FROM:
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Room 14, Fourth Floor, The Conrad Hilton
Chicago, Illinois

RELEASED AT 11:00 A.M.
MONDAY, MARCH 26, 1962

IMPACT OF HIGHER SAVINGS RATES ON INSTALMENT LENDING

Address of M. Monroe Kimbrel, Vice President of The American Bankers Association, before the National Instalment Credit Conference Sponsored by the Association, The Conrad Hilton, Chicago, Monday Morning, March 26, 1962. Mr. Kimbrel is chairman of the board, First National Bank, Thomson, Georgia.

Twenty-one years ago The American Bankers Association formulated an instalment lending creed for the guidance of banks.

Three months ago the federal supervising agencies raised the maximum interest rates which banks may pay on time and savings deposits.

While these actions were widely separated in time and purpose, the interests of sound bank management require that we relate one to the other. Let me suggest briefly why I believe this to be so.

Banks make instalment loans on terms and conditions which best meet the needs of individual borrowers. But the basic test of such loans is whether or not they are sound and contribute to the financial well-being of our customers.

Today the management of many banks finds itself under pressure to increase income to support the additional cost of higher interest rates paid depositors. For those of us who may seek higher earnings through increased instalment lending, the principles of the instalment credit creed serve not only as reminders of our responsibility but as standards to lend by. Consider in particular these four:

1. The extension of instalment credit to individuals and small business on a sound basis is an economically important part of serving the reasonable credit requirements of a community.

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2. Although a bank must be competitive, it should maintain its policies and practices on a basis that will insure continued public confidence.

3. A bank has a responsibility to assist its customers to use their credit wisely.

4. All banks extending instalment credit on these principles will merit the good will and support of the people.

There can be no doubt that the increased rates being paid on savings present us with a real challenge to maintain our earnings. This is the handwriting on the wall. Last year, for example, before the rate ceiling was raised, members of the Federal Reserve System in the Atlanta District increased their operating revenue--but current expenses rose even more. The result: net current earnings declined.

Of the factors contributing to this result, probably the most significant was a sharp rise in the interest cost on time deposits. Time deposits, as you know, rose much more rapidly during the year than did demand deposits, and the average rate paid advanced nearer the then permissible maximum of 3 per cent. Interest costs in the Atlanta Federal Reserve District last year rose by more than double the amount by which operating revenue increased. Is it any wonder that net earnings declined? Generally this has been the situation around the country.

Now we must reckon with the payment of still higher rates under the new maximums and with the resulting additional pressure on net earnings. We face, in short, a king-sized challenge.

It will be said that other costs can be reduced--and this is good theory. As a practical matter, however, all of us try continually to hold these down by improving operating efficiency. While further progress undoubtedly will occur, it appears certain that savings realized through more efficient operations over the remainder of this year will not be enough to offset higher interest costs.

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If this assumption is correct, the one way to avoid a reduction in our net earnings is through greater effort to increase our gross earnings. The question we have to ask ouselves now is how instalment lending can best contribute to this objective.

Before considering the potential for such action, let's see how many banks share the problem of rising interest costs. If you have the problem, you have lots of company, it is clear from a survey made by the Federal Reserve Board in mid-January. By that time, just two weeks after the effective date of the regulation permitting higher rates to be paid on savings deposits, about half of all Federal Reserve member banks had increased their rates, either to the new maximums of $3\frac{1}{2}$ per cent or 4 per cent, or to some permissible level above that previously paid.

The performance by regions showed a wide variation, with the West setting the pace. Over 92 per cent of all member banks in the San Francisco District reported having increased their rate on savings. In the Cleveland District about one out of every five banks had increased their rates, while the count in the Atlanta District was 62 per cent.

If you carry on your banking business in a large city, you are more likely paying a higher rate; 83 per cent of the largest banks reported higher interest rates, compared with 42 per cent of the smallest banks.

More banks undoubtedly have increased rates paid on savings since mid-January, and still more will probably do so over the months to come. Just as the differences we have noted as between areas and cities probably reflect different degrees of competition for savings and different economic conditions, so your response in future months is likely to reflect the special conditions you face in your community. Obviously, this is a highly individual matter.

Moreover, the problem posed by the increasing rates differs in severity from bank to bank. Those of you with savings deposits comprising as much as

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50 per cent or more of your total deposits are, of course, much more concerned than those of you with savings deposits comprising 20 per cent or less of the total. Banks with a relatively small proportion of savings deposits may need to take little action to offset increased costs; for others the problem may be far more severe. Although this seems obvious, I mention it to emphasize, again, that the challenge differs widely in degree, depending not only upon location of the bank and competitive factors but also upon the kind of banking services provided.

Most banks, it seems clear, have sufficient motive to consider increased emphasis on consumer instalment lending as a way to bolster total earnings. Other credit needs have been expanding, however, and will probably continue to do so if economic activity accelerates as expected. Our attitude toward consumer lending, therefore, will have to be conditioned by our responsibility to meet legitimate credit needs of other types, particularly those of regular customers.

What is the potential for increasing our instalment lending to increase earnings? Whether we think in terms of the national scene or in terms of a particular locality, we have essentially two alternatives: either we maintain banking's share of a rising total of consumer instalment lending or we expand banking's share of a steady total volume of consumer instalment lending. Figuratively speaking, it's a matter of obtaining the same old share of a bigger pie or a bigger share of the same old pie. Which situation we find ourselves in will make a great deal of difference, however, for the growing pie implies an expanding demand for credit, while the same old pie implies a stable demand for consumer credit. The latter situation, in all likelihood, would be a highly competitive one.

A brief look at banking's record in consumer instalment lending may give us a clue as to future prospects. Banks, as you know, were slow to enter this field; but once in it, we became the dominant source of consumer instalment credit.

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Back in 1939, bank holdings of instalment credit amounted to about 25 per cent of the total and were exceeded by those of the sales finance companies. In the early postwar years, we expanded our holdings at a rapid rate by increasing our share of a greatly expanding total. In 1950, as a result, bank holdings of instalment credit accounted for 39 per cent of a total that was more than four times larger than in 1939.

Since 1950, however, banks have been able to expand their instalment lending almost solely because the figurative pie has gotten larger; our share of the total, during this period, actually declined. By 1955, the year in which auto sales reached an all-time high and auto credit terms were liberalized to present-day standards, banking's share had dropped to 37 per cent of the total. By the end of 1960, banking had regained some ground relative to other lenders; but during 1961, when total instalment credit rose slightly, our share of the total again declined slightly. Banks now hold about the same proportion of total consumer instalment credit as they held eleven years ago.

What can we learn from this record? A realistic appraisal surely tells us that building volume by increasing our share of the market will be an extremely difficult job, for our share has changed little during a period when we have competed vigorously for the instalment credit business. Indeed, many of you have been leaders in introducing such innovations as the check-credit plans and in-plant services now being used to an increasing extent. These additional services have made instalment credit more available to consumers. Our advertising programs, likewise, have reflected vigorous effort to induce consumers to use the credit services we feel uniquely capable of providing.

How much farther can--or should--we go in trying to capture a larger share of the market? The possibilities include reducing down-payment requirements, extending maturities, and liberalizing borrower qualifications. Most of us, I

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believe, would agree that little, if anything, could be gained by easing already liberal terms, and much could be lost. Exposure to greater risks undoubtedly would bring greater losses; moreover, it could well cost us the good will of valued customers who might be tempted to stretch monthly payments beyond budget reach. To travel this road would be to turn our backs on the responsibility we acknowledge in the instalment credit creed to assist customers to use their credit wisely.

On the basis of both practice and principle, it is clear that banks have only limited opportunity for building instalment credit volume by increasing our share of the market.

The prospect for building volume by sharing in an expanding market is considerably brighter. Economic activity is at an advanced level; and despite some hesitation in the past couple of months, most observers expect further gains in the months ahead. This has brought rising personal incomes and increased consumer spending for those goods and services normally involving the use of credit. The recent rise in automobile sales has been particularly encouraging in view of the dominant importance of such sales as a source of consumer instalment lending volume.

There is a wide belief that consumer instalment credit will increase by approximately $4-billion in 1962. This means that if banks are to retain their present share of the instalment lending pie, they will increase their holdings by approximately $800-million during the current year--which is more than four times the increase in 1961.

While the outlook for sharing in a rising total of consumer instalment lending this year seems promising, current conditions also suggest that we will do well to plan conservatively. The burden of debt repayment in relation to income may be such that total credit volume will expand more in line with income than in

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the past. Phenomenal gains in credit volume were possible in the early postwar years when income was high and expanding and the burden of repaying debt was relatively light. In those circumstances, borrowing could, and did, rise much faster than income.

There is a limit, however, to the share of income that the nation can devote to paying for past purchases. As a matter of prudent lending practice, we pay close attention to this factor in passing on individual applications for consumer loans. For the country as a whole, there is increasing evidence that the upper limit of the repayment burden may have been reached; instalment debt repayments have remained very close to 13 per cent of disposable income for the past two years, and have shown little tendency to rise in relation to income for the past five years. This indicates that future expansion of consumer instalment lending volume will depend primarily on future income growth--and income growth stems from general economic expansion.

Economic forecasting is not my line, and I do not presume to pursue it here. However, if the foregoing adds up to a reasonably accurate general picture--and I believe it does--then at least we are forearmed with the basis for making reasonable plans for increased consumer instalment lending.

To be so forearmed is also to be forewarned to avoid the pitfalls of unsound banking practices that an unreasonably optimistic appraisal of prospects might bring. Competitive deterioration of lending terms and standards could benefit no one--least of all the public we serve and the free enterprise system we cherish. Rising interest costs and the resulting pressure to build volume give us neither cause nor license to violate sound banking principles.

You know, and I know, that we perform an invaluable lending service. Let's see that more people learn about it. Let's stress in every customer contact the advantages of dealing directly with lending institutions that sincerely want to assist people in using credit wisely. Above all, let us make certain we live up to our promises. That's the best way to build instalment lending volume in this, or any other, year.

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