

# LOAN COMMITMENTS TO BUSINESS IN UNITED STATES BANKING HISTORY

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The practice of guaranteeing future credit availability to business enterprises, or what is today called the making of loan commitments, has existed since the beginning of banking in the United States. Although the specific forms of such practices have changed considerably in the past two hundred years, the basic concept has nonetheless been ubiquitous from post-Revolutionary times until the present. Banks originally extended loan commitments only to commercial and industrial businesses, but today they also routinely extend such guarantees to financial businesses and individuals. Commitments to non-financial businesses have retained their traditionally prominent position, however, and now represent approximately three-quarters of the dollar volume of total loan commitments.

It has only been since the mid-1960's that the topic of commercial bank loan commitment policies has become an explicit issue in banking circles. Increasing interest in these policies has recently been expressed by the various groups concerned with the banking industry, including bank regulators, students of monetary policy and, of course, bankers themselves. This increased interest is centered on commitment policies involving credit guarantees for non-financial businesses, and this article has the same focus. Two recent developments have caused the increased attention being given bank-business loan commitments. First, the demand for such commitments by business seems to have enlarged considerably. Second, banks have become more willing and able suppliers of loan commitments, and their liberalized approach has led to concern about the potential effects that vastly increased commitment positions might have on the liquidity, and thus the soundness, of individual institutions. These developments have also resulted in an increased awareness of the impact of loan commitments on the magnitude and direction of credit market flows. It is for these reasons that the topic of commercial bank loan commitment policies has emerged, after many years of quiescence, as one of the more important issues in contemporary banking.<sup>1</sup>

<sup>1</sup> For an example of how the loan commitments issue is viewed by regulatory officials, see Arthur F. Burns, "Maintaining the Soundness of Our Banking System," an address before the 1974 American Bankers Association Convention, October 21, 1974, reprinted in the *Monthly Review*, Federal Reserve Bank of New York, Vol. 56, No. 11, November 1974, 263-7.

Even though recognition of the importance of bank loan commitment policies is currently widespread, the reasons for this change in status have not been fully explored: there has been no formal attempt to explain why businesses are now especially eager to obtain guarantees of future credit availability or why the banking system is so willing to satisfy these demands. The lack of such an analysis should not be considered unusual, however, for the entire evolutionary process leading up to the current situation remains somewhat unclear. The body of literature explicitly dealing with commercial bank loan commitment policies is relatively new, and its orientation has been practical, not analytical. This article attempts to fill the analytical gap by tracing the historical development of commercial bank loan commitment policies from the early days of banking through the present.

To study the development of bank loan commitment policies is, essentially, to study the development of the commercial loan, for the use of loan commitments is simply a refinement of the process by which credit is advanced from lender to borrower. This article shows that the evolutionary process has been motivated by changes in business credit requirements under different economic and financial circumstances and that the banking system's response has been guided by prevailing theories of proper banking conduct. Accordingly, loan commitments are examined within the framework of the various liquidity theories that have guided banking practices in the United States. The hypothesis is developed that today's financial environment encourages the demand for loan commitments by business because of recent experiences with credit stringency. Further, the liabilities management conception of banking doctrine allows banks to satisfy this demand without doing violence to their professional code of conduct. The first section of the article provides introductory descriptive background and definitions about current-day loan commitment practices, and the second section develops the historical review. The final section summarizes the major conclusions reached.

## Current Types of Loan Commitment Arrangements

Agreements reached between borrower and lender with the purpose of establishing guarantees of future credit availability are referred to as loan commitment arrangements. The current trend in commercial lending is to structure loans and loan commitments to fit individual borrower needs, not to force all transactions into preconceived patterns. Although this makes it difficult to distinguish sharply among the various forms that loan commitments take, there are certain basic patterns to which these arrangements conform. These basic patterns are classified here according to the maturity of the intended advance, for maturity is a good indicator of the use to which funds are put. Short-term loans are made for seasonal and transaction needs, intermediate-term loans for working capital needs and interim financing, and long-term loans for investment in fixed assets. Borrower demands for loan commitments reflect these specific types of capital requirements.

One other important distinction is between commitment arrangements that are legally enforceable and those that are not. The majority of arrangements are made between banks and their customers on an informal basis, either verbally or in correspondence. In cases where an unequivocal guarantee is desired, however, legal documentation is prepared. Commitment arrangements legally binding to the bank are almost always accompanied by a fee that is typically computed on a daily basis against the unused portion of the commitment. These fees are justified on the grounds that legally binding commitment arrangements place the bank in a position from which it must be prepared to advance funds without recourse. For the same reason it is common practice for the fee to be retained even if the customer does not utilize his commitment.<sup>2</sup> As a practical matter, however, loan commitments backed by the moral obligation of a bank are honored with the same degree of seriousness as those backed by a legal obligation, because failure to meet commitments for reasons other than cause would destroy a bank's credibility in the financial community. Any commitment disclosed to the customer, therefore, has the status of a serious obligation to be honored by a bank if at all possible. The equal status given all types of disclosed commitments is reflected in a survey of eight large Midwestern banks, which found uniform satisfaction

<sup>2</sup> Eli S. Silberfeld, "Loan Commitment Fees—Some Legal Points," *The Journal of Commercial Bank Lending*, Vol. 56, No. 6, February 1974, 65.

of all commitments during the 1969-1970 period of tight money.<sup>3</sup>

**Commitments for Short-Term Uses** Bank loan commitments to business firms that have an intended short-term use for credit take the form of a line of credit. Lines of credit, which account for most of the volume of loan commitments, are classified into two types: the open line of credit and the firm line of credit. The open line of credit is very informal in nature, usually taking the form of a letter from the bank stating a general willingness to lend funds up to some maximum limit over a specific period of time, generally not more than one year in length. The commitment letter does not specify the terms of the arrangement, which the bank may change while the letter is outstanding. The customer may borrow under the open line of credit at his discretion, with interest being charged only on the actual amount of credit he uses. Continuous borrowing under open lines of credit is discouraged, and most banks require that their lines be "cleaned up" (the level of borrowing must return to zero) at some time during the year. This tradition reinforces the intention that credits granted under open lines are for short-term uses only. The fact that advances under open lines of credit are treated the same way as are direct short-term borrowings, always being accompanied by the customer's promissory note, further emphasizes this intention. In return for an open line of credit, the customer is required to pay an implicit fee in the form of compensating demand deposit balances.

A firm line of credit closely resembles an open line with the exception that a fee is paid based on the unused portion of the arrangement. It thus has legal status but in terms of service rendered offers the customer nothing more than an open line of credit.

**Commitments for Intermediate-Term Uses** The revolving credit is a device that has come into use in response to needs for short-term but continuous credit or for credit of uncertain duration. It guarantees the customer use of fluctuating amounts of bank credit over an extended period of time, usually two or three years, and has legal status. An explicit fee based on the unused portion of the commitment is always involved, and recently a number of banks have instituted an additional charge based on the

<sup>3</sup> Douglas A. Hayes, *Bank Lending Policies: Domestic and International*, Michigan Business Series, Vol. XVIII, No. 4, The University of Michigan, 1971, p. 79.

entire amount of the commitment.<sup>4</sup> The fee commonly charged on the unused portion is one-half of one percent per annum, while that levied on the entire commitment is one-quarter of one percent per annum. Compensating balances are also required.

Given the formal character of revolving credit arrangements, a rate charged on borrowing under commitment is specified. The rate usually has a fixed relation to the prevailing prime rate, and in this way the bank is assured of a return that is realistically related to existing credit market conditions. The customer's borrowing privilege depends upon his ability to meet certain financial conditions specified in a set of protective covenants contained in the contract, a feature designed to protect the bank from adverse changes in credit risk.

**Commitments for Long-Term Uses** Business credit needs related to the acquisition of fixed assets can sometimes be satisfied using bank term loans that have a maximum maturity of about ten years. Term loans represent a popular type of debt financing for moderately-sized companies that do not have access to public credit markets and for larger corporations that may find bank credit terms more flexible than either public debt issues or equity financing. When made directly, term loan commitment arrangements obligate the bank to extend up to a specified maximum amount of credit upon request, provided the customer meets certain financial requirements contained in the contract. Funds can be taken down as needed or the entire amount can be obtained at one time, but either way a long-term promissory note is made out. A fee is charged based on the unused portion of the commitment over its life. The volume of direct term loan commitments is not large relative to other types of loan commitments.

Often revolving credits are supplemented with a term loan option that allows the customer to convert the unused portion of his commitment into a term loan at the arrangement's expiration. The revolving credit with a term loan option is a very flexible arrangement that appeals to businesses engaged in projects that take several years to complete. The revolving credit feature of the contract provides "bridge" financing that can be activated as necessary, while the term loan feature provides an optional source of long-term financing, should conditions in the bond or equity markets prove unfavorable at the time a project is completed.

<sup>4</sup> "Citibank Increases Loan-Pledge Fees Charged Big Firms," *Wall Street Journal*, September 24, 1974, p. 39, and Ben Weberman, "Holland Says Credit Line Commitment Prices Should be More Than Doubled," *American Banker*, November 12, 1974, p. 1.

## Loan Commitment Policies and Theories of Bank Liquidity

**The Commercial Loan Theory of Credit** The first theory to govern banking practices in the United States was imported from Great Britain, for in this matter, as in so many others, early American thought was strongly influenced by prevailing opinion in the mother country. Thus the real-bills doctrine, a most persistent and popular British conception of proper banking conduct, came to play a key role in the early development of U. S. banking theory and practice.

The real-bills doctrine assumed form in 18th century British banking circles, where an oral tradition grew up regarding its various aspects. Adam Smith provided the first systematic exposition of the doctrine in his *Wealth of Nations* (1776), and thereafter many writers contributed to its refinement. During the 19th century, a turbulent formative period for U. S. banking practices and legislation, it was the focal point of debate and discussion in British banking. For the British banking school, the real-bills doctrine represented a central thesis, and its relevance to both banking and monetary management was stressed.<sup>5</sup> Basically a theory of asset management that emphasized liquidity, the doctrine held that banks should restrict their earning assets to "real" bills of exchange (discounted paper financing the movement of goods) and short-term, self-liquidating advances for commercial purposes. In this way, it was argued, individual banking institutions could maintain the liquidity necessary to meet the requirements of deposit withdrawals on demand. Under a somewhat modified character this basic doctrine came to be known in the U. S. as the commercial loan theory of credit, and it remained the rubric of banking until the 1920's.

For about the first fifty years of U. S. banking history, the commercial loan theory of credit was easily compatible with practical standards of conduct, which were quite primitive. The development of commercial banking in this country had a very slow beginning, due largely to the limited demands and special preferences of the colonists for credit. In Colonial times, of course, the economy was largely agrarian, and a flourishing manufacturing industry with heavy capital demands simply did not exist. Given the relatively backward state of the economy, therefore, aggregate credit demand was not large. Existing requirements for financial assistance were

<sup>5</sup> With respect to monetary management, it was argued that adherence to the real-bills doctrine would cause aggregate liabilities of the banking system (notes and demand deposits) to vary in quantity according to the state of real economic activity. In effect, then, the money supply would always be maintained at the most desirable level in a virtually self-regulated manner.

satisfactorily met by individuals (especially merchants), Colonial governments, and colonizing companies. English banks also counted as important sources of credit for Colonial enterprise. In short, important banking functions were performed without the aid of domestic banks, and this combination of circumstances acted to retard the development of a commercial banking industry. It was not until after the Revolutionary War that the first bank in this country, the Bank of North America, was established in 1782 in Philadelphia.

Merchants formed the Bank of North America, as they did most other early banks, in order to make credit more conveniently available for financing trade. The loans of these early banks were of a self-liquidating nature, and they conformed to the appropriate type of asset prescribed by the commercial loan theory of banking. Also, it is reasonable to assume that banks customarily entered into informal loan commitment arrangements with businesses requiring funds for actual short-term purposes. This happy situation did not prevail for long, however. In the second quarter of the 19th century, the U. S. entered a period of sustained and vigorous economic growth. This process required large amounts of capital, especially of a long-term nature, and these demands were partly directed toward the banking system. Consequently, banks were confronted with the problem of meeting credit demands directly at variance with their accepted code of conduct, which emphasized short-term lending.

Without doubt commercial banks did satisfy these demands for longer-term credit, including those associated with fixed investment programs. Yet it is also true that, in form at least, a facade of short-term lending was maintained. This occurred as the bill of exchange, so prominent from Colonial times, slowly disappeared and was replaced by the promissory note as the most common credit instrument, a transition largely completed by the end of the Civil War. Through use of the promissory note on a basis of continuous renewals, banks were able to conform to the letter of the law, as far as theory was concerned, and still meet the long-term credit demands of business. By informally guaranteeing renewal of short-term notes, banks in effect began granting loan commitments for long-term credits to their customers. So completely did the short-term promissory note fulfill the various credit demands of business through repeated extensions that it came to be regarded as accommodation paper, to be used for general credit needs and not exclusively for self-liquidating com-

mercial transactions.<sup>6</sup> Starting in the 1870's, this practice became more overt as banks began to rely on financial statement analysis as a basis for making advances. The use of loan proceeds was left more and more to the discretion of business customers who, upon examination, were found to be financially sound. The earliest analysis of the uses of short-term, unsecured bank loans, made for the several years immediately preceding 1918, places at 20 percent the proportion used for investment in fixed capital.<sup>7</sup> The same source estimates that between 40 and 50 percent of short-term, unsecured loans made at banks in large cities were commonly renewed at maturity.<sup>8</sup> This, it seems, was the state of affairs that existed prior to 1920, the beginning of the next major period of evolutionary change in banking.

The commercial loan theory of credit became obsolete both because of its conceptual flaws and its impracticality. A critical underlying assumption of the theory held that short-term commercial loans were desirable because they would be repaid with income resulting from the commercial transaction financed by the loan. It was realized that this assumption would certainly not hold during a general financial crisis even if bank loan portfolios did conform to theoretical standards, for in most commercial transactions the purchaser of goods sold by the original borrower had to depend to a significant extent on bank credit. Without continued general credit availability, therefore, even short-term loans backing transactions involving real goods would turn illiquid. Rigid adherence to the orthodox doctrine was, furthermore, a practical impossibility if banks were to play a role in the nation's economic development. Moreover, the practice of continually renewing short-term notes for the purpose of supporting long-term capital projects proved unacceptable. The failure or inability of banks to tailor loan arrangements to the specific conditions encountered with longer-term uses in fact contributed to the demise of the practice. By the 1920's these factors became strong enough to work a change in basic banking doctrine.

**The Shiftability Theory and the Doctrine of Anticipated Income** The shiftability theory of liquidity replaced the commercial loan theory of

<sup>6</sup> Harry E. Miller, *Banking Theories in the United States Before 1860*, Cambridge: Harvard University Press, 1927, p. 179.

<sup>7</sup> H. G. Moulton, "Commercial Banking and Capital Formation, Part II," *The Journal of Political Economy*, Vol. XXVI, No. 6, June 1918, 648.

<sup>8</sup> H. G. Moulton, "Commercial Banking and Capital Formation, Part III," *The Journal of Political Economy*, Vol. XXVI, No. 7, July 1918, 707.

credit about 1920, and it remained prominent until the late 1940's, when it was supplemented by the doctrine of anticipated income. Formally developed by Harold G. Moulton in 1918, the shiftability theory held that banks could most effectively protect themselves against massive deposit withdrawals by holding, as a form of liquidity reserve, credit instruments for which there existed a ready secondary market.<sup>9</sup> Included in this liquidity reserve were commercial paper, prime bankers' acceptances and, most importantly as it turned out, Treasury bills. Under normal conditions all these instruments met the tests of marketability and, because of their short terms to maturity, capital certainty. The shiftability theory was enhanced during the 1930's and 1940's by the rapid growth in volume of short-term U. S. Government obligations.

Unlike the old commercial loan theory of credit, the shiftability theory provided a theoretical framework that could accommodate new and innovative approaches to business lending by commercial banks. This was so because liquidity meant the ability to exchange secondary reserve assets for cash, an approach that relaxed the constraints previously placed on loan arrangements. As bank holdings of U. S. Government securities grew, the thrust of the liquidity question was increasingly transferred from loan to investment portfolios. Bank lending techniques changed dramatically against this background, a process that was stimulated as a result of changes in business credit demands after the Great Depression.<sup>10</sup> It is under the shiftability theory of liquidity that commercial bank loan commitment practices began to assume the form that prevails today.

Perhaps the biggest breakthrough in bank lending during this period was explicit recognition of the concept of term lending, a change that signified a clear break with the commercial loan theory of credit. Term lending was first introduced in the early 1930's and came as a response to conditions imposed by the Great Depression. The tradition of making and continuously renewing short-term loans for what amounted to long-term credit needs broke down in the period 1929-1933. One result was a purification of the concept of loan commitments. Henceforth, commitment arrangements would more realistically conform to the intended uses of credit, a much im-

<sup>9</sup> *Ibid.*, p. 723.

<sup>10</sup> The change in debt financing techniques over the period 1920-1940, especially with regard to bank lending, has been described as "... a technical revolution as far-reaching in its significance as technical advances in industrial production, transportation or agriculture." See Neil H. Jacoby and Raymond J. Saulnier, *Business Finance and Banking*, National Bureau of Economic Research, E. L. Hildreth and Company, 1947, p. 139.

proved situation that would contribute to their usefulness and respectability.<sup>11</sup>

Even though many short-term loans were extended with the understanding that they would be used for purposes that would not realistically permit repayment of principal in the short run, some banks were forced into demanding repayment as a result of runs on their deposits. These demands for repayment occurred at a time of depressed business conditions and general financial difficulty and resulted in a number of business bankruptcies. The unfortunate lessons learned from this set of circumstances led to a more realistic consideration of the need for a true long-term bank credit instrument. Additionally, the post-Depression years found many industrial firms with outdated and deteriorated plant and equipment, renovation of which increased the demand for long-term credit. Acquisition of funds through debt and equity capital offerings was discouraged by the high yields on such issues relative to the prime rate on bank loans and by the restrictive provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.<sup>12</sup> In the business revival that began in 1932, therefore, banks represented a preferred source of long-term credit, and the need for a lending instrument to accommodate these demands was that much greater.

Acceptance of the term loan by bank regulatory authorities was not long in coming. Two events in particular gave the new practice an official air of respectability. The first was an amendment to the Federal Reserve Act through the Banking Act of 1935, by which banks were extended the privilege of borrowing from the Federal Reserve Banks against the security of *any* sound asset acceptable to the Reserve Bank at a penalty rate of one-half of one percent per annum higher than the highest discount rate in effect on eligible paper.<sup>13</sup> Prior to this amendment, this privilege was available for use only in "exceptional and exigent circumstances" when a member bank's supply of assets eligible for rediscount was exhausted. This amendment extended the scope of the shiftability theory by allowing long-term assets,

<sup>11</sup> An argument that continuous borrowing for capital investment purposes remained prevalent at least through 1955 is made in "Continuous Borrowing Through 'Short-Term' Bank Loans," *Business Review*, Federal Reserve Bank of Cleveland, September 1956, 6-13. This thesis seems unlikely given the strong acceptance of term lending. While there is no doubt that continuous business indebtedness was and still is common, it can more easily be explained in terms of separate borrowings for distinct short-term credit uses. Commercial loan officers do encounter situations where short-term loan funds are channeled into longer-term uses, but these are generally unintended exceptions to the general norm.

<sup>12</sup> A good synopsis of these background conditions is provided in George S. Moore, "Term Loans and Interim Financing," in Benjamin H. Beckhart, (ed.), *Business Loans of American Commercial Banks*, New York: The Ronald Press Company, 1959, pp. 210-11.

<sup>13</sup> Federal Reserve Act § 10(b), 12 U.S.C. § 347b, as amended by § 204 of the Banking Act of 1935 (49 Stat. 705).

including term loans, to be used as collateral for advances from the Federal Reserve Banks. The second event was the 1938 change in bank examination standards that abandoned the "slow" classification for bank assets based solely on maturity criteria.<sup>14</sup> This examining change recognized the fact that banks had to substitute new forms of loans for their lost volume of short-term commercial loans and emphasized intrinsic soundness rather than liquidity through quick maturity.

The results of a bank term loan survey conducted in 1941 reveal that term lending grew rapidly in the 1930's and represented an important part of total loan volume.<sup>15</sup> Eighty-one of 99 respondent banks, most of which were large institutions, held significant amounts of term credit at mid-year 1941; for 50 of these banks, term loans constituted 22 percent of total loans and discounts. Historical data provided by 56 of the banks revealed that their outstanding term loans increased three and one-half times from 1935 to 1940, reaching a level of \$967 million. It appears, however, that direct term loan commitments were not employed to a very significant degree in the 1930's and 1940's. Term loan commitment arrangements were available under the name of call credits, for which standby fees were charged.<sup>16</sup>

The revolving credit also appeared about the same time as the term loan and probably originated as part of the new long-term lending arrangement. Early discussions treat the revolving credit as a form of term lending because of its multi-year contractual nature, even when the term loan option is not part of the arrangement. Nevertheless it is significant that the revolving credit did appear, for it represents another advance in financial technique. Early usage of revolving credits was very limited, their number being estimated as only 5 percent of the number of term loans outstanding in 1941.<sup>17</sup> There appears to have been some resistance on the part of banks to enter revolving credit arrangements, presumably due to the uncertainties involved with credit usage. After 1947 an interest escalator provision based on the Federal Reserve discount rate in the district where the loan was made was usually included to help mitigate interest rate uncertainties.<sup>18</sup>

<sup>14</sup> Board of Governors of the Federal Reserve System, *Annual Report*, 1938, pp. 37-8.

<sup>15</sup> Neil H. Jacoby and Raymond J. Saulnier, *Term Lending to Business*, National Bureau of Economic Research, Camden: The Haddon Craftsmen Inc., 1942, pp. 135-40.

<sup>16</sup> Herbert V. Prochnow, *Term Loans and Theories of Bank Liquidity*, New York: Prentice-Hall, Inc., 1949, pp. 25-6.

<sup>17</sup> Jacoby and Saulnier, *Term Lending to Business*, p. 77.

<sup>18</sup> Herbert V. Prochnow, *Term Loans and Theories of Bank Liquidity*, p. 25.

A major defect was discovered in the shiftability theory similar to the one that led to abandonment of the commercial loan theory of credit, namely that in times of general crisis the effectiveness of secondary reserve assets as a source of liquidity vanishes for lack of a market. The role of the central bank as lender of last resort gained new prominence, especially in view of the changes of 1935 that broadened its potential role, and ultimately liquidity was perceived to rest outside the banking system. Furthermore, the soundness of the banking system came to be identified more closely with the state of health of the rest of the economy, since business conditions had a direct influence on the cash flows, and thus the repayment capabilities, of bank borrowers. The shiftability theory survived these realizations under a modified form that included the idea of ultimate liquidity in bank loans resting with shiftability to the Federal Reserve Banks. Under this institutional scheme, the liquidity concerns of banks were partially returned to the loan portfolio, where maintenance of quality assets that could meet the test of intrinsic soundness was paramount. The doctrine of anticipated income, as formalized by Herbert V. Prochnow in 1949, embodied these ideas and equated intrinsic soundness of term loans, which were of growing importance, with appropriate repayment schedules adapted to the anticipated income or cash flow of the borrower.<sup>19</sup>

The credit demands of business were well accommodated under this system of banking policy, and the use of loan commitments was freely pursued into the 1950's. This is shown in the Survey of Member Bank Loans for Commercial and Industrial Purposes, conducted by the Federal Reserve System as of October 5, 1955, which found that 56 percent of the 2,000 participating banks extended lines of credit.<sup>20</sup> In this survey virtually all banks with deposits of \$100 million and over extended credit lines as did 38 percent of the banks with less than \$20 million in deposits. Changing economic conditions, however, placed extra demands on the banking system that resulted in a new approach to balance sheet management, and businesses faced new financial challenges as the 1960's progressed. Under this emerging state of affairs, bank loan commitment policies would come to play a more important part in the credit process.

**Liabilities Management** This country entered a sustained period of rapid credit expansion in the

<sup>19</sup> *Ibid.*, p. 402.

<sup>20</sup> Caroline H. Cagle, "Credit Lines and Minimum Balance Requirements," *Federal Reserve Bulletin*, Vol. 42, No. 6, June 1956, 573-9.



1950's that acquired explosive proportions in the 1970's. Banks were eager to participate in this process and share in the profit opportunities that it implied. They succeeded but only by radically changing the approach to liquidity that had been maintained from the earliest days of banking. From the 1780's through the 1950's, banks sought to assure their liquidity almost exclusively on the asset side of the balance sheet, the only exception being occasional borrowing at the discount window. In the 1960's they turned to the liability side of the balance sheet on a massive scale, and liabilities, especially short-term liabilities in nondeposit form, came to be viewed as completely controllable. This approach, which prevails today, is known as the liabilities management theory of liquidity.

Table I shows the extent of increases in credit from the 1950's to the 1970's, along with the changing importance of commercial banks in supplying this credit. In the eight-year period 1952-1959, a yearly average of \$33.2 billion was raised in U. S. credit markets, and commercial banks provided 21 percent of this amount. By the 1970's, the yearly average of funds raised increased to \$148.6 billion, of which 41 percent was supplied by the banking system. Corporate business played an important part in this credit expansion, its yearly average increase in funds raised moving from \$8.0 billion in the 1950's to \$49.3 billion in the 1970's; the banking system advanced 21 percent of these funds in the 1950's and 34 percent in the 1970's.

The flow of funds supplied by the banking system to the nonfinancial business sector has not been smooth, especially since the late 1960's. Chart 1, a plot of the three-month moving average of growth rates in bank business loans stated at annual rates, illustrates the magnitude and frequency of swings in bank business credit since 1960 and highlights the instability that has become prevalent in the last decade. Since the mid-1960's, there have been several major swings toward tightness that have been induced primarily as a result of restricted credit supply. These episodes have had an important expectational effect on the behavior of businesses. As a result of these episodes, business financial managers have been encouraged to seek protection against the possibility of recurring periods of tight credit, a behavioral trend especially noticeable since the "credit crunch" of 1966.

In 1966 the Federal Reserve adopted measures designed to restrict the rate of credit creation, which had accelerated rapidly in conjunction with business investment spending and Government expenditures

Table I  
**TOTAL FUNDS RAISED IN CREDIT MARKETS\* AND FUNDS SUPPLIED BY COMMERCIAL BANKS**

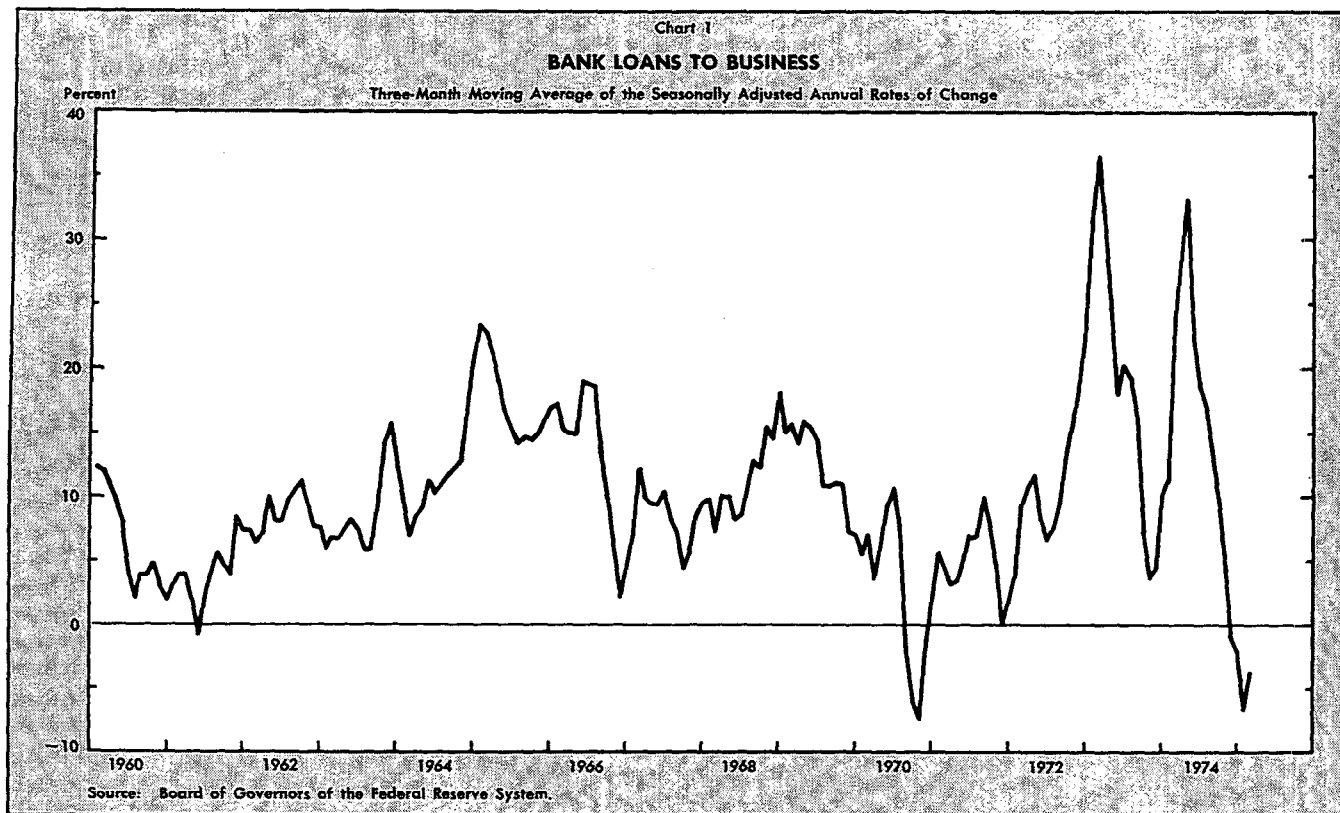
Period	Average Annual Flows \$ Billions			
	All Nonfinancial Sectors		Nonfinancial Corporate Business Sector	
	Funds Advanced	Bank Loans	Funds Advanced	Bank Business Loans
1952-1959	33.2	7.1	8.0	1.7
1960-1969	64.4	22.3	19.8	6.1
1970-1974	148.6	61.4	49.3	16.8

\* Excluding equities.

Source: Board of Governors of the Federal Reserve System, Flow of Funds.

for the Vietnam War. This had a direct impact on commercial banks and, through them, on the financial markets in general. For some time prior to 1966, commercial banks had been restructuring their asset portfolios to include more higher-yielding assets, especially commercial loans and municipal bonds, at the expense of short-term Government securities. The emphasis on commercial lending, depicted in Chart 1 by high growth rates for 1965 and the first half of 1966, was supported by sales of CD's. When the yield on competing money market instruments rose above the 5.5 percent maximum rate on new CD issues in the summer of 1966, the Federal Reserve, contrary to past policy, did not raise Regulation Q ceiling rates. With this source of loanable funds effectively cut off, banks reacted by liquidating their holdings of municipal bonds. Given other unfavorable conditions in the municipal bond market, this action had the result of lowering prices dramatically, making further sales impossible. Banks found themselves with no other choice than to curtail business lending, and credit became unobtainable at any price—except for businesses with prearranged loan commitments. If any doubts about the possibility of recurring shortages of credit persisted after 1966, a similar experience in 1969 certainly acted to dispel them.

It is no coincidence that business demands for bank loan commitment arrangements surged and reached unprecedented proportions following the tight money episodes of 1966 and 1969, for these events demonstrated that the vigorous use of monetary policy for purposes of economic stabilization could result in severe credit shortages. The eagerness of businesses to enter into loan commitment



arrangements for defensive reasons, and to intensify their use of such arrangements during tight money periods, is clearly attested to in at least one bank's case history.<sup>21</sup> In this example the dollar volume of disclosed lines of credit rose moderately but steadily from mid-1960 to mid-1966 and then leveled off before resuming an upward trend in 1969. Total firm commitments trended slightly downward from 1960 through early 1964 but then began a rapid climb that lasted through 1966. This rapid upward trend in total firm commitments was also present in the first half of 1968 and 1969 before falling off in response to an internal policy designed to reduce their volume. While the ratio of borrowings under disclosed lines of credit to total disclosed lines of credit showed only modest positive changes in 1966 and 1969-1970, the similar ratio for firm commitments increased remarkably in response to tight money. In the eighteen-month period from the beginning of 1965 to the middle of 1966, the ratio of total borrowings under firm commitments to total firm commitments increased from about 35 percent to over 55 percent; in the two and one-half year period from early 1968 to

mid-1970, the ratio increased from about 37 percent to about 60 percent.

It appears that aggregate demand for loan commitments continued to increase rapidly in the early 1970's. The results of a sample survey of large commercial banks revealed that the dollar volume of unused loan commitments to business firms increased by 68 percent between July 1970 and July 1972. The respective percentage increases were 55, 45, and 200 for confirmed lines of credit, revolving credits, and term loans.

Certain alterations in Regulation Q implemented between 1970 and 1973 signaled a change in emphasis for monetary policy away from credit availability toward the price rationing mechanism. By removing interest rate ceilings on CD's, a process completed in July 1973, banks were provided with the opportunity to remain active competitors for funds even in periods of rising interest rates. This basic change indicated to business borrowers that in future periods of tight money, the banking system would have the freedom to meet their credit demands, although at increased cost. While this may have initially reduced the perceived need of businesses for loan commitment arrangements, it has since become clear that, even under this new set of ground rules, periods may still occur that find banks unable to fulfill all business credit demands directed to them. The first example of this

<sup>21</sup> The behavior of aggregate firm commitments and lines of credit at Mellon National Bank and Trust Company over the period 1960-1972 is described in James H. Higgins, "Loan Commitments," *The Journal of Commercial Bank Lending*, Vol. 54, No. 11, July 1974, 2-9. The techniques for managing loan commitments presented in this article are widely considered to be a model for other banks to follow.



situation occurred in the summer of 1974, when a two-tiered market for regional and money center bank CD's developed, which made it difficult for some banks to maintain or achieve desired liability positions.<sup>22</sup>

It appears, then, that conditions continue to exist that make loan commitment arrangements desirable as protection against periods of credit stringency. At the same time, however, the willingness of banks to enter confidently and freely into such arrangements may have been reduced as a result of imperfections discovered in the liabilities management concept of liquidity. Given their adaptability in meeting many types of special business financial requirements throughout the history of U. S. banking, there is every reason to suppose that banks will also meet the current-day need for protection of credit availability. The current mood of prudence and caution will hopefully act to keep bank compliance with such demands within a range that can be reasonably managed under all possible financial market conditions.

### Summary and Conclusions

Commercial banks have engaged in the practice of making loan commitments to business enterprise from the beginning of modern banking in the United States. Since the mid-1960's, however, there has been a significant change in approach to loan commitments that has resulted in enlarged demand and liberalized supply, thus increasing contemporary interest in the topic. This article traces the historical development of commercial bank loan commitment policies and offers an explanation for their recent increase in importance, using as a reference framework the various liquidity theories that have governed banking conduct in the U. S.

From the 1780's through the 1950's, commercial banks, according to prescribed theory, insured their liquidity by concentrating on asset management. Under the commercial loan theory of credit, theoretical restrictions on asset composition prevented banks from making long-term business loans. Informal renewals of short-term loans, implying guarantees of continuing credit, reconciled theory and the necessity to meet business demands for longer-term credit. Beginning in the 1920's with the shiftability theory of liquidity, an atmosphere more tolerant of

innovation was introduced and prevailed. Term lending began in 1933 and then grew rapidly, one result of which was to purge loan commitment practices of those arrangements whereby continuously renewed short-term loans supported long-term business investment. Term loan commitments and revolving credits were developed in this period, although they did not acquire early importance.

The liabilities management concept of liquidity became prevalent in the 1960's, at a time when aggregate credit demands were growing rapidly and as financial markets showed increasing instability. Business demands for loan commitments as a defense against credit shortages increased in the late 1960's, especially in response to the tight money episodes of 1966 and 1969, and were accommodated by banks operating under the liabilities management framework. While the perceived needs of businesses for defensive loan commitment arrangements may have moderated between 1970 and 1973 as a result of the removal of the ceilings on CD yields, the experience of restricted CD markets and credit availability in the summer of 1974 had the opposite effect. The general conditions that encourage demands for loan commitments continue to prevail, and past experience indicates banks will aggressively attempt to meet these demands.

The legitimacy of prudently managed loan commitment practices cannot be disputed, for they represent an economically useful service. Today loan commitments are especially important to businesses as a type of hedge against financial uncertainty. It does seem, however, that commercial banks and bank regulatory authorities should modernize their thinking to keep up with contemporary changes in the use of loan commitments. For their part, banks should recognize that loan commitments have become a distinct financial service and treat these arrangements accordingly. This includes the careful monitoring of loan commitment positions as part of the overall planning process and adoption of expanded fee schedules that fully cover the risk exposure connected with providing such services. Regulatory authorities should make an explicit determination of what constitutes appropriate bank involvement in the commitments area and apply these standards in the examination process. In these ways, ambiguity will be reduced, and some assurance will be provided that loan commitments will not occupy the position of a potential hazard to the banking system's stability.

<sup>22</sup> The financial market disturbances in 1974 involving bank liabilities solicitation are treated in "Banking Developments in 1974," Federal Reserve Bank of Richmond, *Annual Report*, 1974, p. 13.