Ninth District Quarterly

The Safeguard of Contingency Planning for Banks

Federal Reserve Bank of Minneapolis
February 1976

How real is the possibility that a bank might face a loss of its depositors' and creditors' confidence? What implications does such a loss of confidence have for a bank's financial position? An exercise in contingency planning would give banks a safeguard against problems that might result from a sudden need for cash. It would also give the Fed additional information on credit demands that might be made at the discount window.

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District Conditions

Second Half '75
Year-end economic indicators in the district—as in the nation—remained mixed. Several factors suggested that the district economy was on a course of modest recovery, but evidence of how substantial the upturn was had to be qualified.

Growth in consumers' real personal incomes improved as price increases slowed and eroded less of the nominal gain. Consumer spending advanced.

Employment increased steadily from mid-year 1975, but growth in the labor force held the seasonally adjusted unemployment rate above 6 percent. Despite the growth in overall employment, the manufacturing sector still showed no employment gains. Although employers appeared in no hurry to rehire workers or rebuild inventories, the sales outlook in the manufacturing sector seemed to be improving as the year ended.

In the farm sector, both gross cash marketings and net farm incomes for last year were down from 1974. But 1975 was still a good year for district farmers when compared to year-end figures for the years preceding 1973.

Finally, despite a high rate of savings inflows into district banks and S&Ls, the housing sector remained depressed at year's end. Though some improvement was seen in nonresidential construction, the construction sector as a whole was imparting little impetus to the recovery.

First Half '76
It seems likely that the district economy will stay on a path of modest recovery in the first half of 1976.

Improvements in real incomes and the continuation of the tax cut should provide a solid base for continued advances in consumer spending.

Stronger corporate profits have created potential for higher business investment spending, and district financial institutions have ample liquidity to support expansions in both business and consumer lending.

District employment is apt to continue growing into 1976. However, anticipated labor force growth and a persistently high level of initial claims suggest that district joblessness will not decline much in coming months.

High rates of cash flow into the farm sector will presumably be sustained as strong export demand and high domestic feed consumption will slow or reverse declines in grain prices.

Finally, weakness in the construction industry will probably extend into 1976.

Consumer Spending
At the end of 1975, many economic analysts were hoping that improved consumer spending would generate a broad-based economic recovery. Although many indicators pointed to strength in the consumer sector, not all signs were positive.

District consumer spending grew as the rate of inflation slowed in 1975.

*Minnesota retail sales, Minneapolis-St. Paul price changes
Sources: U.S. Departments of Commerce and Labor

The rate of price increase was slowing. The fourth-quarter increase over a year ago in the Twin Cities consumer price index was 7.2 percent—the slowest rate of increase since the fourth quarter of 1973. According to preliminary estimates, current dollar personal incomes improved substantially in the third quarter, and with the slowdown in inflation, constant dollar incomes were probably also improving.

Following increases in real incomes, Ninth District retail sales were quite energetic early in the second half. There was evidence of strength later in the year as well. Qualitative surveys conducted by this bank indicated that:

- The 1975 holiday season was very good for retailers, even after discounting for the impact of inflation.
- Auto sales were far above the depressed levels of 1974's fourth quarter.
- Despite a long, warm autumn, many tourist resorts said that winter business was good.
- Finally, consumer installment credit turned upward from the lows reached in early 1975.

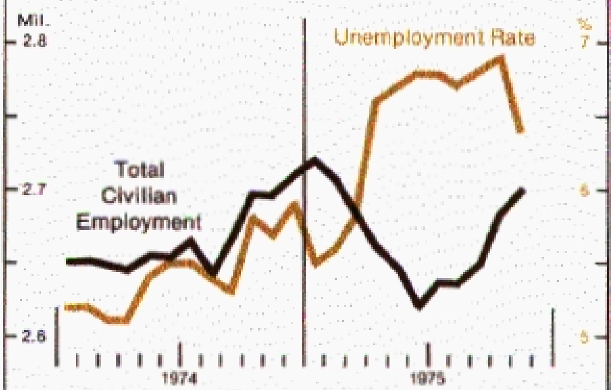
However, other retailers weren't so optimistic. Some said the 1975 sales gains, though much improved over 1974's disastrous fourth quarter, were still lower than 1973's gains. Others said that consumers were being extremely value-conscious in their buying habits.

Labor Markets

Even if consumer spending was fairly buoyant in the fourth quarter, strength was not yet being transmitted to district labor markets.

District employment bottomed out last June and rose through most of the subsequent months. Yet the district unemployment rate was still down only slightly from the peak rate reached earlier. The lagging unemployment figures were due to labor force growth and employers' reluctance to expand operations until recovery seems assured.

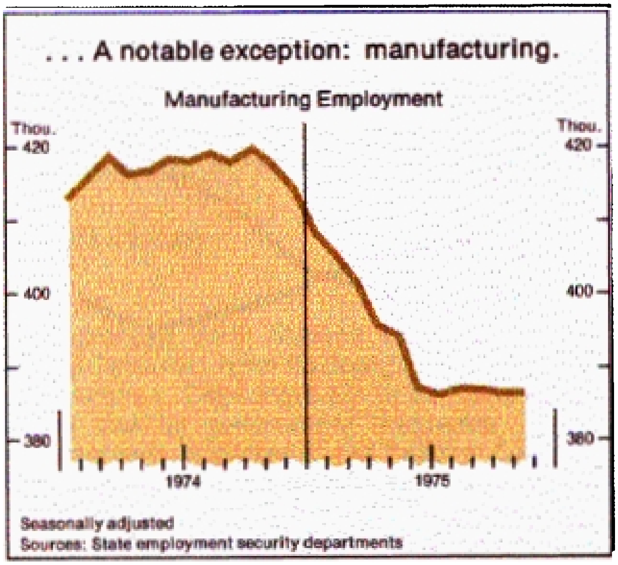
Although unemployment remained high, employment rebounded in most industries . . . .



Seasonally adjusted
Sources: State employment security departments

Industrial Activity

The general pickup in the consumer sector didn't provide much strength to industrial activity either. Manufacturing employment remained weak, and though there were some signs of improvement, gains in other areas of the manufacturing sector were not very robust.



Since the 1975 recession was largely a manufacturing recession, there was particular interest in manufacturing employment. The number of manufacturing jobs fell sharply from October of 1974 to June of 1975; after that the number remained virtually stable.

But conditions may be improving. In the latest Industrial Expectations Survey, conducted in November, expectations for fourth-quarter manufacturing sales were revised upward to 7 percent above a year earlier, perhaps a slight improvement in real terms. In the previous survey, manufacturers had forecast a 4.8 percent sales gain for the fourth quarter.

Given past performance, manufacturers' predictions two quarters ahead—or even one quarter ahead—have not been highly accurate. However, manufacturers tend to revise their expectations over time, and their revised estimates are nearly always more accurate than earlier estimates. (Not since 1967 has the last forecast proved less accurate than an earlier forecast.) Hence, the fact that sales expectations were boosted upward in November is a fairly reliable indication that economic conditions were improving in the district's manufacturing sector.

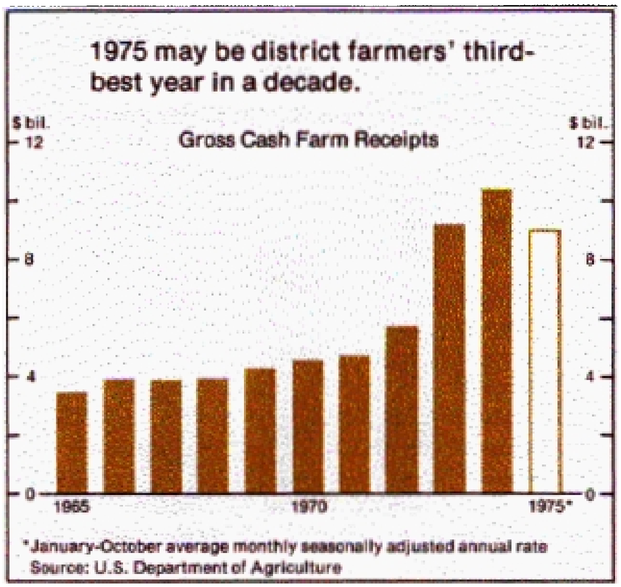
Agriculture

Lately, agriculture has provided a buffer between Ninth District economic conditions and fluctuations in the national economy. This still seemed to be true in the second half of last year. Overall, the district's farm sector had a good second half, though 1975 figures were down somewhat, compared to those of 1974.

Gross cash receipts from farm marketings in the Ninth District ran at the seasonally adjusted annual rate of better than $9.5 billion through most of 1975's second half, following a slow first half. For the entire year, gross receipts from farm marketings were likely to be over $9.0 billion—the third highest total in recent history for district farmers.

The high cash receipts over the summer and fall were due largely to better prices of livestock:

- Hog prices soared in the summer, and though they were down to $48-$50 per hundredweight toward year-end, they were still higher than a year before.
- Cattle prices were also better than last year, though they too dropped seasonally late in the year.



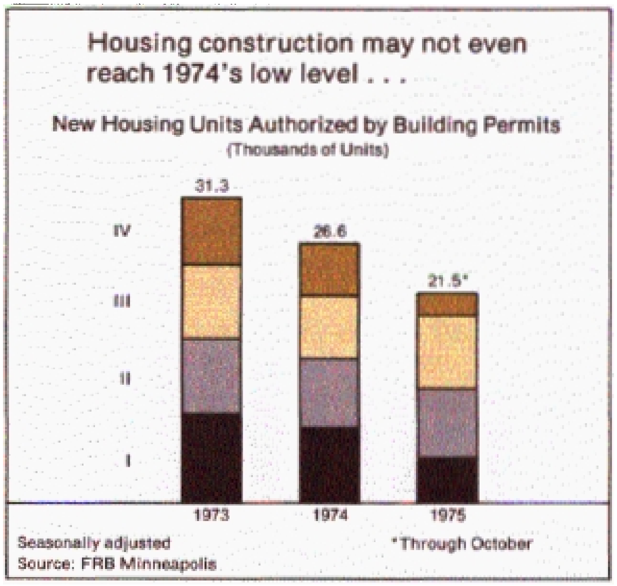
- Dairy prices were at record highs and provided a positive boost to district incomes.
- Prices for feeder cattle remained fairly low, even though demand improved later in the year.

Allowing for farm income other than cash marketings, it appeared that last year's total realized gross farm income before inventory adjustment would be about $9.7 billion. If so, net realized farm income in current dollars, though down rather sharply from 1974, would still be higher than previous years.

Construction

The construction sector gave little impetus to the second-half recovery. Homebuilding activity, as measured by new permits issued, failed to sustain earlier strength, and total 1975 permits seemed likely to fall short of even the low 1974 level.

Nor was there much substance to nonresidential construction, though there was a slight second-half recovery in the sector. The only positive activity in either the district or the nation was accounted for by power and light projects or other public projects.



Finance

As had been true throughout 1975, savings inflows at district banks and S&Ls remained substantial in the fourth quarter, due in part to high levels of savings in both the consumer and business sectors.

Both S&L mortgage loan commitments and loans made rose sharply during the year, even though new home construction remained depressed. Much of the new mortgage lending was apparently being made on existing housing; another reason for the sharp rise was merely higher prices; and still another factor was a higher rate of spending on home improvements.

Business lending by commercial banks closed the year on a flat note in both the district and the nation. At year's end, lending institutions seemed to have ample liquidity to finance increases in both business and consumer spending.

The Safeguard of Contingency Planning for Banks

James N. Duprey

A commercial bank obtains the bulk of its lending resources from its depositors and short-term creditors. Depositors are in part protected against loss by government insurance. However, amounts in excess of the Federal Deposit Insurance Corporation (FDIC) insurance limits and all funds provided by short-term creditors are uninsured and highly sensitive to the ongoing fortunes of the banking business.

Any information suggesting that the safety of a bank is in question can bring a loss of confidence and a withdrawal of these confidence-sensitive funds. If large enough, a withdrawal can suddenly force a bank into an unanticipated search for cash. One solution for a Federal Reserve System member bank experiencing such a need for cash is to apply for temporary assistance under the Federal Reserve's emergency lending program. Any aid given by the Fed provides a bank time to sort out its problems and find a durable solution.

For several years before 1974, little importance had been given to the idea that a bank could lose the confidence of its depositors and creditors. But the events of the past two years—particularly the difficulties of New York's Franklin National Bank—provide a clear reminder that such a loss is not at all impossible.

Considering this real possibility of a loss, contingency planning for meeting an outflow of confidence-sensitive funds would seem to be a necessary safeguard, especially for banks that finance themselves with a sizeable volume of uninsured liabilities. Information derived from such formal contingency plans would also give the Federal Reserve a more precise idea of the credit demands that would be made on its discount window in liquidity crisis situations. The Fed would thus be able to better anticipate the problems of its emergency lending program.

The following discussion will briefly recount several of the key financial developments of 1974, describe the contingency planning exercise recently developed by this bank to encourage planning by large member banks, and discuss the relationship between planning and risk in banking operations.

The Need for Contingency Planning

On Friday, May 10, 1974, Franklin National Bank canceled its second-quarter dividend—the first such action by a major bank since the 1930s—and then topped this with a weekend statement that its foreign exchange department had lost about $14 million since the end of the second quarter and had potential losses of approximately $25 million. Uninsured depositors and creditors, alerted by earlier market speculations on the soundness of Franklin, reacted promptly and began to withdraw substantial amounts of funds.

Having been assured by the Comptroller of the Currency that Franklin was solvent, the Federal Reserve extended emergency credit through the discount window to help offset these losses. This assistance continued until early October when Franklin was declared insolvent. Its remaining deposit liabilities and an equal amount of sound assets were immediately taken over by the European-American Bank and Trust Company.

The May 10 announcement came at a time when financial markets were under severe pressure. Business firms were trying to finance a rising volume of inventories with bank credit; banks were trying to satisfy these demands with funds from the certificate of deposit, Eurodollar, commercial paper, and federal funds markets; and the Federal Reserve was trying to keep the growth of the money supply within desirable bounds. In this environment, interest rates rose to new highs while market prices of fixed income securities dropped rather substantially and, in dropping, forced banks to take losses on their trading account securities. Further, many banks were either suspected of or known to be holding real estate loans that at best were temporarily nonearning, or at worst would ultimately lead to substantial write-offs.

News of Franklin's losses aggravated a difficult situation. Many creditors and large uninsured depositors switched their funds to either federal government obligations or to the ten or so largest banks in the country, feeling that the size of these large banks and the concern of the federal banking authorities would provide relatively greater safety. Smaller banks that had been tapping the national market for funds were seriously affected: some had to pay substantial premiums, others could not borrow all they wanted, and a few, it is rumored, could not obtain funds at all.

The possibility that other banks would experience liquidity problems raised questions within the Federal Reserve concerning its information about the financial position of banks. What banks were likely to experience a loss of depositor confidence? If cash outflows developed, how much assistance would be required of the Federal Reserve, for what length of time, and with what types of collateral?

In an attempt to obtain better information, staff members at the Federal Reserve Bank of Minneapolis asked the larger banks in the Ninth District about their contingency plans for meeting unanticipated withdrawals of confidence-sensitive funds. The responses indicated that planning was well developed in a small minority of cases and quite informal or nonexistent in the remainder.

Few banks in this area have either formalized or implemented contingency planning in the year and a half since the Franklin crisis, despite rather frequent discussion and speculation in the press concerning the soundness of the banking system. The most recent and prominent example of this concern centered on the impact on bank capital positions resulting from a possible default by New York City.

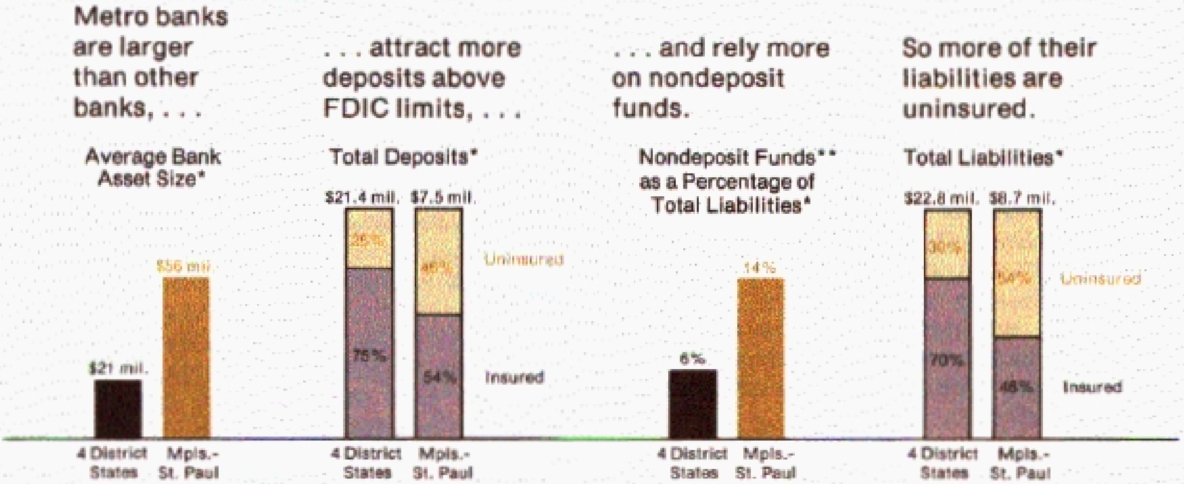
More to the point, an immediate return to the relative tranquillity of the 1950s and 1960s, while possible, is certainly not assured. Individual banks may still on occasion lose the confidence of their creditors and uninsured depositors because of, say, a default on an important group of outstanding loans. There are a variety of events that could trigger a confidence loss. As long as they remain realistic possibilities, contingency planning should be considered "good management practice."

The Planning Exercise

To encourage planning by large member banks, this bank designed a contingency planning exercise that would help individual commercial banks and the Federal Reserve. It was felt that the exercise would be most helpful if the Fed could improve administration of its emergency lending program by acquiring more information about the contingent discount window demands of member banks and their problems in meeting cash outflows and maintaining viability.

The exercise, developed with these information requirements in mind, is subject to change based on the critiques offered by banks who have been asked for comments as well as others who may have an interest.[1] In its

[1]Copies may be obtained from the Research Department, Federal Reserve Bank of Minneapolis, 250 Marquette Avenue, Minneapolis, Minnesota 55480.



*December 31, 1974, at commercial banks

**Federal funds purchased, securities sold under agreement to repurchase, and other liabilities for borrowed money

Source: FRB Minneapolis

preliminary form, the exercise is based on the assumption that a bank's confidence-sensitive liabilities are its large certificates of deposit (both negotiable and nonnegotiable, but excluding those against which pledged securities are held), federal funds purchased and securities sold under agreements to repurchase, amounts borrowed from foreign branches, and funds obtained through the issuance of commercial paper by the holding company parent. These constitute the major part of a large bank's uninsured short-term liabilities. Since uninsured liabilities constitute a relatively minor part of their total resources, smaller banks will likely find the exercise less valuable than will the larger banks.

The exercise considers two contingencies. The first is a complete runoff of confidence-sensitive liabilities for a period of six months. At the end of the runoff period stability is achieved in the sense that the bank does not lose any more of its liabilities but also cannot borrow again to rebuild them. A runoff this large could only occur in the most unusual circumstances: for example, if a bank had a demonstrated inability to generate earnings, reflecting poor management, and then was confronted with sizable losses in loans, securities, or foreign exchange dealings.

The second contingency considered is that of a partial runoff of uninsured liabilities. As in the first case, the bank loses its foreign branch borrowings and securities sold under agreements to repurchase, but unlike the first case, it experiences an outflow of only those certificates of deposit held by customers located outside the Ninth District, federal funds purchased from noncorrespondents, and just a part of the amounts obtained through the issuance of commercial paper by the holding company parent. A crisis of this dimension might come about because of a bank's performance—for example, a poor yearly earnings report and the omission of a dividend—or possibly because of a large bank failure elsewhere that significantly reduces the confidence of all holders of uninsured liabilities.

For each of these cases, the planning exercise requires the bank to indicate the timing and magnitude of its cash outflows and the amounts it would obtain to meet these outflows from maturing assets, asset sales (in normally operating markets), and Federal Reserve borrowing. The bank is also asked to furnish information on its collateral for borrowing and on the assets it would liquidate at the end of the six-month period to repay the Federal Reserve. Finally, with the help of tables supplied with the exercise, the bank provides estimates of the losses that would be sustained on asset sales both during and at the end of the period and compares these losses with the resources available for absorbing them. Losses are defined as the difference between book and market values, where market values are taken to be those of the crisis conditions of June 1974.

An underlying assumption of the exercise is that the only need for cash is to meet the supposed loss of liabilities. Yet a bank, confronted with either of the two contingencies, might want to extend new loan credits to old customers or to customers to whom binding commitments have been made. Cash requirements of this kind have not been allowed for in the exercise because of the difficulty involved in estimating them.

A Further Use of Contingency Planning

The emphasis so far has been on contingency planning as a tool of good commercial bank management and as an informational aid to the Federal Reserve's discount window. Contingency planning also has a potential role in controlling risk in banking operations. To develop this point requires a step back to discuss the Fed's emergency lending program and its relationship to risk incentives.

There is the possibility that a member bank could experience a liquidity problem so serious that, if it tried to meet it by immediately selling its assets, the bank would likely take a substantial loss and jeopardize its ability to survive. Under the current emergency lending program, the Federal Reserve will assist a solvent member bank when it faces such a situation. By extending short-term credit, the Fed prevents an immediate loss and provides time for an evaluation of the problem. It then joins with other supervisory and chartering authorities and the bank's management to consider and choose from the available options (including merger and receivership). If a recovery program is selected, the bank's progress is kept under review at least until it has cleared its debt to the Federal Reserve.

In those cases where, for whatever reason, the problem arises because a bank has lost the confidence of its depositors, an extension of emergency credit provides time for both an evaluation of the problem and a continued withdrawal of funds by uninsured depositors and short-term creditors. If emergency credit is not granted and the bank is forced to close, investors in other institutions, lacking complete information on the safety of their funds, might also lose confidence, withdraw funds, and force further distress-sale losses and possible insolvencies.

It is clear that the role of an emergency lending program would be considerably reduced if all depositors and creditors were insured. The present insurance system, as noted earlier, provides only partial coverage for depositors and none for other creditors. The principal argument in favor of partial coverage is that creditors and large depositors have an incentive to carefully evaluate a bank's safety and thus force it to follow safer practices in order to hold and obtain uninsured funds. Under present institutional arrangements, where the Fed along with other regulators attempts to prevent losses to all depositors for the sake of financial stability, this argument loses force.

In fact, as lender of last resort the Federal Reserve is viewed by some as indirectly providing insurance on the otherwise uninsured liabilities of banks—with no explicit premium paid for the coverage. In these circumstances, a bank may reach for higher earnings by accepting greater risk to the safety of its banking operation, without compensating the insurer for the added risk. To the extent that a bank is concerned with earnings and the improvement of its position, a no-premium insurance system clearly sets up an incentive for greater risk taking.[2] And if that incentive is acted upon, the task of supervisory and regulatory authorities becomes more difficult, since their job is to keep the level of bank risk in line with FDIC insurance contributions.

How does contingency planning fit in? The information generated from planning could be used in conjunction with facts obtained from the regular bank examination process and from periodic balance sheet and income reports to improve supervisory estimates of bank safety. And a bank's contingency plan could serve as a focal point for discussing the bank's projected use of the discount window under different contingencies and the reasonableness of those projections in view of the risk being taken and the appropriateness of that risk level.

MINNESOTA HORIZONS is a report on a special legislative symposium presented early last year. At the symposium, state legislators were briefed on the current status and the future of the people, economy, environment, and government of Minnesota. Copies of the booklet may be obtained from:

MINNESOTA HORIZONS
Minnesota Futures Commission
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[2]The flat rate charged by the FDIC contributes to the problem. In principle, a variable rate insurance premium could set matters straight. Whether such a system is operationally feasible is a question that has been gaining in importance.