GO-GO BANKING: EVER CHANGING YET EVER THE SAME

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by

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Poets have long been fascinated by rivers which flow and flow yet are always the same. They see the constantly changing faces of new generations and marvel at the changelessness of human nature. They would probably not be surprised to find the same curious combination of change and permanency in today's rapidly unfolding banking scene. Our profession is not the same today as it was fifteen years ago or even five years ago. Innovations appear so fast that some people call it super banking and go-go banking. And yet banking is in many ways the same calling it was fifty years ago. We need to keep pace with the changes, and we need also to remind ourselves of some well-weathered propositons that remain with us.

A great many things <u>have</u> taken place in recent years impelling the rapid evolution of the banking system. Our banks emerged from World War II with well over one-half of their combined assets invested in Treasury securities. These were a prime source of liquidity. When the demand for loans tended to rise, banks simply sold the readily marketable securities to obtain the requisite funds.

At that time, few people foresaw the great development in technology and the expansion in productivity that marks our era. And few were the bankers who foresaw the accompanying dramatic growth of loans. In 1948, bank loans were equal to about 20 percent of bank assets, but, by the 1960's, the fraction had risen to over 50 percent. The progressive expansion in the loan component of bankers' portfolios left fewer securities that could be sold to obtain loanable funds. Moreover, with the vigorous demand for credit, interest rates were also rising. As a result, many of the remaining securities held in bank portfolios experienced large capital losses which

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bankers were reluctant to realize. Security holdings became less and less a ready source of funds.

With interest rates generally rising, bankers also found that corporations were less willing to hold idle funds as demand deposits. It was much more profitable for corporate treasurers to invest excess funds directly in Treasury securities, commercial paper, or other money market instruments. In 1950, demand deposits made up 65 percent of bank liabilities. By 1970, the fraction had fallen to 35 percent. Thus, the traditonal sources of banks' loanable funds--demand deposits and securities--were not keeping pace with the economy's growth.

The economy's demand for loans, however, remained strong, and banks were forced to seek other methods of acquiring loanable funds. The banking system had to more effectively mobilize its reserves. The long-dormant Federal funds market became active. In the Fifties, this form of overnight borrowing of reserves from other banks was common only to a handful of New York and Chicago banks. Now newspapers report daily Federal funds rates to the public. Daily borrowings that totaled less than $1 billion in the late Fifties reached the $8-billion mark by the late Sixties.

Perhaps the most significant innovation for garnering funds, though, has been the negotiable certificate of deposit. To combat the loss of demand deposits and to acquire additional funds for lending, New York banks began to issue negotiable CD's in 1961. Other large banks quickly followed suit, offering competitive rates of return to corporate treasurers. The negotiability feature meant that if the purchaser should need the money before the CD matured, it could be sold in the secondary market. As a

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result, CD's offered both liquidity and yield. Large banks in the U. S. acquired $18 billion in such funds by 1966 and $24 billion by 1968.

Initially, CD's served as a means for an individual bank to minimize its deposit losses from customer withdrawals to purchase open market instruments. Bankers quickly learned, however, that by varying the rate they offered for CD's, they could gain some control over their banks' deposit flows. For example, if a bank required additional funds to make loans, it could readily acquire them by offering a slightly higher rate on CD's than was available at other banks or from other market instruments.

Unfortunately, banks lose this control over deposit flows when money market rates rise above regulatory rate ceilings they are permitted to offer on CD's. This occurred during two previous periods of credit restraint. Between July and December 1966, commercial banks lost one-sixth of their CD's because of higher open market rates. Again during 1968 and 1969, money market rates rose above the ceilings which commercial banks were permitted to pay. This time banks lost $13 billion in funds, or over one-half of their large CD's. The consequent shortage of loanable funds in 1969 caused banks to turn to nondeposit methods of securing funds such as acceptances and the Eurodollar market.

During the present period of credit restraint, though, the Federal Reserve, with the cooperation of the FDIC and Federal Home Loan Bank, has moved to avoid this sort of development by adjusting the rate ceilings. In the words of Chairman Burns, "Individual banks can obtain funds...if they--and ultimately the business firms that are borrowing from them--are willing to pay the price." Large U. S. banks currently hold a record $86 billion in CD's.

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Banking is indeed quite different than it was fifteen years ago. We have learned to husband our resources as deposits have become less plentiful in the face of extraordinary loan demands. And although we now issue CD's in the practice of what is called "liability management," changes are occurring as well on the asset side of bank ledgers. As previously mentioned, securities as a percent of assets have been declining while business loans, consumer loans, and loans to nonbank financial institutions have been increasing. Funds flowing back into banks as these outstanding loans mature and are paid off make up an important source of bank funds for new loans. Thus, bank liability managers must also consider the maturity structure of their banks' assets when deciding what new liabilities to issue.

Lines of credit, though, and term loans--which make up a considerable 30 percent of business loans in this Reserve District--have less predictable periods of use than the standard seasonal loan payable in 90 or 180 days. These have created obstacles for efficient funds management. To alleviate some difficulties, many bankers are developing new lending techniques that will likely be dubbed a return to "asset management." Term loan agreements offer optional conversions to revolving credit lines. Participations in mortgage loans and consumer paper are growing in importance. And lines of credit now often entail a commitment fee rather than a compensating balance as in the past. Assets are thus producing income from services and commitments rendered to the customer as much as from funds actually loaned.

Participations and loan pooling appear to have an especially promising role in the control of asset structure. As mortgage bankers have long known, loan origination and servicing fees are profitable, and the service provided aids both the borrower and the ultimate loan holder. Moreover,

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such packaging of assets into pools of mortgages or pools of consumer paper will help to create a viable secondary market for assets. This may be a beneficial counterpart to the secondary CD market that developed during the 1960's.

The growing importance of assets that provide a return from services as well as from loaned funds is also evident in the acquisition of service-oriented subsidiaries by bank holding companies. The desire to originate and "package" consumer paper and mortgage loans is reflected in the numerous holding company acquisitions of out-of-state finance companies and mortgage companies.

At this point, our look at the changes in banking brings us only to a threshold where many more developments are in the offing. The mention of holding company expansion portends that tomorrow's financial markets are likely to be much more competitive than they are today. Banking organizations that gained a measure of control over fund sources using certificates of deposit discovered in the opening years of this decade that their investment in computer capacity and trained personnel opens new areas for the use of these funds. Banks can offer additional, profitable services which utilize equipment and skills similar to those already in operation. The jump from payroll services to full accounting services suddenly appeared feasible. Such possibilities drew management's attention to service expansion. They realized that their banks had already made the initial investment required to sell insurance, underwrite revenue bonds, perform accounting and data processing services, leasing services, and operate mutual funds.

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In addition, the bank holding company form of organization had been found to be a functional vehicle for geographic expansion in the 1960's. Now the holding company appeals to many as a vehicle with the flexibility needed to expand services in the 1970's. This development also leads us to expect increased competition between banks and nonbank financial institutions. As a consequence, major competitive pressures confronting Georgia bankers in the coming years may not come from other Georgia bankers. The major competition could well come from out-of-state holding companies and from nonbank institutions within the state.

For instance, commercial banks in Connecticut and Massachusetts are not nearly as challenged by other commercial banks as they are by the generally conservative savings banks. Two years ago, these savings banks suddenly began offering NOW accounts, which are, in effect, interest-paying demand deposit accounts. A Boston bank's competitive response has affected our southeastern markets. The First National Bank of Boston is now represented in the Alabama mortgage loan market through its newly acquired local affiliate, Cobbs, Allen, and Hall. Southeastern institutions have also responded across state lines. In 1973, First Amtenn of Nashville acquired the Atlantic Discount Company in Jacksonville, Florida. First National of Atlanta has acquired the Woods-Tucker Leasing Corporation in Hattiesburg, Mississippi. In July of this year, First Railroad and Banking Company of Augusta acquired the CMC finance group in Charlotte, North Carolina.

These examples illustrate that subsidiaries of bank holding companies may legally establish offices and provide services in areas beyond the state branching limits of banks. The possible avenues for entry into the growing banking markets of Georgia are numerous.

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We have still not mentioned the future appearance of new deposit instruments such as the controversial Citibank floating rate notes nor the many changes confronting us as we seek to improve the payments mechanism. The vast expansion of the Federal Reserve System's regional check clearing centers and the automatic payroll deposit service initiated by the Atlanta Committee on Paperless Entries appear to be only a preview of coming events.

Yet for all of these rapid-fire changes in the way we go about our business of banking, we need to remind ourselves that some very basic propositions of deposit banking have not changed. Recall the poet Edmund Spenser's epic where the goddess Mutability claimed rulership over the world because all things change. Jove rebuked her, saying that things change only in form, thus revealing all aspects of their true unchanging character.

To make a similar point about banking, let me borrow from the banking classic, Lombard Street, written in 1873 by Walter Bagehot, then editor of the Economist. "In any new trade English capital is instantly at the disposal of persons capable of understanding the new opportunities and of making good use of them." This is so, Bagehot continues, "not because England has rich people--there are wealthy people in all countries--but because she possesses an unequaled fund and floating money which will help in a moment any merchant who sees a great prospect of new profit."

"A million in the hands of a banker is a great power. But the same sum scattered in tens and fifties through a whole nation is no power at all: no one knows where to find it or whom to ask for it...." "A citizen of London in Queen Elizabeth's time could not have imagined our state of mind. He would have thought that it was of no use inventing railways, for you would not have been able to collect the capital with which to make them."

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These remarks of Bagehot's seem altogether appropriate for today. Have we not just spent some minutes discussing the liability management techniques developed during the past decade to collect just such a pool of loanable funds? Bagehot goes on, "But in exact proportion to the power of this system is its delicacy...." "Of the many millions in Lombard Street, infinitely the greater proportion is held by bankers or others on short notice or on demand...." "Credit means that a certain confidence is given, and a certain trust reposed. To put it more simply--credit is a set of promises to pay; will those promises be kept? Especially in banking, where liabilities, or promises to pay, are so large, and the time at which to pay them, if exacted, is so short, an instant capacity to meet engagements is the cardinal excellence."

Bagehot reminds us that deposit banking has a huge payoff in terms of economic development. This has been especially evident in the Southeast's recent history. But the many changes that occur in the way we bankers collect those loanable funds appear to unfold against the constancy of safeguarding adequate bank liquidity. The growing reliance by banks on borrowed funds requires an increasingly close watch over the maturity of these obligations and the maturity of the assets in which these funds are invested.

During the recent boom, some carelessness has crept into our financial system, as usually happens in a time of inflation. Some commercial banks allowed their dependence on volatile funds--such as overnight loans from other banks, certificates of deposit, and Eurodollars--to reduce their liquidity. They also permitted their liabilities to grow much faster than their capital. The great majority of our banks have been managed prudently;

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but, in some instances, unhealthy practices have turned up--such as speculating in foreign exchange or acquiring large amounts of long-dated securities. The recent Franklin National experience reminds us at a time when the central bank is so visible as the purveyor of monetary policy that its primary function is to provide ultimate liquidity. Chairman Burns reiterated before the Joint Economic Committee last August that "the Federal Reserve stands ready, as the nation's lender of last resort, to come promptly to the assistance of any solvent bank experiencing a serious liquidity problem."

Again, looking at the effect of future competitive developments on bank safety, one of the critical issues is whether or not the risks undertaken by a holding company parent and its nonbanking subsidiaries may eventually have to be borne by the firm's banking subsidiaries. The recent banking emergencies involving the U. S. National and Beverly Hills National Banks press upon us the need for some common understanding among investors, regulators, creditors, and the public about where the risks may ultimately fall. This is a very old question among bankers.

In conclusion, then, we can certainly agree that your chosen profession is indeed changing: Use a sharp pencil on both the asset side and the liability side of your balance sheets. And we can also agree with the poets. Your chosen profession is ever the same: Serve the customer with the full power of capital mobility but avoid borrowing short and lending long.

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