month last year.

Moreover, there is some possibility that business expenditures on new plant and equipment will continue to decline, and that further increases in business inventory holdings will be relatively small. Bumper crops in many lines of agricultural production foreshadow continued downward pressure on farm prices and incomes. It is evident to you, I am sure, that we are still confronted with marked price disparities, such as aluminum versus copper, synthetic fabric versus cotton and wool cloth, and lumber versus other building materials. For example, the price of lumber is still over 3 times its 1939 average, as compared with a current average price of building materials (excluding lumber) that is somewhat less than twice the 1939 level. More liberal pension fund provisions, of the type recently negotiated in the steel industry, together with postwar wage increases in most lines of industry and trade, and the high cost of postwar additions to plant and equipment, have saddled many business concerns with relatively large and inflexible cost structures which may seriously impede price reductions that might be needed if demand should start to fall off.

All things considered, the credit man is faced with the rather formidable fact that the present balance between further inflation and deflation is a delicate one, which could easily be upset by expansion in Government expenditures and deficit financing on the one hand, or by any pronounced curtailment of consumer or business demand on the other. Such a situation calls for lending policies that will permit utilization of credit for continued production of goods and services, and at the same time will not encourage premature exhaustion of consumer demand. Later in my talk I shall mention several types of lending activity which credit men are watching closely in view of recent economic developments.

Recent Economic Developments Abroad

If I learned anything in my several assignments abroad, it is the fact that the time has long since passed when we could isolate our domestic economy from that of the rest of the world, particularly from the effects of economic developments in the western European countries. Immediate postwar European demand for food and manufactured products of various types provided a large export market for whatever could be spared in meeting our domestic requirements. At the same time, and especially as ECA aid became available, European countries began to rebuild their factories, re-establish their raw material supply lines, and resume production of manufactured goods. In order to attract private capital to their industries and place their own economies on a sound footing, most of the western European countries introduced drastic currency reforms for the purpose of stabilizing prices and money values.

Once the European countries succeeded in establishing some measure of internal stability, their next step on the road to economic recovery was to rebuild their export trade, particularly to this hemisphere. Devaluation of their currencies in relation to the dollar has had the effect of lowering the price of European goods in the American market and enabling European countries to sell more in this country. At the same time, it has raised the prices of our goods in foreign markets and curtailed their consumption to some extent. All these changes are no doubt reflected in your thinking and planning.

It is most important to us that the progress toward general economic stability, in which most countries of the world have participated, should continue. While United States aid has been essential to the progress that many foreign countries have made since the end of the war, I am confident that the contemplated gradual reduction in the amount of such aid will not interrupt nor delay such progress. However, this does mean that if foreign countries are to continue buying goods which they need from the United States, they must be able to expand sales of such of their goods as have a market in this country. To spend dollars here they must first earn dollars, directly or indirectly, and with much of their international transport, financial, and other dollar producing <u>services</u> destroyed or disrupted by the war, more emphasis must be placed on the sale of <u>goods</u> in the world market.

In this connection, the credit man today asks questions about the value of the dollar, not only from our own domestic viewpoint, but in relation to the currencies of other countries. Recently you have been hearing many rumors about devaluing the dollar in terms of the price of gold. Devaluation of foreign currencies was a necessary step toward trade expansion and recovery; undoing its effects by devaluing the dollar would have just the opposite consequences. Nor would dollar devaluation aid our domestic situation one iota. On the contrary, it would add to any inflationary tendencies that exist. There is no shortage of credit or gold reserves in this country, and an increase in the dollar price of gold, even if the legal obstacles to such action could be overcome, would merely mean an indiscriminate subsidy to domestic and foreign gold producers.

<u>Financial Developments of Current Significance</u>

Thus far, we have been talking about some of the broader aspects of the domestic and international economic scene that have a bearing on credit policies. Now let's take a look at a few of the more specific problems in the field of credit and commercial banking that are of interest to the credit man today.

<u>Instalment credit</u>. Since June of this year, the amount of consumer instalment credit outstanding has increased by nearly one billion dollars. Some thought is being given by the lending officer to the implication of too rapid an expansion of such credit at this time. Many people buy certain large items of furniture and major household appliances only once in their lifetime. To a certain extent, the same is true in the case of automobiles. Once immediate demands are fulfilled, they may recur only after the lapse of considerable time. Moreover, the use of instalment credit enables people to buy now and pay for purchases out of future income. If we encourage too widespread a use of instalment credit at a time when cash demands of consumers are high, we may exhaust not only the present market but a good part of the potential market of the future. The results of doing so should be perfectly obvious--sales of automobiles and other consumer goods may suddenly fall off and unemployment may ensue, while a larger proportion of the reduced income available would go to pay for goods purchased last year or the year before.

No credit man is in a position to say who shall or shall not buy with instalment credit, provided the borrower can establish his credit-worthiness. On the other hand, he can influence the use of instalment credit by maintaining prudent downpayment and amortization requirements.

<u>Real estate credit</u>. My comments with respect to instalment credit are equally true of real estate credit. During the four years 1946-49 home mortgage debt alone has increased by an estimated net amount of some 17 billion dollars. In part, your concern is that the volume of debt incurred may be so large as to threaten a serious credit liquidation. In part, it is that the ability of individuals to purchase housing with the aid of mortgage credit is being exhausted so rapidly that the remaining demand will

not be adequate to ensure continued high levels of employment in the building and building materials industries. Again, the banker cannot deny credit to credit-worthy borrowers. He can, however, require conservative owner equities and repayment provisions in times of abnormally high demand, and relax his requirements somewhat when the demand begins to slacken. These are powerful measures of influence, and I am certain that bankers want, in their own as well as in the general interest, to make them as effective as possible.

Term loans. Term loans are often employed by the borrower in the purchase of machinery, equipment, and other more or less fixed capital items, and are repaid out of future earnings. In recent years the well-informed credit man is making term loans with caution, for three reasons. First, construction and machinery and equipment costs are well above prewar levels, and there is a good chance that such fixed assets may prove to be overvalued in the long run. Second, there is always some uncertainty about the profitability of future business operations. Third, the situation with respect to business expenditures on machinery and equipment is somewhat analogous to purchasing of automobiles and housing by individuals--some restraint in the use of credit during boom times should be encouraged.

From time to time questions arise as to the feasibility of developing a formula, or of devising definitions and limits for the guidance of banks in determining what proportion of their assets may properly be invested in term loans. Such an undertaking would have little chance of success. In the first place, the diversity of type, purpose and conditions of such loans makes satisfactory definition practically impossible. In the second place, the appropriate position for an individual lending institution can only be determined after careful analysis and consideration of the character and volatility of its liabilities, its relative capital position, and the probable credit demands to which it may be subject. The determination of an optimum amount of term loans involves problems similar to those in selecting an investment portfolio, and no rule of thumb applicable to all banks would appear to be practicable.

Conclusion

It is evident, therefore, that the time-honored distinction between the trees and the forest is equally true of credit. The individual credit man is primarily and rightfully concerned with the welfare of the individual trees; the central credit authority is charged with responsibility for promoting the welfare of the forest. While the interests of the two may appear to conflict in specific situations, the thoughtful credit man realizes that there are no fundamental differences in their ultimate objectives.

It is further evident that certain types of credit, notably consumer instalment and home mortgage, have increased substantially in recent years. In the interest of minimizing their inflationary pressure, spreading demand for automobiles, housing and other consumer goods over a longer period of time and protecting loan portfolios against subsequent deterioration in value, credit men are examining downpayment and repayment provisions with particular care.

As we know, change has always been characteristic of human behavior, whether it be social, political, or economic. The principal difference in the economic changes that occur now and those of a hundred years ago is that present changes occur more rapidly, and affect a much greater number of economic activities. No able credit man can isolate himself from change, nor prevent it by ignoring it. On the contrary, he deems it his responsibility to maintain that prudent flexibility of thought and action that welcomes the opportunities for constructive service afforded by change. His is not a dull and routine duty. It is full of constant interest--not only in loans and lending policies, but also in broader economic developments.