BANKERS AND CORPORATE BORROWERS

REMARKS BY

John J. Balles

PRESIDENT
FEDERAL RESERVE BANK
OF SAN FRANCISCO

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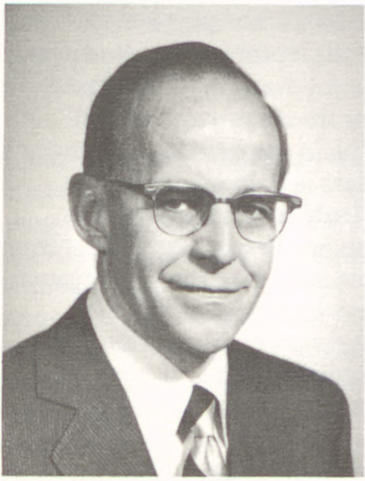

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From my previous contacts with your organization, I know that you represent a wide range of firms in manufacturing, retailing and banking. Obviously you are aware of the very heavy demands which corporations have placed on the credit markets in the last several years, and thus are interested in the banking system's ability to accommodate future demands for such funds. Accordingly, I will attempt to assess some of the difficulties facing the banking industry before discussing the current outlook for business credit needs.

First of all, how well equipped is the banking system to cope with the stresses and strains, partly domestic and partly international, which have become so evident in our economy? In reply to this often-asked question, let me state right off that I see no danger of a major liquidity crisis in the banking system. The great bulk of our banks are in sound condition, and only about 150 banks are on the FDIC problem-bank list, or fewer than two years ago. That does not mean that the regulatory authorities are unconcerned with problems arising in the banking system, since some banks admittedly have encountered difficulties in recent months. However, those few banks that have gotten into real trouble have done so not because of any structural weakness of the commercial-banking system, but rather because of problems unique to each troubled institution.

Individual Causes of Failure

It's sometimes difficult to assign a direct cause to any particular bank failure, because by the time a bank reaches the danger stage, it has already become entangled in a number of serious problems. But if we had to cite a single broad reason for bank failure, it would be quite simply, poor management. After all, operational procedures and loan-and-investment policies are all determined by management, so the front office must bear the blame for failure in any of these areas. I don't want to overstate this point, but it should be obvious that poor management pays a very high penalty whenever the economic climate turns stormy.

Consider for a moment the case that's been in the headlines in recent months—Franklin National Bank. The underlying problem here reportedly was the lack of the management aptitude and depth to run an operation of Franklin's size—a shortcoming that became painfully evident when this regional Long Island bank attempted to compete with the big New York City banks. It appears that Franklin's well-publicized foreign-exchange losses were simply a catalyst; the bank probably could not have remained a viable banking institution anyway because of its vast operational problems and poor income prospects.

Nonetheless, the regulatory authorities must be concerned with the need to arrest erosion of bank capital and liquidity that has accompanied the rapid expansion of bank assets in recent years. This rapid expansion pace results partly from the voracious demand for funds, and in addition, from the advent of various marketing and technological innovations stemming from the innovative practices of bank customers. These forces are not likely to be reversed, and for that reason, as well as their impact on bank liquidity, they deserve mention at this point.

Emphasis on Liability Management

One major factor has been the increased emphasis on "liability management"— more specifically, the reliance upon sources of funds other than demand deposits. This trend goes back to the early 1960's, with the emergence of the market for large CD's, and was given major impetus in the credit crunch of 1966. The trend then reached full maturity in 1969, when commercial banks financed a $15-billion increase in credit in spite of a $5-billion loss of deposits, by drawing upon some $20 billion in non-deposit sources of funds, such as Eurodollars and holding-company paper. These innovative actions then led the Federal Reserve to respond by defining these sources of funds as deposits for purposes of reserve requirements.

Throughout this past decade, banks have relied heavily upon the issuance of CD's, in order to complement demand deposits, which had traditionally been the major source of bank funds. This shift in turn has reflected the growing corporate stress on reducing "inventories" of funds to an absolute minimum. Bank customers thus have found more and more ways of improving cash management, which is now at the heart of many commercial bank services. Indeed, the skill of corporate treasurers in playing "float" through such devices as "lock boxes" and "zero balances" has had a significant impact on the banking system. One result is the increasing reliance by banks on fee income rather than compensating deposit balances. Another result is the growing emphasis on Regional Check Processing Centers to facilitate settlement on a same-day or overnight basis, and the consequent reduction of a major element of instability (float) in the supply of bank reserves.

The shift in the banks' liability structure is seen from the past decade's decline, from 65 to 40 percent, in the demand-deposit share of total funds, and the offsetting rise in the CD share from virtually zero to more than 33 percent. At present, some banks are heavily dependent upon access to short-term money markets—in the form of CD's, Federal funds and repurchase agreements—to attract additional funds to meet takedowns of outstanding commitments.

A second major force for change has been the rapid growth of bank holding companies and their non-bank affiliates. From the individual bank's viewpoint, the holding-company movement offers ways to expand business and realize economies of scale, while cushioning the effects of tight money and escaping the legal constraints of geographical limits on banking. Above all, holding companies offer banks a way of increasing their income, through the development of affiliate services that are "closely related" to banking.

A third important issue has been raised by the greatly increased foreign operations of U.S. banks, seen in the rise of their foreign branch assets from $5 billion in 1962 to $80 billion in 1973. As Chairman Burns has noted, overseas expansion has been a major component of the upsurge in assets that has called for commensurate increases in bank capital. Also, in many cases equity capital has been highly leveraged, with holding companies financing their equity investments in their own subsidiaries through reliance on the debt markets.

No Single Formula for Safety
What, then, constitutes adequate capital and liquidity? Actually, no single formula can be applied to all banks, which vary enormously—in terms of both size and structure—from one end of the country to the other. Moreover, capital does not just represent an idle, immediately accessible reserve of cash, but rather the sum total of the proceeds of equity offerings, debt offerings and retained earnings which have been invested in one or another form of asset.

The adequacy of a bank's capital and its overall liquidity ultimately depend upon the skills of the bank's management in handling its assets and liabilities. Thus, relatively low capital ratios do not necessarily indicate any weakness in the bank's situation. After all, the 8,000 banks or more that failed during the 1920's and 1930's, as a group, maintained higher capital ratios than the banks which survived those difficult decades. Even so, we don't need a statistical discussion to tell us that banks today should put some extra effort into improving their capital positions.

I should note here that banks in the San Francisco Federal Reserve District have traditionally maintained relatively low capital ratios. After a decade's decline, the overall ratio of equity to invested domestic assets last year was 7.3 percent in this District, compared with a figure of 9.7 percent for banks elsewhere in the nation, and 10.5 percent for New York City banks. In itself, this does not indicate any weakness in Western banking, but rather reflects certain circumstances which tend to give Western banking its unique flavor.

For one thing, this area is a stronghold of branch banking, with enormous geographical as well as product diversification. Western banks thus are well equipped to accommodate sudden shifts in the supply of deposits or the demand for funds. Moreover, Western banks exhibit somewhat greater stability than New York City banks, in terms of a much lower ratio of net borrowed funds to total assets (20 vs. 35 percent), or in terms of a much higher proportion of passbook savings to total deposits (22 vs. 13 percent). Also, they enjoy a high and steady inflow of funds from amortized loan payments, because of the comparatively large proportion of their gross loans (other than Fed funds) in consumer loans and mortgages—44 percent, as against 30 percent for other banks nationally and 14 percent for New York City banks. These considerations underscore the relatively small dependence of Western banks upon highly volatile sources of funds, and thus are critical to any assessment of comparative measures of capital adequacy and liquidity.

In other words, there is no single formula for capital adequacy that would be uniformly applicable or meaningful for all banks. On the other hand, we could use a very rough approximation, which would be the net worth adequate to protect a bank's depositors against losses that exceed net worth, based upon the historical loss experience of the bank in question. Such a measure necessarily puts a premium on managerial skills, competence and prudence, without which no amount of capital could possibly be adequate.

Federal Reserve Role

Now, the Fed's vital concern with maintaining a sound banking system stems in part from the key role which banks perform as the primary vehicle, or fulcrum, for the transmission of monetary policy through the credit markets. Consequently, one of the central bank's primary responsibilities is to act as a lender of last resort to banks that are solvent but which suddenly may be confronted with a severe liquidity problem, such as a heavy outflow of deposits. I can assure you that the resources which the Fed can muster in support of this mission are very large—more than adequate to cope with any foreseeable situation. Also, the channels through which this assistance can be provided are constantly being improved. For instance, a recent change in Regulation A provides for a special discount rate to member banks for prolonged periods to help them cope with unusual emergency situations, whether national or purely local in nature.

Meanwhile, the Fed is urging that banks sacrifice, if need be, shorter-term "performance" goals—including higher profits which might accrue from riskier loans—in favor of policies which will contribute to longer-term stability. The Fed is urging banks to preserve and improve their liquidity, partly by lengthening the average maturity of purchased funds such as CD's. It is also suggesting that banks keep a tight leash on business-development activities, and concentrate on serving the minimal needs of established customers while screening out non-essential loans. What is needed at this time is more attention to the soundness of assets and the quality of earnings.

Another necessary step is a careful scrutiny of holding-company activities, both foreign and domestic. Many proposed activities, while offering the prospect of rapid growth, also require substantial amounts of capital and highly specialized managerial resources, which conceivably might be diverted from the commercial-bank subsidiary. In this and other ways, the Fed is emphasizing the need for prudence—by far and away the most important ingredient of successful banking, especially in today's murky environment.

Inflation and Credit Demand

Next, let us turn to the prospects for business-loan demand, first considering the ability of commercial banks to meet this demand. Very heavy business-credit requirements have been a major factor behind the liquidity pressures experienced by the commercial banks—and by credit markets generally—and thus have contributed to the record high level of interest rates reached last summer. The business sector has accounted for roughly 2/5 of the total volume of funds raised by all sectors in the nation's credit markets during the past three years. At an average of $75 billion annually, business borrowing has soared at far more than double the annual average of the 1960's. Incidentally, that figure should indicate that the Fed has not been especially stingy in supporting the growth of credit where needed.

The huge business demand for funds is attributable in part to an internal cash flow which, because of inflation, has not been adequate to finance either the replacement of higher-cost inventories or the fulfillment of record fixed-investment plans. Then, in view of the serious problems of the bond and equity markets, corporations have been forced to turn to the banks to finance badly needed additions to plant and equipment. I don't need to remind you that new industrial capacity is critical in our struggle to increase productive efficiency and thereby curb inflationary pressures.

Heavy credit demands are related also to the insidious effect of inflationary expectations. These expectations affect the demand for loans, which will be repaid in cheaper dollars, and also the supply of funds, because of the inflation premium which investors will insist on receiving for making their funds available. Indeed, the apparent insensitivity of corporate borrowers to record-high borrowing costs reflects their own assessment of inflationary prospects. Even apart from the other factors affecting the total cost of borrowing, such as compensatory balances, a nominal prime rate of 10¼ percent looks relatively cheap when inflation is running at 10 to 13 percent annually.

Inflation and the Budget

A major element in the anti-inflation fight —one which could reduce strains on the credit markets and the resultant distortions in the pattern of real resource allocation—is the struggle to bring the Federal budget under control. Budget outlays have risen from $100 billion to $300 billion in the past 13 fiscal years—an unlucky number indeed. This jump in spending has been accompanied by deficits in 12 of those 13 years, totalling over $130 billion altogether. In turn, the financing of these deficits has necessitated heavy demands on the credit markets, and these demands have been aggravated by the borrowing needs of a rapidly growing number of off-budget agencies, whose combined debt now exceeds $80 billion.

Originally designed to shift funds from surplus sectors to "socially desirable" deficit sectors of the economy, the agencies have vastly expanded their activities at a time when the competition for funds has been uniformly strong throughout the economy. Last year, the agencies alone accounted for one-third of all the funds raised in capital markets, and the Treasury and the agencies together accounted for two-fifths of all funds raised. Surely, the pressure from this relatively little-known source has contributed significantly to the strains in the credit markets and the record level of borrowing costs.

I feel strongly that we must critically examine our priorities and rationalize them through a Federal budget that is not chronically open-ended. By definition, a budget is the optimum vehicle for determining priorities. Budgetmaking thus is extremely important in view of the enormous demands for capital in the decades ahead—to provide the housing we need, to develop new energy sources so as to reduce our heavy dependence on foreign supplies, and also to put our environmental house in order. Ultimately, these increased capital requirements will have to be financed out of increased taxes or savings. However, the necessary savings will not be generated by a Federal government operating at a deficit, nor by a plethora of agencies competing with the private sector (and with each other) for existing supplies of funds.

Fortunately, this year's Budget Reform Act holds considerable promise for rationalizing the priority-setting process. Under the act, Congress will first determine an overall ceiling on expenditures, and then decide how funds will be allocated in support of specific programs. But Congress should also go further, and reincorporate the operations of the off-budget agencies into the overall taxing-spending-borrowing process. If this step is not taken, tomorrow's priorities could become the tax loopholes of the day after tomorrow.

Congress should also consider slaughtering a host of "sacred cows", that is, all the laws and regulations with an anti-market and pro-inflationary bias which are imbedded in the interventionist policies of past decades. I have in mind such laws as the Davis-Bacon Act, which sets a floor under costs and pushes up prices by requiring the Federal government to pay prevailing union scales for construction work. Minimum-wage laws, fair-trade laws and buy-America clauses in public contracts similarly act to fix prices, invariably above a competitively determined level. (Incidentally, minimum-wage laws also seriously impede the entry of the unskilled into the job market.) Whatever their original intent, laws such as these seriously aggravate our inflation problem.

Short-term Market Prospects

Let me now say a few words about the prospects for the credit markets in the period immediately ahead. Most observers expect some further easing of short-term interest rates, partly as a result of weakening demand pressures in some sectors of the economy, and partly in response to the Fed's efforts to facilitate growth in the money supply along the long-term growth trend. Significant reductions in the bank prime rate have already occurred, and further reductions may well be expected. At the same time, a precipitate decline in rates seems quite unlikely—especially in the long-term sector—in light of the heavy demands now developing in the credit markets from the Treasury, agency and corporate sectors.

The banks are seriously affected, as are other credit intermediaries, by the problems attendant to the recycling of so-called petrodollars. Chairman Burns recently said that the term "recycling" is a misnomer for what, in some circumstances, simply involves the piling of bad debt on good debt. U.S. banks—actually, only some of the largest banks—have received over $5 billion in petrodollars to date, but they may be increasingly reluctant to accept more of these potentially volatile funds in view of the additional pressure thereby exerted on their liquidity positions and capital needs.

A further easing of the formerly overextended corporate market may be expected, for a variety of reasons. With a recession continuing, there is an overall weakening of loan demand. Then again, with market rates—such as the commercial-paper rate—falling faster than the prime rate, the relatively high prime rate tends to ration some would-be borrowers out of the banking sector. Another restrictive factor is the banks' emphasis on stricter lending practices, including the accommodation of local customers and the granting of loans only for "productive" purposes.

Concluding Remarks

In the last analysis, the ability of the banking system to improve its basic liquidity while meeting heavy corporate loan demand depends upon the success of the nationwide struggle against inflation. We've seen that poor management has been at the root of the few "problem bank" cases, yet some of these might not have occurred in the absence of the insidious inflation and the necessary tight policy response. We've seen also that bank liquidity has been weakened by some industry innovations, such as liability management, yet the excesses generated in that regard may not have occurred without the pressure placed on the banks by inflation-generated loan demands. Consequently, we must pursue our mission of wringing the inflationary excesses out of the economy, fully realizing that, with a recession, we must also deal with other problems, such as increasing loan losses. But let's remember that a recession also presents bankers with the opportunity to strengthen their capital and liquidity positions, so that they can prepare for an orderly expansion of business credit in the remainder of the decade.