

## LIABILITY MANAGEMENT

There are any number of possible definitions of liability management, but here's one that I find serviceable: a conscious, aggressive use of funds purchased by a bank to supplement deposit growth, thus expanding earning assets and revenues faster than otherwise would be possible. In less pedantic terms: bankers' efforts to go out and get the money any way they can. Obviously, the concept is a matter of degree because bankers from time immemorial have been out beating the bushes for deposits. Buying funds via liability management is merely a different intensity of what has long been a major thrust of bank managers.

In recent years, however, large commercial banks have vigorously pushed liability management. To illustrate this point, I'd like to quote from a recent speech by Jack Sheehan, Governor of the Federal Reserve System. His remarks, delivered last November, were titled "Bank Capital Adequacy -- Time to Pause and Reflect." I recommend the speech to you if you haven't seen it. Sheehan indicated that in 1965 demand deposits plus consumer savings represented 62 percent of the liabilities of commercial banks. By July 1973, that ratio had declined to 43 percent. On the other side of the same coin: as traditional deposit sources declined in relative importance, large CDs and bank borrowings increased from 13 percent to 33 percent. Thus, liability management is in our midst.

Instruments of liability management are common knowledge to those of you who work with balance sheets of banks. I'd like to touch on a few of them, and some of their increasingly exotic variations. The practice of using Federal funds has been with us for a long time; I can remember one of my early assignments at the Boston Federal Reserve Bank as a summer employee in 1958

was to review the use of Fed funds by Boston district banks. I discovered that Parker Willis, the son of a famous man instrumental in establishing the Federal Reserve System, had documented the use of Fed funds back in the 1920s. So obviously it's not a new practice, but reliance on Federal funds has increased considerably in recent years, particularly in this district and particularly by large banks. A new variation on Federal funds transactions is the use of "term" Federal funds. Term Federal funds are purchased for a stated period that ranges from several days to several weeks or months, rather than for just overnight as had been traditional.

Other instruments of liability management used with increasing frequency are securities sold under repurchase agreement, negotiable certificates of deposit and "due bills." Due bills is a term that has long been used in the securities market but is fairly new in banking circles. It's an evidence of debt representing securities sold but not delivered. There's nothing reprehensible per se about selling securities you don't have in position on the assumption you can acquire the necessary issues in time to make delivery. And when it turns out you can't, you temporarily resort to a "due bill" as evidence of the "fact." But I had assumed that due bills were at least pieces of paper. To my surprise, I am told that in some instances they are simply oral commitments. I was even more surprised to learn that some banks permit these due bills to remain outstanding for as long as two weeks before securities are delivered.

Commercial paper issued through bank holding companies and Eurodollars are other examples of instruments of liability management that are now familiar. Related, but not strictly instruments in the same sense of direct liabilities, are bankers acceptances, letters of credit and documented

discount notes. The latter have gained notoriety of late because of the failure of the U.S. National Bank in San Diego. Documented discount notes and letters of credit of the bank were involved in that unfortunate case, I understand. Other imaginative liability management efforts include commitments to repurchase securities -- commitments that constitute a contingent claim on the resources of the bank.

Liability management has grown up and has quickly come of age in various forms. Most of us, as bank supervisors and regulators in our various guises, tend to think of anything banks do to increase their risks or stretch their liquidity as somehow inherently bad. That's a frame of mind we need to guard against in my view. Clearly, it's our responsibility as regulators to insure that banks are not going "too far." And our biggest problem, at least my biggest problem, is to define how far is "too far." That's the crux of this whole discussion.

There are clear advantages to liability management from the point of view of bankers, or it wouldn't be so popular. The first, and obvious, advantage is that banks can expand their resource bases more rapidly than by cultivating traditional deposit sources. More bank resources mean increased bank earning potential over time. Nothing startling about that conclusion. But that conclusion assumes a couple of things. First, that there are assets, whether they be loans or investments, available that are as sound as the existing portfolio of bank assets. Another way of putting it -- in expanding their assets and liabilities more rapidly, banks should be expected not to increase the average risk of their assets. The second assumption is that the bank's average margin does not decline -- that is, the difference between the cost of obtaining funds and the cost of lending funds should not decline over time.

It seems to me that these two assumptions are or should be implicit in the policy of any aggressive liability management bank.

Another possible advantage of liability management deserves our attention. If (a big if because there are conflicting studies on this point) -- but if there are economies of scale in banking, which is to say a greater rate of return on equity in larger banks than in smaller banks, then it makes economic sense to achieve these economies of scale. Thus, liability management might hold promise of allowing banks to get up in size, so to speak, faster than otherwise would be possible.

If a bank's earnings are growing at the same pace as the rate of expansion of liabilities (that is, average margins have not been undermined by expensive borrowed funds and lower-return investments), then that bank maintains the potential for attracting new capital through either retained earnings or new equity. However, if a bank is expanding simply "to preserve its market share," at the expense of its profit margin, then its return on equity rises only insofar as its equity-debt ratio declines.

So expanding a bank's resource base can be an advantage, not just to the bank but also to the economy.

Bankers will also argue, sometimes persuasively, that liability management provides them with an additional means of satisfying the demands for credit in their community. If you have a credit short area, as the Upper Midwest is sometimes said to be, then to the extent you can find new ways of drawing funds into this area, you are, by definition, serving the community better than otherwise would be the case.

Similarly, banks will argue that by offering a whole range of liabilities they are also better serving the investor in the community as well,

providing new, attractive uses for his funds. That's less persuasive in my view, but still a point to consider.

A further allegation of some bankers is that liability management in a unit banking state like Minnesota is simply an alternative to "inhouse" transactions for a branch banking system. I think this analogy can be pushed only so far, but it does make some sense on the face of it.

From the standpoint of the efficient functioning of the economy as a whole, liability management also offers some advantages to the extent that it assists in providing a more efficient allocation of funds throughout the economy. If funds can be attracted into a local market area at a competitive rate, then almost by definition the result is a more efficient allocation of capital in the economy, assuming, as by and large I do, that the market allocation system based on interest rates reflects real economic differentials.

Liability management also has permitted banks to compete more effectively with other financial institutions and, specifically, with finance companies. If we prevented banks from competing with other institutions to tap national money markets, we would narrow their base, and narrow, relatively, the role of banks in the economy. I see banks as pretty efficient intermediaries, and I don't see why by regulation they ought to be foreclosed from competing vigorously in the national money markets via liability management.

Does unlimited use of liability management undermine the potential influence on the economy of monetary policy? I would argue not. Monetary policy can compensate for the increased velocity of circulation of money that is implied in a more efficient use of existing deposits and existing capital. In fact, it could almost be argued that the opposite is true. If banks can compete better with other financial institutions through liability

management and thus increase their market share, then the Federal Reserve, which has direct influence over the banking system but only indirect influence over nonbank financial sectors, has greater influence on the money supply, and the effectiveness of monetary policy may, in fact, be enhanced.

So much for the advantages of liability management. What about disadvantages? There certainly are some, and I suppose the most telling disadvantage of liability management is reduced liquidity for the banks that aggressively practice it, and also for the economy as a whole. As you well know, banks first began to vigorously pursue improved earnings by "managing" their asset side so as to increase yield, and did so at the expense of liquidity. In general, banks now own a lot fewer government securities than they used to, and they are by and large extending the maturity of their assets. So they've managed their assets to increase yield, but at the expense of liquidity.

Now, as banks turn to liability management to help improve earnings, a couple of generalizations can be put forward: first, these new liability sources they have been tapping are probably not as reliable or as predictable as the old sources, namely deposits; second, as more and more banks bid for a limited total pool of capital, individual banks have less flexibility (and the banking system has less flexibility) to turn to innovative devices to obtain funds in an emergency. In that sense, exhausting some of the potential for borrowing is inherent in the game plan of liability management.

The conclusion, I think, is obvious. As bank liquidity is lessened and emergency options exhausted, there is greater exposure to loss by banks, which is to say, bank risks have increased. Therefore, one might argue that banks need a larger capital base as an offset to increased risks. Ironically,

of course, just the opposite has been happening. The ratio of capital to total assets or liabilities in banks has been falling rather than rising. Again quoting some figures from Governor Sheehan's study, the ratio of equity plus reserves to total liabilities minus cash assets was 13 percent in 1962. It declined to 8.1 percent in 1972, a pretty rapid drop in equity as a proportion of total liabilities in the decade.

It's not surprising, therefore, that the return on that reduced base of equity has been rising rather rapidly -- which is the name of the game for many liability management bankers. To illustrate, the return on equity for large banks in 1962 was 8.4 percent. Ten years later, it was 11.4 percent, a substantial increase attributable in part, though not exclusively, to liability management.

All right, so the equity ratio has been decreasing; so what? Is capital adequate or not? From the evidence of bank failures, it's difficult to prove that it's inadequate. Let me quote from Governor Sheehan on this point:

"In a study of 493 banks which closed between the beginning of FDIC operations in 1934 and early 1972, none of them failed because of inadequate capital. Of the 54 banks in this group which closed since 1960, 13 failures were caused by defalcation and the remainder closed because bank management decisions involved the misuse of brokered funds, self-serving loans to bank management, fraud, and bad loans to borrowers outside the bank's normal territory.

"Nor have statistical studies of the relationship between bank failures and capital ratios been revealing. A typical study of that relationship found, in analyzing over 8,000 banks failing between 1920 and 1931 that, in fact, the nonfailing banks had lower capital ratios than those that failed."

This "evidence" raises a real question as to whether inadequate capital ratios have contributed to bank failures.\* This, I admit, tends to undermine the

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\* But see recent memo by Les Gable giving a different interpretation to this evidence.

argument that liability management should be opposed simply because it shrinks the equity/liability ratio.

A different type of problem that can result from emphasis on liability management is that it breeds an effort to put the new funds to work in increasingly risky assets. It's an intriguing and, on the face of it, a rather logical kind of an argument. There has certainly been a growth in classified assets over recent years, with a significant bulge in 1971. But again we must ask, how bad was it? We as regulators have to have facts, but we also have to view them in perspective. And another quote from the Sheehan study puts these facts in perspective:

"Loan losses charged off during 1971, when the industry experienced its highest loss rate since 1939, amounted to only 2-1/2 percent of the capital of the industry or equal to approximately 1/4 of 1971 income before securities transactions."

Thus, current earnings were more than sufficient, in the aggregate, to absorb the losses. And if one looks at the large banks that suffered the greatest losses in 1971 (primarily caused by Penn Central problems, as you recall), the largest proportionate loss for any one bank was 65 percent of its earnings in that particular year. In other words, in no case did loan charge-offs in 1971, the worst year since 1939, more than deplete total earnings in the year. So classified assets have grown, but have they grown enough to alarm us regulators?

That question has clear implication for the Federal Reserve, I can assure you. With banks operating in a tighter market and providing less in-house liquidity, they clearly have to look more to the Fed's discount window than they did in the past to obtain liquidity if they get into difficulty. Is this appropriate? Should the Fed be disturbed by the fact that the discount window is more likely to be called upon than in the past? One can argue that the Fed, as the lender of last resort, now is subject to greater exposure

because banks are more exposed to liquidity pressures. It can be further argued that the result is, in fact, a federal subsidy to banks. Banks are, conceivably, increasing earnings because when the chips are down they can rely on the Fed.

Is this in the interest of the economy as a whole? I don't have an answer at the moment, but I'm not ready to dismiss it out of hand as inappropriate. This is a concept that we at the Fed are musing about with a mind to present and future discount policies.

An interesting sidelight -- inasmuch as banks (in contrast with, say, industrial firms) are protected from failure by regulators acting in the public interest, should banks expect a rate of return on equity that is as high as the return for industry in general? The fact of the matter is, according to Governor Sheehan's figures, that for the manufacturing industry, the rate of return on equity has declined from 13 percent in 1966 to 10 percent in 1971. But during this same period banks went from 8.7 percent return on equity in 1966 to 11.7 percent return on equity in 1971. In fact then, they have become more profitable in terms of rates of return on equity, which prompts us at the Fed to wonder to what extent the back-stop of the discount window has contributed to the rise.

I'm intrigued by David Grande's suggestion that regulators ought to monitor aggressive high liability management banks with some sort of a measure. Then perhaps those banks falling in the high risk area of the spectrum should be asked to come in and formally report a contingency plan as to how they expect to deal, if necessary, with a strained liquidity position that they have invited by their own operations. That's not an unprecedented action by regulators -- it's already been done with respect to outstanding loan commitments -- and worthy of further thought in this context. Banks that

aggressively practice liability management should have well thought out contingency plans in any case, and they should be reviewed and approved by the directors of such banks. Yet our initial investigations indicate that few such plans exist in any detail.

For its part, the Federal Reserve must take note of the changes in banking that speak to tighter liquidity positions. The Fed has to be ready and able to meet liquidity crises which may face it more in the future as a result of liability management on the part of banks. That is not without recent precedent, and I'm referring to the Penn Central case. In my opinion, this can be regarded as one of the days of glory in the Federal Reserve System, having met a crisis, or a potential crisis, in a pretty effective way. Similarly, this past summer when the change in Regulation Q took place, there was a substantial drain on the S&Ls. The funds went into market instruments or into commercial banks and, again, the Federal Reserve, in what I think was an appropriate undergirding of the financial community, set up a contingency plan to provide liquidity to S&Ls, even though they are not members of the Federal Reserve, through Federal Home Loan Banks, if that were necessary.

In summary, it's my opinion that banks in total have not as yet gone overboard in employing liability management. However, there are some banks that are straining at the limits and, in these cases, contingency plans are in order and should be known to the appropriate supervisory agency. Such would be nothing less than bank managers themselves should desire and nothing less than the public should expect from the regulatory agencies that represent them.