

'70's: NO BANK IS AN ISLAND

by

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Periodically we all seek to withdraw into isolation. Probably this is natural whenever we have gone through severe stress. Today many would like to see the United States withdraw from involvement in world affairs, concentrate on settling our domestic problems, and protect our producers from foreign competition. Many would like to slow down the pace of change and have everybody let everybody else alone.

You as bankers have been through a period of extremely rapid change and have been under a good deal of pressure, and you too may want, understandably, to withdraw from the kinds of problems you have been having. My theme today is that in banking, as well as in other aspects of our society, the search for isolation is fruitless. Over three centuries ago the poet John Donne said that "No man is an island..." In the 70's, no bank is an island.

I want to give some examples, first, of how much more closely banks will be interrelated with the economy, and then explore some implications for you of actions taken by two important people in the Fed-- the examiner and the discount officer.

### Interrelations

You, of course, have always been influenced by what others did. When the bank across the street raised its savings rate, you had to decide whether to follow. When your largest depositor made a sudden withdrawal, you had to raise the funds somewhere. When an important borrower had trouble paying off his note, you had to work with him. But in the 70's you will be much more affected by what others do, many of them people you will never know. Let me give a few examples:

- Federal funds. Now that so many of you have come to rely on selling Federal funds to get earnings or buying them to get liquidity, you are much more aware of how vulnerable you are to changes in the market. This implication will be brought home to some of you in a very tangible way when you see your earnings record at the end of this year.

- Interest rates. The days when most of you could charge all your borrowers 6 per cent and pay all savers 2 per cent are gone forever. You are now much more influenced by changes in interest rates generally--which means that you are subject to broad changes in the supply and demand for funds which originate in areas very remote from your communities. Your depositors and borrowers are more interest-conscious than ever before, and if they don't like your policies, they are more likely to go somewhere else for what they want. And you are more concerned than before about what the authorities will do to interest rates; in our recent series of meetings, bankers without fail asked about the future of Regulation Q.

- Competitors. Savings and loans want to be more like banks. Banks want to take on the insurance and mutual funds business. Distinctions among competitors are becoming more blurred every day. This means that if you insist on doing the same kind of business you have always done you may be out of business.

- Banking structure. New Jersey now has state-wide holding companies and regional branching. It is moving toward still more changes in its structure. In Pennsylvania, large regional banks are developing in areas that before had only small community banks. Some large correspondent banks are wondering whether the correspondent business is really very profitable; some smaller banks are wondering whether larger balances they are asked to carry are really worthwhile. The whole banking structure,

in short, is in a state of flux, and this means that you are likely to be more affected by what somebody else decides to do than you ever were before.

- Credits. Failure of Penn Central has raised many questions (not to mention eyebrows) about credit standards and procedures. With many banks sharing large loans, dependence on credit analysis of lead banks is an area of vulnerability for many banks. This also means that the general forces bearing on the liquidity and profitability of corporations generally will have more influence on more banks than ever before.

The point of this list is that banks can never again return to the days when they could simply mind their own business in their own communities. They are part of a smaller, more interdependent world and will be increasingly immersed in this world in the 70's.

As I look at these prospects from the vantage point of my job in the Fed, it seems to me that there will be two people at the Fed who will be particularly important to you--the examiner and the discount officer. Let me say a few words about each.

#### The Examiner

The examiner is concerned ultimately about the solvency of banks. He thinks about liquidity, too, but mostly as it relates to solvency. As he looks at banks in the 70's, there is good reason for some concern.

The decade starts off with a record that has alerted the examiner to be on his toes. In the Third District, the volume of classified loans of all member banks in 1970 was almost double what it was in 1968. One of the more disturbing aspects of these numbers is that the

poorer record is at the larger banks, where credit analysis would be thought to be the more sophisticated. In the State of New Jersey, the record is better; nevertheless, classified loans were 55 per cent higher in 1970 than in 1968.

The examiner, of course, always has problems keeping his balance over the course of the business cycle. His standards are supposed to be constant whether business is good or bad. But when sales shrink, costs rise, money is hard to find, and businesses generally find the going rough, the results naturally show up in bank loans and there are good reasons to look at credits more closely. Besides, the examiner is only human. He can't help but be influenced by the prevailing psychology.

All of which is to say that some of the increase in classified loans is the result of the slowdown in the economy, and that as business improves the record should begin to look better. But the examiner can't assume that all problems will go away. Some of the same forces that will prevent banks from seeking refuge in isolation in the 70's will keep the examiner busy in the 70's.

One is the complexity of credits today and the state of flux of accounting standards. It is no longer enough for banks to take statements at face value. It will not be enough for the examiner to assume that he can make a thorough analysis of the bank's credits during the course of an ordinary examination.

Another is the need to assess factors outside the control of a firm but vital to its financial health. Penn Central is a sick railroad but it is also in a sick industry. Not all of Lockheed's problems were under the control of the company itself. With increasing amounts of bank loan portfolios in longer-term loans where payback depends as much on

developments in the industry as on developments within the firm, analysis needs to be more fundamental and forward looking than it used to be.

At the Federal Reserve Bank of Philadelphia, we are running an experiment in augmenting our own examination procedures. This experiment involves intensive analysis of large credit lines by a team independent of bank examination dates and time limitations. If the experiment works, it will help both us and the banks have a better fix on the quality of their large loans.

Another problem facing the examiner is related to holding companies. How much should he be concerned with the solvency of the holding company that spins off its trust, small loan, and mortgage businesses into separate subsidiaries? How much attention should he pay to the non-bank subsidiaries? A nonbank subsidiary of a holding company could be in dire straits without any direct financial involvement of the bank Sub. However, banks are peculiar institutions which rely heavily for success or even survival on the confidence of their customers. How would this confidence be affected if other units of the holding company were in trouble?

Finally, with cost pressures mounting in the 70's, bankers may be tempted to cut back a bit on internal auditing and control standards which make no explicit contribution to the "bottom line." This temptation exists and we know of unfortunate instances in which bank managements have succumbed to it. The examiner then is left bearing a greater part of the burden of assuring a viable bank.

In short, the examiner, as he works with you in safeguarding solvency, will play an important role in your attempts to meet the problems which the 70's will present you with.

The Discount Officer

The discount officer's main concern is with banks' liquidity. As he looks to the 70's, he sees reason why banks will be vulnerable to liquidity pressures and some ways in which the discount window can play a more important role in easing them.

The commercial paper crisis of a year ago illustrated how the greater mobility of funds these days can affect not only direct participants in this market but others as well. Commercial banks with back-up lines, as well as the banks from which they sought funds when they were called upon to honor these lines, were all involved. By opening the discount window the Fed prevented the involvement of the financial community from spreading still further.

The way in which banks lend today makes them vulnerable to liquidity squeezes on their borrowers. With many banks making what are essentially long-term capital commitments to their borrowers, a change in business activity can have a substantial effect on the banks' own liquidity.

The sensitivity of many depositors to interest rates has also made banks more vulnerable. Given all the needs of our society for funds in the 70's, pressures for relatively high interest rates may recur. Banks may well find depositors becoming even more responsive to changes in rates and their own liquidity positions subject to sudden change. The Federal funds market met a large part of these needs in the 60's, but whether it will be capable of meeting them in the 70's nobody knows.

All of this suggests that the discount window can play a more important role in the 70's. As you know, the old discount mechanism has been under review. Within the next year, a new window is likely to be

in operation. One objective is to make it a more important instrument of monetary and credit policy. For example, at the height of the 1970 squeeze, well over a billion dollars in Federal Reserve discounts was outstanding. When the new mechanism is in operation, it is contemplated that perhaps two or three times that amount could be outstanding regularly. The discount window also would be a more important source of reserves to the banking system, a more important way for individual banks to adjust to changes in reserve positions, and a more important way for them to cushion the impact of temporary shocks.

A final question relating to the discount window is what to do, if anything, about the nonmember bank which has no ready access to the window. You may have heard about provisions for "emergency credit" to institutions other than members. The purpose of such provisions, however, is to prevent a cumulative liquidity crisis that could seriously imperil the banking system, a group of banks, or the economy of an entire community.

The intent is not simply to bail out the individual nonmember which finds itself in difficulty and is unable to raise funds from other banks or other sources. This bank will be on its own. In an era of growing exposure, access to the discount window could prove to be a more valuable privilege of membership in the Federal Reserve System.

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In conclusion, let me stress that what I have been saying about banks in the 70's applies equally well to the Federal Reserve Bank--we cannot afford to become isolated if we're to fulfill our purposes. We'll be trying to help bankers in our District to adjust to the stresses of a changing environment. We'll be communicating with you and cooperating with you so that together we can make the most of the opportunities of the 70's.