HOWARD D. CROSSE

MANAGEMENT POLICIES for COMMERCIAL BANKS

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FOREWORD

Management Policies For Commercial Banks by Howard D. Crosse, Vice President of the Federal Reserve Bank of New York, meets a long-felt need of the commercial banker as well as the teacher and student of banking. A great merit of the book is that it brings together in one volume a large number of topics which are usually treated in separate works. Its value is enhanced by the fact that the author has a thorough theoretical background combined with practical knowledge based on years of experience.

The book deals not only with practical problems of great interest to the banker, but also with broader questions, such as commercial bank functions, the banking structure, and the relation of the bank to the community. Some chapters are of particular current interest at a time when the banks have to adjust themselves to changed conditions, notably the rapid increase in time and savings deposits.

Chapter V, dealing with Earnings, and Chapters VII and VIII, dealing with bank liquidity, are of particular importance. Because of steadily rising costs, all banks are troubled by a profit squeeze and are seeking ways to overcome it. Liquidity is a long-standing problem which still confronts many banks. These chapters offer practical guidance that will help overcome these problems. The solutions suggested are based on vast experience with all classes of banks, large as well as small.

Also of great interest is the discussion of capital adequacy, another topic which has received a great deal of attention from bankers, students of banking, and the supervisory authorities.

It is not often that a busy executive of a Federal Reserve Bank finds the time to write a book embodying the fruits of years of study and investigation. *Management Policies For Commercial Banks* is a valuable contribution to the literature on United States banking and will be welcomed by all concerned with this subject.

Marcus Nadler
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New York University

PREFACE

The management policies of the more than 13,000 commercial banks in the United States are the responsibility of their directors. Relatively few bank directors, however, are professionally trained in banking but, to perform their directorial duties effectively, they should have some knowledge of the basic principles which underlie commercial bank policy formation. At the same time there are thousands of students in banking schools and universities who want to know what makes our uniquely diversified banking system function. Some of these, in time, will themselves become senior bank officers or bank directors.

This book attempts to examine the whole spectrum of commercial bank policy formation and to relate practice to theory in all those various aspects which make each individual bank the unique institution that it is. The early chapters establish a background of understanding of the function of commercial banks, the banking structure, bank organization and banking risks to which specific policies can be meaningfully related. Subsequent chapters develop the formulation of policy in specific areas in such a way as to minimize risk while performing the essential banking functions most effectively. The specific techniques of banking, which are the province of executive management rather than the policymaker, have been covered only to the extent necessary to make their direction meaningful.

Most of the views expressed in this book are derived from the author's thirty years of experience as bank examiner, operating officer, and bank supervisor with the Federal Reserve Bank of New York. They are entirely personal views, however, and in no way reflect any official position of the Federal Reserve System. The form of presentation is derived from the author's experience in presenting similar material to students of banking and to bank directors in various banking schools and seminars and as Lecturer in Banking at the Graduate School of Business, Columbia University, for the past four years.

Acknowledgment is due to Dr. Marcus Nadler of New York University who has been my friend and mentor throughout all my thirty years in banking and without whose prodding this book would not have been written. I am also deeply grateful to Mr. R. B. Wiltse, retired Vice President of the Federal Reserve Bank of New York, whose sound advice and graceful editing have contributed substantially to the book as they did during the ten fruitful years when, as my "boss," he encouraged me to pursue the studies that led to its writing.

Thanks go also to Miss Mae Greene, my patient secretary, and to many other members of the staff of the Bank Examinations Department of the Federal Reserve Bank of New York, who have helped materially with typing, charts, and footnotes, and also to Dr. William H. Baughn, Dean of the College of Business and Public Administration, University of Missouri, who read the manuscript. Special acknowledgment is due my artist-wife who designed the book's jacket.

H.D.C.

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COMMERCIAL BANKING FUNCTIONS

INTRODUCTION

A clear and concise understanding of the role of commercial banking in the economy is obviously a prime prerequisite for the formulation of bank policy. Often the banker's concept of that role shapes the nature and character of his bank. The deposit-minded banker may overstress conservatism and liquidity; the loan-minded banker may underemphasize safety. These attitudes often reflect the nature of the locality in which a bank operates; conservatism is frequently the mark of the stable, long-settled comunity, whereas more aggressive banking is found where growth is rapid and the need for credit greatest.

Actually, commercial banks perform a number of interrelated functions, all of which are vital and form a part of a balanced view of banking policy. Commercial banks bring into being the most important ingredient of the money supply—demand deposits—through the creation of credit in the form of loans and investments. Banks are the custodians of the community's money as well as the suppliers of its liquidity. For those bank customers who seldom borrow, the depository function may be the most important. Commercial banks also provide flexibility and mobility to the money supply by maintaining the interchangeability of currency and bank deposits, and by providing the mechanism through which money payments can be most speedily and efficiently carried out. Commercial banks participate with other institutions in the process of accumulating and investing real savings and perform a number of other incidental functions.

As creators and custodians of the money supply the concern of commercial banks with the liquidity of the economy is of course fundamental.

CREDIT CREATION

It is the ability of the comercial banks to create money in the form of demand deposits by making loans and investments that distinguishes them from all other financial institutions.[1] This is a seeming magic which is often difficult for the layman to understand and which occasionally even baffles bankers. For the individual bank, as contrasted with the banking system as a whole, cannot expect that the deposits it creates will remain with it. The money it can lend and invest is, at any moment, its excess of cash and bank balances over required reserves and minimum cash requirements. The individual bank must stand ready to pay out the deposits it creates when it makes new loans and to pay for the securities it buys upon delivery.

In practice, out of the vast aggregate of financial transactions the individual bank gains and loses funds in the course of each day's business. From its net gains it can increase its loans and investments; if it has net losses it must collect loans or sell investments. As one of the theoretical aggregate of "all banks" it competes for its share of the deposits which the banking system as a whole may create when additional reserves are supplied by the Federal Reserve System.

A bank does not create credit [2] in a vacuum; it creates it in order to supply the funds that are needed by the community it serves and the nation of which it is a part. Bank loans and investments

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[1] For a complete explanation of deposit creation, see *The Federal Reserve System; Its Purposes and Functions,* Board of Governors of the Federal Reserve System (Washington, D. C., 1947), chap. II.

[2] Chapin and Hassett define credit as "the measure of the ability of an individual or a business enterprise or government authority to obtain present values (money, goods, or services) while deferring payment, usually in the form of money, to a definite future time." The creation of credit by a commercial bank is the other side of this coin. It is the recognition of the borrower's credit-worthiness and need. Albert F. Chapin and George E. Hassett, Jr., *Credit and Collection Principles and Practice* (7th ed.; New York: McGraw-Hill Book Company, Inc., 1960), p. 4.

may finance production, distribution, investment, consumption and the needs of government. Credit enables goods to move through the channels of trade, young couples to acquire homes, factories to be built, workers to buy automobiles, the nation to finance its defense, and many other useful or profitable purposes. Without credit, business as we know it would be almost impossibly impeded and our level of living would never have been attained.

Bank credit supplies money where it is needed and when it is needed, and the repayment of bank credit removes money from circulation when the specific need for it has passed. When the economist speaks of a "balanced" economy he envisions an over-all balance between production and consumption. With respect to both the businessman and the individual, however, such a balance usually involves a time lag. The farmer puts six months' effort and investment of seed and fertilizer into a crop before he can harvest and sell it. The manufacturer must assemble, pay for, and put to use plant, materials, and labor before he can produce a saleable product. The individual who wants to buy a car or who must meet unexpected medical expenses may not have the money on hand, but is able to make his purchase or pay his bills out of future income. In supplying credit to farmers, manufacturers, and individuals, the commercial bank bridges the time lag between production and consumption and thus helps to bring the financial affairs of the economy into balance.

This is another way of saying that commercial banks supply liquidity to the economy. Through their ability to lend and invest they can provide money immediately in consideration of assets or efforts which have a future money value. This is not to say that they convert assets into money—a common fallacy; a sound extension of credit is one that will be repaid in the normal course of business from the liquidation of the transaction financed, or from income generated by it or otherwise normally available to the borrower. Sound bank credit, as will be elaborated upon in a later discussion of lending policy, is temporary; it calls for repayment, not forced liquidation.

The granting of credit takes many specialized forms. In larger banks separate departments are generally established to specialize in certain forms of lending. The foreign departments of some large banks, for example, are almost separate institutions in themselves.

In smaller banks, farm lending, or consumer credit is frequently departmentalized.

THE DEPOSITORY FUNCTION

It is easy to say, as the layman does, that a bank "is a place to keep your money." So it is, but to put it thus is an oversimplification. Commercial banks hold different kinds of deposits and hold them in a variety of forms. There are also other places to "keep your money," ranging from the cookie jar to a mutual investment fund.

The most useful way of examining the depository function of the commercial banking system is to look at the purposes for which money is deposited. Again the layman's concept is likely to be misleading; "for convenience" he says, or "for safety." These are partial truths which shed but little light on the functional role of banks as depositories.

Demand deposits in commercial banks constitute the major portion of the money supply.[3] A primary function of money is its use as a means of payment. Consequently, one of the most important reasons for becoming a bank depositor is to use the payment facilities of the commercial banking system. Demand deposits also frequently consist of funds kept with a bank to support credit requirements or to compensate the bank for a wide variety of banking services. All such funds can be designated collectively as "working balances." Whether held by individuals or corporations, they are funds needed in the transaction of daily business and cannot even be temporarily invested. They are funds which must be kept in the most liquid of all forms—money.

Money has another primary function; that of providing a reservoir of purchasing power for the future. It shares this attribute with a number of other assets which can normally be readily exchanged for money at short notice and with minimum risk of loss. Such assets include short-term government securities, commercial paper, bankers acceptances, and, for individuals, funds held (generally in

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[3] Usually defined as currency outside banks plus demand deposits adjusted (Federal Reserve Bulletins). The volume of demand deposits, however, is not an accurate measure of their importance as money because of their relatively rapid turnover (velocity).

fairly substantial amounts) in the form of savings deposits or savings and loan share accounts. Such assets are held for reasons of liquidity (known or anticipated future expenditures) and, in contrast with working balances and real savings, may be designated as investment funds or liquidity reserves. Such funds generally seek the highest available interest return consistent with ready or specific availability at minimum risk.

Finally, funds may be deposited in commercial banks for true savings purposes. Such funds are generally accumulated by individuals over relatively long periods of time for nonspecific purposes such as the proverbial "rainy day," retirement, or unknown personal emergencies. These funds have greater stability than "investment funds," and the latter, in turn, are less volatile than "working balances." True savings are more likely to be deposited in banks for the sake of convenience than for the sake of interest return and are therefore less sensitive to interest rate differentials between different savings media and savings institutions.

It is important to recognize that form does not necessarily follow function in bank deposits. A considerable number of depositors still keep their liquidity reserves, and, in the case of individuals, even their savings, in the form of idle demand deposits. The former reluctance of New York City banks to accept time deposits from domestic corporations, for example, stemmed from their appraisal of the degree to which such corporations still kept a portion of their liquidity reserves in non-interest-bearing demand deposits. Conversely, some individuals may try to keep their working balances in savings accounts, although commercial banks discourage this practice because it results in abnormally high, and costly account activity.

Essentially, demand deposits are likely to represent working balances; time deposits (other than savings deposits) [4] usually consist of the liquidity reserves of corporations, including municipalities and foreign banks, and of individuals when banks offer higher rates

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[4] *Regulation Q of the Board of Governors of the Federal Reserve System* distinguishes between "time certificates of deposit" with fixed maturity and "time deposits open account" subject to stated notice of withdrawal. It provides further that "savings deposits" may be held only for individuals and certain nonprofit organizations engaged in charitable, educational and similar activities.

on longer-term certificates of deposit. Savings deposits are likely to represent an admixture of true savings and of the investment funds or liquidity reserves of individuals.

Because commercial banks are the primary source of commercial and industrial loans, and because they operate the payments, or check collection system, they have little competition for the deposits that represent purely working balances. This is the bread-and-butter business of the commercial banking system. For investment funds and savings deposits the competition is very keen [5] and has grown keener with the postwar rise in the level of interest rates. This fact has vital implications for bank policy and practice.

When banks could pay interest on demand deposits [6] it was customary for corporations and others to keep their liquidity reserves as well as their working balances in the form of demand deposits, although, in 1928 and 1929 when market rates reached abnormally high levels, large amounts of such funds were placed, through the banks, in the "call loan" market. During the long depression of the 1930s, through the Second World War, interest rates were kept so low that it did not pay depositors to transfer their liquidity reserves from demand deposits to other short-term investment media. This was a period of very high bank liquidity. When short-term interest rates began to rise after 1947 the cost of money, and therefore the cost of keeping money idle, rose commensurately. As a result, both individuals and corporations tended to convert that portion of their demand deposits which they did not need for working balance purposes into earning assets. The holding of such assets has risen steadily since, imposing an increasing squeeze on bank liquidity. Between 1946 and 1958, while the money supply was increasing by just under 20 per cent, holdings of other liquid assets increased by 78 per cent.[7] The impact of this drastic shift of liquid

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[5] *Cf.* Jules I. Bogen, *The Competitive Position of Commercial Banks,* New York University, Graduate School of Business Administration, Banking Research Study.

[6] The payment of interest on demand deposits was prohibited by the Banking Act of 1933.

[7] John G. Gurley "Liquidity and Financial Institutions in the Postwar Period," *Joint Economic Committee*; in *Employment, Growth and Price Levels, Study Paper No. 14,* 86th Cong. 1st sess., 1960. (Washington, D.C.: Government Printing Office, 1960), p. 5.

assets from the banking system to the nonbanking sector of the economy will be discussed later. Its effect has been to reduce the volume of deposits in the banking system and to make the remaining balances more volatile.

THE PAYMENTS MECHANISM

The commercial banking system not only creates the principal means of payment (demand deposits) and serves as the custodian of this supply of money, but it provides the means by which payments can be simply and expeditiously made. This is the collection system through which checks, primarily, but also notes, drafts, coupons, and money transfers by letter and telegraph are made each day in tremendous and ever-increasing volume. It has been estimated that over 90 per cent of the payments made in the economy each year are made by check.[8]

Checks serve as money, although they are not legal tender, because they can be collected quickly and cheaply through the banking system. The collection of checks and other forms of payment orders is largely a routine banking function. The law with respect to negotiable instruments has been well standardized and the procedures of collection, as almost uniformly followed, are set forth in detail in the regulations of the Federal Reserve System. Nevertheless, if one includes the payment and receipt of funds through the teller's "window," more man-days are spent by banks in the performance of the collection function than in any other. Available figures indicate that a third of bank operating costs, exclusive of interest paid, are the direct costs of their teller-transit-bookeeping operations.

From the viewpoint of bank policy, the operation of the collection system is primarily a service function. While banks may not pay interest on demand deposits, the Board of Governors of the Federal Reserve System, in administering the law, has taken the position generally that the failure to charge is not a payment. As a result banks have competed for demand deposits on the basis of

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[8] *Report of the Joint Committee on Check Collection System.* (A study group established by the Federal Reserve System, The American Bankers Association, and the Association of Reserve City Bankers), June 15, 1954, p. 1.

services which they are willing to render the depositor; mostly in the form of handling his collection problems.[9] Where the size of the deposit is not large enough to support the related collection activity, banks generally impose service charges. If these charges are adequate, the operation of the collection function can be a source of additional income to the bank.

SAVINGS ACCUMULATION AND INVESTMENT

A function which the comercial bank shares with a number of other financial institutions is that of accumulating and investing savings funds. The savings process takes place when a holder of money elects to defer its spending for current consumption to some definite or indefinite future date. The saver exchanges his money for a claim on money subject to varying, but specific conditions. The liquidity of these claims on money range from savings deposits and savings and loan share accounts which are payable virtually on demand, under normal circumstances, through securities of various maturities, to equities with no fixed payment date, the "liquidity" of which depends upon their marketability.

Through the savings process purchasing-power is diverted from current consumption into the market for capital goods. As savings are invested in plant and equipment, in homes, or, through Government, in schools and roads and exploration of space, the productive capacity and therefore the real wealth of the economy is increased. In this vital process commercial banks play two roles; they themselves help to channel savings into productive uses and, through their short-term lending, they supplement or provide liquidity to other savings institutions and investment media.

The holding of savings deposits is not essential to the operation of a commercial bank. In fact, there are a few commercial banks that do not accept such deposits. It was because many commercial banks especially in large cities were not interested in "thrift deposits" that the mutual savings banks were originally organized as a kind of eleemosynary institution.

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[9] One of the most recently developed services of this character is the so-called "locked-box" system in which the bank's depositor arranges for his customers' remittances to be mailed to a post office box under the bank's control. The bank collects the checks and accounts to its depositors for the accompanying bills or invoices.

While not essential, time and savings deposits have long been an important part of commercial banking. From the viewpoint of the individual bank both demand and time deposits bring in funds (reserves) which are equally available for lending and investing. In many small communities the local bank could not take care of the community's credit needs without the availability of savings funds.[10]

In 1913 the Federal Reserve Act recognized savings deposits only as a variety of time deposits for reserve purposes. It was not until 1927 that national banks were empowered to invest in residential mortgages of more than one year's maturity, and the holdings of such mortgages were directly related to the aggregate of their savings deposits. In 1926 the House Committee on Banking and Currency had found that "National banks have on deposit about $5 billion of savings deposits from 11,000,000 depositors."[11] And with varied success commercial banks have been in the savings deposit business ever since. In recent years time deposits of all insured commercial banks accounted for about one-third of all deposits, which is about the same percentage as they held in 1926. Savings deposits have not until recently been regularly separated from the total of "time deposits" in reported figures. In September 1961 they accounted for 76 per cent of the total of time deposits.[12]

TRUST SERVICES

The fiduciary field is a specialized function not directly related to ordinary commercial banking operations. Commercial bank trust departments, nevertheless, are by far the most important group of corporate fiduciaries in the country. Trust business is generally handled by a specialized and separate staff (except in the smaller banks) and the operations of the trust department are subject to a separate body of law and tradition.

Trust business, nevertheless, is an important adjunct to the activities of many of the country's larger commercial banks. As of a recent date it was estimated that there were 3,100 banks exercising

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[10] Marcus Nadler, *The Banking Situation in New York State.* Study prepared for New York Bankers Association (1956), p. 287.

[11] House Report No. 83, 69th Cong., 1st sess., 1926, p. 6.

[12] Board of Governors of the Federal Reserve System, *Summary Report,* No. 161, Sept. 27, 1961, p. 3.