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RESPONDING TO ECONOMIC CHANGE: WHAT HAVE WE LEARNED?

It is a pleasure to have this opportunity to meet with you representatives of the Twelfth National Bank Region and particularly at Scottsdale. The subject I wish to discuss with you today concerns our response as Bank regulators to the forces of economic change. Specifically, considering the dramatic and rather traumatic economic changes we have seen in recent years, I would like to explore with you what we--as economic policymakers and bank regulators--should have learned from the economic events of recent years.

I should emphasize at the outset that we in the Federal Reserve, in our capacity as economic policymakers, have always been attentive to economic changes and their implications. As far back as the 1930's, for example, the marked shift to a deep-seated depression in business activity brought to the fore the need for new approaches to economic policy. In response to that need, as you know, the so-called Keynesian revolution emerged. That revolution in economic thought in effect led to the application of both expansionary monetary and fiscal policies to achieve faster economic growth and full employment. The inflationary implication of such policies was not thought to be a serious matter at that time due to the very depressed state of business activity.

After World War II, a distinct change occurred in the economic climate. Throughout the world there was a dramatic upward shift in the aspirations of people to increase substantially their overall standard of living. To accommodate these aspirations, governments increasingly applied the expansionary economic policies that were originated and developed in the 1930's to maximize growth and minimize unemployment. For the most part, as you know, these policies have been enormously successful in raising the economic well-being of people in the United States and elsewhere in the free world.

Unfortunately, however, efforts to fine tune the economy so that it can continuously achieve its maximum potential have led to severe inflationary implications. In the United States, the inflationary problem first became readily apparent in the mid-1960's; and since that time it has increased almost steadily in its severity. What is particularly disturbing is that--despite the periodic downturns in business activity we have experienced in the last decade, the forces of inflation have remained persistently strong. Thus, in contrast to the depression of the 1930's when slack demand and unemployment were the major problems, the post-World War II period has seen the emergence of inflation as our most pressing and important economic problem.

It was once thought, as you know, that a moderate degree of inflation was simply the price a country would have to pay for rapid economic growth. According to this view, some degree of inflation was perfectly acceptable. In recent years, though, we have learned all too clearly the fallacy of that proposition. Indeed, the sharp runup in prices in the years of 1972 and 1973 is now generally thought to be the primary factor in causing the recession of 1974-75. And, that recession, ironically, was the worst slump in business activity that our country has experienced since the 1930's.

At the present time, fortunately, our economy is a year and a half into the recovery phase of the business cycle. However, the pause in business activity of the past few months has led a number of people to recommend that more expansionary policies now be put into place. Underlying that view is the very legitimate concern that the unemployment rate is still undesirably high. At the same time, the specter of inflation is still with us. While some progress has been made in diminishing the rate of inflation, we are still experiencing price increases at about a 6 per cent annual rate. Quite clearly, this rate of price inflation does not provide a sound basis for a healthy economic expansion in the period ahead.

The crucial issue now facing policymakers, therefore, is how best to respond to the current economic situation. Should expansionary monetary and fiscal policies be implemented to reduce the unemployment rate? Or, should policies be tempered by the realization that a continuance of inflationary conditions is the surest way to steadily erode the vitality of our free-market system?

Current Federal Reserve thinking about this critical policy issue was voiced by Chairman Arthur Burns last week in statements to Congress. In these comments, he pointed out the need for the Federal Reserve to "adhere to a course of moderation in policy" in the present stage of "our struggle with inflation." Thus, it seems abundantly clear that the Federal Reserve remains firmly committed to its anti-inflationary stance.

Given the Federal Reserve's forceful commitment to halting inflation, banks must be aware of the implications of the Fed's stand as they make their lending and investment decisions. I believe the clearest message is this: Federal Reserve policies are and will be geared to slow the rate of inflation. Furthermore, should inflation appear to be getting out of hand, the Fed will move even more forcefully against it.

Thus, as bank regulators, we must be concerned not only with the impact of the inflationary environment on the banking industry, but we must be cognizant of the impact that anti-inflationary policies have on banks.

As you all know, inflation in recent years has affected banks directly through its immediate effect on interest rates and indirectly through its influence on business activity and the overall economy. However, it would be a mistake to attribute all of banking's recent problems to inflation or to other economic developments. For example, Franklin National's problems were not those of inflation or the economy, but those of management. It is true, though, that the recent inflation-recession experiences have exposed some significant problem areas in banking. For the next few minutes, I want to examine a few of these areas--

particularly the problems of bank capital, of matching sources and uses of funds, and of banking's fundamental approach to lending. I believe there are lessons we might draw from such a review.

Asset growth in banking has been profoundly affected by inflation. Over the past eight years, for example, total assets in the banking system have grown at a compound annual rate of 10.7 per cent. This growth is high by historical standards, and while not troublesome in and of itself, it has certainly placed some pressures on the banking system. For one thing, bank capital has not been able to keep pace with asset growth, which has caused bank capital to asset ratios to decline steadily since the early 1960's. Furthermore, the high demand for funds has led bankers to "push" their assets harder by loaning out a greater proportion of total assets. In recent years, as you know, the loan to asset ratio for banks has increased to a high of 59.7 per cent. Thus, the thinning capital base, combined with the more aggressive use of assets, has served to increase the exposure of banks to problems.

In trying to abstract the lesson of this development, we should note that many of the events and economic conditions of recent years were largely unanticipated. The resulting uncertainty contributed to a lack of public confidence in the banking industry and financial markets, and many banks were unable to acquire new capital in the market. We as regulators were equally prevented from taking action since all practical avenues for improving capital were closed off: not only were the markets unwilling to accept new issues, but current stockholders were generally unable to provide additional capital. In many instances, banks conserved capital by drastically cutting dividends, particularly in the smaller banks where the growth tended to be the greatest. Today, in the aftermath of the recession, banks are still making the necessary adjustments by increasing liquidity and rebuilding capital.

Over the longer term, of course, the problem of adequate bank capital remains to be dealt with. As regulators, our dilemma is unpleasant: Do we wait until bank capital positions improve through better earnings, or should we insist that added capital be acquired as soon as possible despite problems of market acceptance and diluted ownership? Of course, we all hope that the capital problems may be resolved in an orderly manner.

Problems related to asset growth might not have been so worrisome had earnings, loan, and security loss difficulties not confounded the banker's plight. Many who had not anticipated the mushrooming inflation were tied into fixed rate income commitments while being subjected to much more flexible interest costs in the purchased money market. Hence, the rapid and sustained growth in inflation served to deteriorate the more normal profit margins on lending activity as interest costs continued to rise.

Bank lending problems in the recession were not just those of interest rates. Many banks sustained historically high loan and security losses. While certain losses can be expected in such abnormal circumstances, it is not at all clear that some banks could not have minimized their losses with a little more prudence. For example, because collateral was often the name of the game in the REIT business, bankers looked on the rising values of real estate as an ever-increasing cushion against loan losses. Likewise, businessmen viewed inflated real estate values as an increasing base against which additional funds could be borrowed. The fallacies in these assumptions are all too clear now.

Even more fundamental problems than those of collateral were the grounds on which credit was often granted. Letters of credit were extended to REIT's on the assumption they would never be exercised and credit was granted to borrowers such as New York City on the simple assumption that taxes would always increase or, at the worst, that the city would not be allowed to go under. Again, the fallacies in the assumptions are now realized with abundant clarity.

Based on our recent experience, it is clear that few people have accurate insight into the future. Hence, the best bank policies toward interest rates should be a posture which keeps adjustments in interest income in line with a bank's cost of funds. Many bankers have been building this kind of flexibility into their interest income--if it was not there before--by using such diverse means as variable rate loans and even the Treasury bill futures market to hedge in profit margins and thus insulate bank income from interest rate changes. Of course, the regulators have yet to finally determine the effects of variable rate loans and participation in the T-bill futures market on a bank's health.

In terms of general guidance in the purchased funds area, though, one thing we regulators can do is to promote the idea that banks should have a definite policy covering their actions when the cost of funds gets out of hand. Such a policy might imply linking more directly the relationship between funds costs and returns on new loans. Furthermore, perhaps we regulators should accelerate development of our own procedures and measures for determining a bank's exposure to interest rate changes so that we can monitor how bankers deal with these problems.

Expecting the unexpected further necessitates not only thorough credit evaluations but also analysis of all credits in the portfolio. We have long been aware of the problems of granting too much credit to a single borrower. Similar difficulties may be encountered when too much credit is concentrated among similar borrowers. Sometimes credit concentrations are voluntary. In other cases, they may be involuntary, such as for smaller country banks with primarily agricultural loan opportunities. As we all know, of course, well managed agricultural banks which understand the industry they serve generally handle their concentration problems with skill--and profit. In any event, risks from credit concentration should be understood by both bankers and regulators and minimized to the extent possible. We bank regulators should seek greater authority to act in instances where it appears that

excessive concentrations of credit can be avoided. At the minimum, we should promote a concept in which evaluation of loan collateral is broadened to incorporate a look at the industry involved.

Just as bankers have worked to improve their capital and liquidity situations, they have also been active in correcting their credit related problems. We have noted, as you have, that bankers have adopted a more careful--if not stricter--lending posture, and are striving for better credit analysis. In this context we applaud the return to basic principles of loan analysis and we would urge that bankers and examiners alike be prepared to take account of not only the inflationary impacts on balance sheets and net worth, but to be aware of the dropping of the other shoe, so to speak--the effects of anti-inflationary policies on inflated real property values.

A note of caution is appropriate here, I believe. It seems to me that, as regulators, we have a significant responsibility to prevent overreaction to past problems just as we have to insure that all bankers make policy corrections where needed.

In my judgment, it would be wrong to limit bankers' access to the purchased money market simply because in some instances use of such funds has contributed to earnings problems. Likewise, I believe it would be an incredible mistake if REIT's and municipal bonds were "redlined" because of past problems and were not given a fair credit analysis to uncover their individual merits. In a different environment, these investments might be the banker's bread and butter.

Finally, I think we must move back one step further to see what might be learned from the past about our entire system of financial markets and institutions. This topic has drawn great attention from Congress and, in spite of the voluminous legislation which was proposed and discussed in 1976, little was enacted. Even so, I think some significant points were brought to the attention of Congress which deserve further attention.

Our financial institutions and their transactions mechanisms are in the midst of great change, primarily because of the maturing of electronics technology. Another important development affecting banks and their customers is the fact that the average American has more investment opportunities than he has ever had. For example, he can now invest in diversified portfolios of bonds and money market instruments through bond and money market funds. Such innovations, while contributing to disintermediation, also serve to get funds to the areas of greatest demand. In turn, disintermediation has forced many bankers to resort to acquiring money via financial instruments unknown 10 or 15 years ago.

In light of the impacts on banking from inflation and other economic events, and from technology, what sort of role should the regulators assume? What can the field examiners on the "front lines" do to ease the impacts of outside influences on banking? In my judgment, we regulators must encourage and support adherence to the principles of sound credit analysis. Perhaps we should develop techniques and support services to provide the best possible information to bankers and examiners about the economic environment and about trends affecting specific industries. We should accelerate our efforts at early identification of problem areas. At the same time, we should strive to insure that you examiners know the reasons behind headquarters-type policy decisions so that you can relate our concerns directly to the bankers you serve. Overall, because we generally have been late in asking bank managements the hard questions we should, we need to redouble our efforts to communicate our understanding of the environment into the context of a banker's everyday decisionmaking.

As we regulators absorb the lessons of the recent inflation/recession period, it is obvious, in my judgment, that regulation of markets and institutions must be actively pursued to keep pace with the times. At the same time, we regulators must approach our supervision with care so that we do not create as many problems as we alleviate. We cannot sidestep our

responsibilities to foster soundness and stability in banking, but we also must recognize the benefits in allowing financial institutions to offer more services, for example, or to have better access to funds, and in general to be more competitive. New problems for banks and bank regulators undoubtedly will arise as the economic, financial, and technical environments change. How we regulators react, adjust, or accommodate in light of these changes will play a major role in determining the ultimate nature of banking and the public's array of financial services.

In conclusion, it seems to me that the recent bout with inflation has provided us with an opportunity to examine some apparent weaknesses in our banks and financial system that were not wholly obvious before. However, in spite of the complexity of some of the problems, I think the lessons for financial institutions and regulators are relatively clear: avoid overreaction to the past and, in the future, expect the unexpected. As regulators we must recognize that certain problems in banks resulting from severe economic change might not be avoided while other problems can be minimized using simple, but sound, loan and investment policies. It is our responsibility to recognize the difference and act where appropriate.