Form F. R. 511 Mr. Young

TO Mr. Thomas

FROM Mr. Thurston

REMARKS: 5/1/46

What do you think of this request for 100 copies of our article on bank profits.

I would like very much to know what your experts think of Howard Stoddard's attached analysis.

E.T.

CHAIRMAN'S OFFICE

MICHIGAN NATIONAL BANK

BATTLE CREEK FLINT GRAND RAPIDS LANSING
MARSHALL PORT HURON SAGINAW

LANSING, MICHIGAN

HOWARD J. STODDARD
PRESIDENT

April 24, 1946

Mr. M. S. Eccles, Governor
Federal Reserve Board
Washington, D. C.

Dear Marriner:

I have just completed reading an article from the Federal Reserve Bulletin for April, under the caption, "Member Bank Profits for 1945." This is one of the best things of its kind that has been published in recent years, and I am wondering if your Board has considered the possibility of having it published separately, and more widely distributed, as the number of people who will read it in the Bulletin might be relatively few.

I know that our organization would like to have at least 100 copies of this article, in order that they might be placed in the hands of all of our officers and directors.

As you are probably aware, I dug up some information for my own guidance from FDIC reports, made up rather a home-made compilation and sent it to a number of banks. The response from this was sufficiently great that I am sure the excellent detailed report that might be made from your office would be a valuable contribution to bank literature.

Cordially yours

Howard

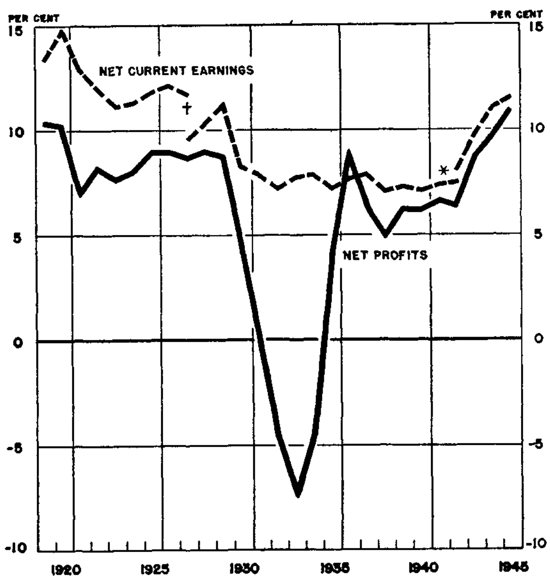
President

HJS:M

MEMBER BANK PROFITS IN 1945 *

According to preliminary reports, net profits after taxes of member banks of the Federal Reserve System increased further in 1945. This increase was due in part to a continued growth in earnings on Government securities and in part to exceptionally large profits obtained from sales of securities. The latter source of earnings is largely temporary and may not be expected to continue, and, with the prospects for debt retirement by the Treasury, it is likely that bank earnings on Government securities have reached their peak. Bank expenses and taxes also increased further in 1945, and somewhat higher expenses may be expected in 1946, although taxes will be lower.

MEMBER BANK EARNINGS AND PROFITS
AS PERCENTAGES OF CAPITAL ACCOUNTS



† Prior to 1927, profits on securities were included in current earnings.
* Beginning in 1942, taxes on net incomes are not, while recurring depreciation is, a current expense deduction from earnings.

Net profits after taxes of all member banks aggregated 794 million dollars in 1945, and the ratio of net profits to total capital accounts was 11.0 per cent. About one-third of the net profits was paid out as dividends to stockholders; the remainder was added to capital accounts.

As is shown in the chart, net profits after taxes of member banks have increased rapidly since 1942, from the relatively low level that prevailed during the 1930's. Unlike manufacturing profits, bank profits did not spurt up suddenly at the beginning of the war; indeed, profits in 1942 were below those in 1941 and were not much above the general average of the 1930's. Since 1942, however, bank profits have exceeded those of the late 1920's, the latest period of high earnings.

The present level of bank profits, as compared with that of the late 1920's, results from circumstances markedly different from those which prevailed at that time. Total earning assets of banks in 1945 were about three times as great as in 1929. The rate of interest return on these earning assets, however, was decidedly lower. While the level of market interest rates had fallen substantially for a decade and a half, the average return received by banks from earning assets had dropped even more. The composition of earning assets had shifted from a dominance of loans, a high-yield asset, to United States Government securities, the lowest yielding of all earning assets. At the same time, however, banking losses had also declined greatly.

Nearly all of the wartime growth in bank earnings is the result of income and profits from United States Government securities. Earnings from other sources remained almost unchanged over the war period, while income from Government securities increased rapidly and now constitutes almost half of gross earnings.

This characteristic of the wartime growth in earnings has been accompanied by a narrowing of differentials in earnings among classes of banks and among individual banks. In 1940 the estimated average return received from Government securities by country banks was almost twice as great as that received by money market banks. At present there is little difference between these groups of banks. Furthermore almost every bank, regardless of size, is now earning some profit, and the profits ratios of most banks cluster around the average, that is, fall within the range of about 9 to 12 per cent.

* This article was prepared by Roland I. Robinson and Caroline Cagle of the Board's Division of Research and Statistics.

Factors Influencing Bank Profits

The most important factor explaining the growth in bank profits over the past five years has been the increase in interest received on Government securities. The revenue from this source for member banks has increased about three-quarters of a billion dollars. As shown in the accompanying table, gross earnings of member banks increased by about the same amount while expenses increased by 345 million dollars. This increase in expenses was due to a variety of factors, the most important of which was the rise in salaries and wages. Recoveries and profits on securities sold were large during this period and losses were smaller than in earlier years. At the same time taxes made deeper inroads on bank earnings as the war progressed, and in 1945 member banks were paying more than a quarter of a billion dollars in income taxes.

Sources of Income

The principal sources of bank income from current operations in the period 1919-45 are shown in the accompanying chart. It is clear that in this interval of more than 25 years interest and dividends on securities has supplanted earnings on loans as the principal source of bank earnings.

For the year 1945 the amount of interest on United States Government securities reported by member banks amounted to 997 million dollars, or almost half of gross earnings. For all com-

MEMBER BANK EARNINGS, EXPENSES, AND DIVIDENDS 1929, 1935, AND 1940–45

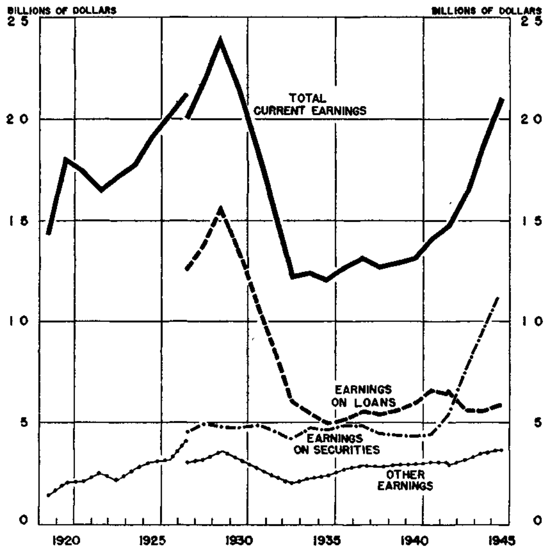
[In millions of dollars]

Item	1929	1935	1940	1941	1942	1943	1944	1945
Earnings	**2,399**	**1,207**	**1,323**	**1,417**	**1,487**	**1,650**	**1,874**	**2,100**
Interest and dividends on securities:								
United States Government	473	467	•229	•239	•336	•594	•802	997
Other			202	206	204	172	158	•153
Interest and discount on loans	1,563	498	595	665	649	563	563	•585
Other earnings	363	242	297	307	298	321	351	•365
Expenses	**1,684**	**833**	**921**	**988**	**1,002**	**1,039**	**1,127**	**1,266**
Salaries and wages	464	334	400	426	461	487	525	•586
Interest on time deposits	445	196	147	140	128	124	144	•180
Other expenses	[1]775	[1]303	[1]374	[1]422	413	428	458	•500
Net current earnings before taxes on income	**[1]715**	**[1]374**	**[1]402**	**[1]429**	**485**	**611**	**747**	**834**
Recoveries, profits on securities, etc.	**137**	**376**	**303**	**278**	**188**	**312**	**318**	**•427**
Losses and charge-offs	**295**	**538**	**356**	**318**	**223**	**251**	**232**	**•200**
Profits before income taxes	....	....	....	....	**451**	**673**	**833**	**1,061**
Taxes on net income	(1)	(1)	(1)	(1)	**68**	**115**	**184**	**267**
Net Profits	**557**	**212**	**349**	**390**	**383**	**557**	**649**	**794**
Cash dividends declared [2]	**387**	**187**	**210**	**211**	**203**	**208**	**226**	**•246**
Asset and liability items:[3]								
United States Government securities	4,161	11,492	14,823	17,753	25,408	48,182	60,324	71,795
Other securities	5,951	5,422	5,799	5,994	5,842	5,286	5,131	5,566
Loans	25,615	11,985	14,298	16,699	17,218	16,229	17,682	19,815
Total assets	46,954	41,607	58,025	65,044	72,610	94,299	108,920	125.132
Time deposits	13,332	10,181	12,055	12,458	12,413	14,176	17,198	21,487
Total deposits	37,295	35,694	51,919	58,717	66,103	87,381	101,484	116,983
Total capital accounts	6,360	5,118	5,597	5,798	5,977	6,304	6,712	7,243
Ratios to total earnings (per cent):								
Interest and discount on loans	65.2	41.3	45.0	47.0	43.6	34.1	30.1	•27.9
Interest and dividends on securities	19.7	38.7	32.6	31.4	36.3	46.4	51.2	•54.8
Other earnings	15.1	20.0	22.4	21.6	20.1	19.5	18.7	•17.3
Salaries and wages	19.3	27.7	30.3	30.0	31.0	29.5	28.0	•27.9
Interest on deposits	31.7	17.3	11.1	9.9	8.6	7.5	7.7	•8.6
Other current expenses	19.2	24.0	28.2	29.8	27.8	25.9	24.4	•23.8
Total expenses	70.2	69.0	69.6	69.7	67.4	63.0	60.1	60.3
Other ratios:								
Net current earnings (before taxes on income)[1] to total capital accounts	11.2	7.3	7.2	7.4	8.1	9.7	11.1	11.5
Net profits to total capital accounts	8.8	4.1	6.2	6.7	6.4	8.8	9.7	11.0
Interest and discount on loans to loans	6.1	4.2	4.2	4.0	3.8	3.5	3.2	•3.0
Interest and dividends on securities to securities	4.7	2.8	2.1	1.9	1.7	1.4	1.5	•1.5
Interest on time deposits to time deposits	3.3	1.9	1.2	1.1	1.0	0.9	0.8	•0.8

• Estimated; 1945 figures are based on preliminary tabulations.
[1] Taxes on net income were included with "other expenses" and, therefore, deducted in computing net current earnings prior to 1942.
[2] Includes interest paid on capital notes and debentures.
[3] Figures are averages of the amounts reported for every call date in the current year and for the last call date in the preceding year, except for 1944 when the figures are the averages for three call dates, the spring call being omitted.

mercial banks this amount must have been about 1,150 million dollars. Since member banks held an average of 71,790 million dollars of Governments during the year, the average return on these securities was in the neighborhood of 1.39 per cent. This return is about 0.15 per cent lower than the estimated average of 1.54 per cent for member banks for 1940. Nevertheless estimated earnings on Government securities were more than four times as great in 1945 as in 1940 because of an increase during this period of 57 billion dollars in average holdings of Government securities.

MEMBER BANK EARNINGS



Current earnings do not include recoveries, profits on securities sold, etc., except that prior to 1927 profits on securities sold are included in "other earnings." Beginning in 1942, "service charges and fees on loans," formerly included in "other earnings," are included in earnings on loans.

The interest reported by banks on their holdings of Government securities is based on the book value of these securities. Such income was separately reported for the first time in 1945, and the figures for earlier years shown in the table on page 2 are therefore estimates. For securities acquired from the market above par value the reported income is less than the coupon interest collected. Since direct offerings of securities by the Treasury to banks after the fall of 1943 were small and most additions to holdings were acquired by market purchase, banks paid premiums for most of the securities purchased over this interval. In other words, the effective earnings rate on Government securities held by member banks in 1945, which was computed above to be 1.39 per cent, is appreciably below the average interest rate paid by the Treasury on securities held by these banks in 1945, which is estimated at about 1.64 per cent. The difference in these rates is indicative of the amount applied to the amortization of premiums. In 1945 it is estimated that the Treasury paid or accrued 1,370 million dollars of interest on the United States Government securities held by commercial banks. This amount was equal to 28 per cent of the average computed[1] interest cost of the public debt in that year.

The average return booked by member banks on their holdings of Government securities, while below the average coupon rate, is considerably in excess of the prevailing average market yield. Banks are still receiving income from the securities purchased in earlier years when higher yields prevailed. In other words, without a further increase in holdings the interest income of banks will tend to recede if yields stay at their present levels. If yields decline further the reduction in income will be all the sharper.

One of the striking developments of the war period has been the convergence of average rates of interest income on Government securities for the various classes of banks. Before the war most money market banks concentrated their portfolio holdings in relatively short-term issues and received correspondingly lower average returns. Country banks, on the other hand, held larger proportions of Treasury bonds and received correspondingly higher average yields. The policy followed by the Treasury since the fall of 1942 of allowing only the relatively short or intermediate term securities issued to be eligible for bank ownership has tended, however, to reduce this differential. Country banks during this period made large additions to their portfolios from intermediate term securities. Money market banks, on the other hand, having increased confidence in the stability of yields for the near-term, went more and more from short into intermediate term securities. The convergence of the average interest returns on Government securities

[1]The computed interest cost of the public debt allows an interest return on all nonmarketable securities at their average rate for the entire period outstanding. In other words, the interest on Series E savings bonds is computed at 2.9 per cent rather than at the rate of accrual according to the redemption schedule of these bonds. If the interest paid or accrued on Government securities held by commercial banks is compared with the budgeted expenditure for interest on the public debt, which is on the latter basis, it would amount to about 34 per cent.

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2,125

for various classes of banks is shown in the following table:

AVERAGE YIELD ON MEMBER BANK HOLDINGS OF UNITED STATES GOVERNMENT SECURITIES, 1940-45
[Per cent per annum]

	[1]1940	[1]1941	[1]1942	[1]1943	[1]1944	1945
All member banks...	1.54	1.35	1.32	1.23	1.33	1.39
Central reserve city banks:						
New York City..	1.01	.87	.97	1.05	1.18	1.29
Chicago........	1.43	1.28	1.32	1.27	1.36	1.32
Reserve city banks.	1.81	1.62	1.48	1.29	1.32	1.37
Country banks....	2.00	1.78	1.60	1.34	1.46	1.49

[1]Yields estimated; earnings on U. S. Government securities not reported separately before 1945.

It is estimated that in 1940 country banks were earning an average of 2.00 per cent on their Governments while central reserve city banks in New York City earned only 1.01 per cent, a differential of about 1.00 per cent. In 1945 this range was from 1.29 per cent for New York City banks to 1.49 per cent for country banks, a differential of only .20 per cent.

Earnings of member banks from loans remained relatively constant over the war period, as shown by the chart on page 3. The average volume of loans held increased about 5.5 billion dollars (from 14.3 billion in 1940 to 19.8 billion in 1945), but the average interest return on loans declined from 4.2 to about 3 per cent. This decline in average return appears to have been due in part to a lowering of rates but it is very likely that the more important reason was a change in the composition of loans. High-rate consumer credit loans became a smaller share of loan portfolios while loans for purchasing and carrying Government securities, on which very low interest rates are charged, became an increasing share.

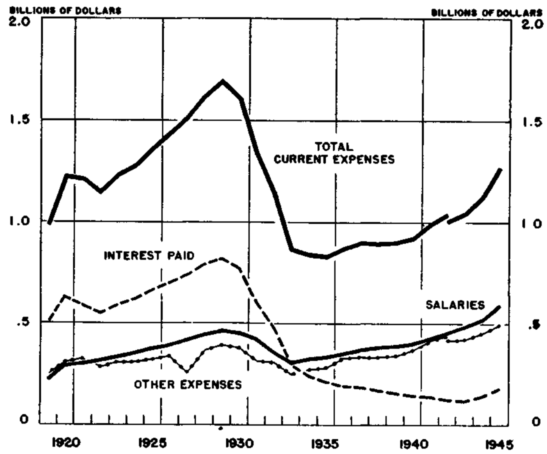
The average rate of earnings from loans has declined greatly over the past decade and a half. In 1929 the average return on loans was over 6 per cent, while in 1945 it appears to have been about half this rate.

Bank Expenses

Along with all other lines of business, banks encountered higher costs of operation during the war years, as is shown by the accompanying chart. From 1940 to 1945 expenses increased 37 per cent. The salary and wage bill increased both because of more employees and higher rates of pay. Interest on time deposits grew because of a larger volume of savings deposits; the rates paid on such deposits continued to decline. Other expenses also increased.

For many years salaries and wages have been the most important item in bank expenses. This item increased substantially in dollar amount during the war period and in 1945 was in the neighborhood of 585 million dollars, an all-time peak. As is indicated in the accompanying table, from 1940 to 1945 the number of persons employed by member banks increased by roughly 43,000, and the average annual salary of employees and officers by about 27 and 17 per cent, respectively. As a result the total wage bill increased by around 46 per cent. Both salaries and wages and total ex-

MEMBER BANK EXPENSES



Current expenses do not include losses, charge-offs, etc. Beginning in 1942 taxes on net income are excluded while recurring depreciation is included in current expenses.

AVERAGE NUMBER AND AVERAGE SALARY OF EMPLOYEES OF MEMBER BANKS, 1940, 1943, 1944, AND 1945

	1940	1943	1944	1945 (est.)
Average number of employees (full- and part-time)................	195,731	222,190	228,863	238,336
Officers.............	34,771	36,001	37,046	38,513
Others..............	160,960	186,189	191,817	199,823
Salaries and wages (in millions of dollars)......	400	487	525	586
Officers..............	155	175	188	200
Others.........	245	312	337	386
Average salary [1]..........	$2,044	$2,192	$2,294	$2,459
Officers..............	4,458	4,861	5,075	5,200
Others..............	1,522	1,676	1,757	1,930

[1] These are rough averages derived by dividing aggregate annual salary payments by the average of the number of full- and part-time employees at the beginning and end of the year.

penses, however, increased less rapidly during the war period than total earnings.

Noncurrent Losses and Gains

As credit grantors, banks ordinarily suffer some losses on earning assets. While the losses are usually offset in part by recoveries of previous charge-offs and by profits on securities sold, there has generally been some net loss on noncurrent account. This net loss varies considerably in amount from time to time and often has an important bearing on net profits of banks. During the war period, however, the rise in Government security prices, together with the differential maintained between long- and short-term interest rates, has resulted in an increase in bank profits from security transactions of such magnitude that noncurrent income accounts of banks have shown substantial net gains.

Profits from the sale of Government securities have resulted from two factors: first, the general decline in interest rates and the accompanying rise in price of outstanding issues, and, second, the difference between short- and long-term interest rates. Profits that result from a decline in interest rates continue to be reported as long as market yields decline and even after the decline ceases if banks are selling securities from portfolios acquired earlier at lower prices. But with stable yields these profits tend to shrink. Profits from the sale of securities that result from differences between short- and long-term interest rates arise because any security when sold has a shorter period to maturity than when purchased; hence, depending on the amount of the difference, it sells at a lower yield and therefore a relatively higher price than when purchased. But for ease of computation the premium is usually amortized on a straight-line basis or a constant yield basis. Hence if the security is sold before maturity the difference between the relatively higher price and the amortized book value is realized as a profit. Such profits could continue even with stable interest rates. The amount banks have realized in the past few years from these sources is not known, but it certainly has been material. As long as interest differences and these accounting methods persist, this revenue will have an assured character, similar for all practical purposes to interest income. None of this income is, however, included with the 997 million dollars of interest on Government securities reported by member banks for 1945.

On assets other than securities, losses in recent years have been low, and there have been appreciable recoveries, particularly through the sale of real estate acquired in earlier foreclosures.

Taxes

Income taxes increased by 200 million dollars from 1942 (the earliest year for which separate figures are available) through 1945, although other taxes remained almost unchanged during this period. In 1945 Federal income taxes for all member banks amounted to 267 million dollars, or 25 per cent of net profits before income taxes.

The increase in Federal income taxes paid is the result of new levies inaugurated during the defense and war periods, increases in rates, higher earnings and profits, and the dwindling supply of tax-exempt securities. In 1940 a new excess profits tax was inaugurated. In 1941 the introduction of the surtax had the effect of further increasing taxes on income, including income from partially tax-exempt United States Government securities. In addition to the new taxes the rate schedules for all Federal taxes were increased. As a result small banks (with taxable income of less than $25,000) paid a minimum rate of 25 per cent while large banks (with taxable income of $50,000 or more) paid a minimum rate of 40 per cent. Also, the capital gains tax of 25 per cent on net long-term capital gains has added considerably to bank taxes in recent years. Some banks were also subject to the excess profits tax, the rates of which ranged from 25 to 50 per cent of adjusted excess profits net income in 1940 to an effective rate of 85.5 per cent in 1944 and 1945. Prior to 1944 few banks were affected by the excess profits tax levy, largely because of the substantial proportion of their income derived from tax-exempt securities. In 1944 and 1945, as their tax protection from this and other sources dwindled, more and more banks, particularly large ones, entered the excess profits tax bracket.

Cash Dividends and Retained Earnings

Notwithstanding the substantial profits associated with the war years 1943-45, banks have followed a conservative policy with respect to dividend payments. Dividends for the war period reached their peak in 1945, when they were 246 million dollars, or about 30 per cent of net profits. This is in contrast to dividend payments of 387 million dollars or almost 70 per cent of net profits in 1929, and of 210 million dollars or 60 per cent of net profits in 1940.

As a result of conservative dividend policy the greater part of net profits of banks in the war period was retained as capital, thus providing additional protection to bank depositors. Capital accounts of member banks increased from 1940 to 1945 by about 1,600 million dollars, or about 30 per cent. This is in contrast to a decline of 1,500 million dollars in capital accounts from 1929 to 1933 and an increase of 700 million from 1933 to 1940.

Comparison of Bank Profits by Class and by Size of Bank

All classes of banks shared in the high wartime profits, and the differentials of earlier years were largely eliminated. The accompanying table shows that in 1940 net profits after taxes of country banks were only about 5 per cent on invested capital, while at reserve city banks the average rate was about 7 per cent and at central reserve city banks about 6 per cent. In 1945 the rate of return on invested capital was practically uniform at all classes of banks and averaged close to 11 per cent.

RATIO OF NET PROFITS TO CAPITAL ACCOUNTS, BY CLASSES OF MEMBER BANKS, 1940 AND 1945

[Per cent per annum]

Class of bank	1940	1945
All member banks	6.2	11.0
Central reserve city banks	6.2	10.6
Reserve city banks	7.3	11.2
Country banks	5.3	11.1

The figures of profits by size of banks for 1945 are not yet available but partial tabulations indicate that the differences between large and small banks were less than before the war. Small banks received somewhat higher average rates of return on loans and on earning assets as a whole, but they also had relatively larger proportions of capital to earning assets. As a result the ratios of net profits to capital accounts were about the same for small as for large banks.

Net Profits of Banks Compared with Profits in Other Lines of Business

While bank profits relative to invested capital were below the level for most other groups of business from 1940 to 1942, they have been above the corporate average since that time, as shown by the accompanying tabulation. Since 1942 bank profits have been relatively higher than those of such stable earning industries as public utilities and transportation. In 1945 they exceeded those of every industrial group except service and construction.

BANK PROFITS COMPARED WITH PROFITS OF OTHER LINES OF BUSINESS

[Percentage ratio of annual net profits to invested capital]

Business	1940	1941	1942	1943	1944	1945
Banking:						
All member banks	6.2	6.7	6.4	8.8	9.7	11.0
Manufacturing	10.5	12.3	9.9	9.6	9.8	9.1
Mining and quarrying	6.3	6.8	7.4	7.2	7.6	7.6
Trade	10.4	11.0	9.9	10.1	10.2	10.9
Transportation	1.8	4.6	8.2	7.7	5.8	3.8
Public utilities	7.1	6.8	6.2	6.6	6.5	6.7
Service and construction	7.0	9.4	11.1	12.5	11.7	11.6
Finance	8.5	7.2	6.9	8.0	7.7	7.6
All group	7.8	8.9	8.5	8.6	8.2	7.6

SOURCE: National City Bank letter.

Although there is likely to be some drop in earnings and profits on securities, banks are better assured that net profits will continue to be adequate than are most other lines of business, mainly because most bank assets are relatively riskless Government securities. If there should be a rise in interest rates and assets were measured at current market values, banks could suffer some capital losses, but these would not need to be realized in most cases and would be more than recouped from higher earnings on new credit extensions. In the case of deflationary developments there would be no capital losses from Government security holdings since interest rates would probably remain low.

Not only are bank earnings relatively high, but the banking business is materially different from other industries in that virtually every bank in the country is making some profit. In 1944 less than one per cent of the member banks failed to earn a profit. This is in contrast with other industries such as manufacturing, trade, and service, in which appreciable numbers within the industry —ranging from 20 per cent to 50 per cent—suffer losses even in good times.

Prospects Beyond 1945

The prospects for banking profits beyond 1945 depend on a number of variables, the most important of which are: (1) the volume of Government securities held by banks and the rates of interest prevailing on these securities; (2) the volume of loans made by banks and the rates of interest received on these loans; and (3) the expenses of bank operations.

The prospect for 1946 is that bank holdings of Government securities will shrink somewhat. The use of large accumulated Treasury cash balances to retire maturing notes and bonds and to reduce the volume of Treasury certificates outstanding works in this direction. Banks may be able to replace a part of these holdings by buying from the market but the extent to which this can be done is limited. The volume of securities eligible for bank ownership now held outside the banking system is steadily dwindling. With no new Treasury offerings in sight the nonbanking holders of these eligible securities may be more and more reluctant to sell.

Even if interest rates do not fall further, the rates now prevailing will tend to diminish the interest income from Governments received by banks. The 1.39 per cent average rate received by member banks on their holdings of Government securities in 1945 is materially above the average of yields prevailing in the market on securities eligible for bank purchase. With the retirement of higher-coupon securities now held in bank portfolios the average rate of earnings from Governments will approach the market rates.

Now that the large-scale market operations incident to war financing have passed, the opportunities for banks to realize profits on securities sold will be less. As indicated above, the profits so far obtained have been largely the result of both the general decline in interest yields and consequent increase in price of securities over the past decade and of the differential between long-term and short-term rates. Unless there should be a further decline in rates, profits arising from the first of these factors will tend to disappear. Profits on the sale of securities which result from the differential between long- and short-term interest rates will probably tend to shrink because this differential was considerably reduced by sharp declines in market yields on longer term securities during 1945 and early 1946.

Profits reported for the first half of 1946 may, however, exceed the 1945 average. Banks purchased a large volume of securities just before the end of 1945 at the time of the Victory Loan drive. Banks that do not accrue the interest on Government securities reported no revenue from these issues for the year 1945 but will book this revenue in the first part of 1946. Even for banks using accrual accounting the period of accrual was relatively short.

The volume of loans made by banks and the rates received from loans will also have an important bearing on bank profits. A large part of the loans for purchasing and carrying Government securities probably will be liquidated during 1946. Although these loans were sizeable in dollar volume, the rates received on them were relatively low. Loans made primarily for war purposes were being reduced during 1945 and there will probably be further liquidation in 1946. On the other hand, the volume of commercial and industrial loans for nonwar purposes appears to have grown considerably during the second half of 1945 and further growth in 1946 is probable. In spite of the generally high level of business liquidity, considerable demand for credit at the present levels of business activity seems to exist. The expansion of consumer credit which has already occurred with relatively little increase in the supply of consumer durable goods would indicate that with the appearance of durable goods in volume the amount of credit extended for this purpose could be considerable. The strong and continued demand for housing will also open up new opportunities for mortgage lending. Since the expected contractions are of low-yield loans and the expected expansion is in higher yielding loans, the average rate of return received from loans could increase with no increase in market interest rates.

The expenses of bank operation increased throughout the war and some further increases are in sight. During the war period the number of bank employees increased less than any measure of physical banking activities which can be devised. The number of employees, for example, increased less proportionately than the number of checks cleared (and a great deal less than the dollar volume of checks cleared). The number of bank employees also appears to have increased less proportionately than the number of deposit accounts. Although better office machinery and new methods may, in the long run, reduce the number of bank employees needed, a further growth in their number as manpower becomes available is likely. Salaries and wages at banks may also increase further in line with the upward adjustments of other wages. The hourly rate paid employees appears to have increased much less during the war than in the service industries or in manufacturing and mining.

The recent deposit growth has been more in savings accounts than was the case in the early part of the war period and this factor has brought about some increase in the amount of interest paid on time deposits. Some further growth in total interest payments may be in prospect.* Other expenses of bank operation may also increase. On the other hand, the repeal of the excess profits tax and the reduction in other income tax rates will add to net profits, particularly of the larger banks.

All factors considered, the dollar volume of bank profits may be at or nearly at its peak. If substantial loan volume appears, the dollar volume of profits may not recede appreciably, but any further increase, except possibly for the first half of 1946, does not seem likely. In view of the large growth in earning assets, however, it seems probable that bank profits while no longer increasing will be well sustained.

AN ANALYSIS OF COMMERCIAL BANKING IN THE UNITED STATES

In common with most bankers, I have been deeply interested during recent months in the current discussions relative to commercial banking in the United States. My interest has been largely centered on the three major qustions:

1. Are bank earnings excessive?
2. Will interest rates remain at the present levels?
3. Are bank capital funds adequate?

While attempting to form some satisfactory personal conclusions from the various statements and articles dealing with these questions, I took occasion to study rather carefully the published statistical reports relative to banking operations. I set down for my guidance, in comparative form, the consolidated balance sheets and earning statements of all insured commercial banks in the country over a ten year period.

The visual presentation of this data, in condensed form, gave me a reasonable, satisfactory answer to the foregoing questions. The thought then occurred to me that other banks might be equally interested in these reports and some of the conclusions which seem obvious from a study of the figures. With this thought in mind, I am pleased to present the following brief analysis.

ARE BANK EARNINGS EXCESSIVE?

During the past ten year period, the average net earnings of all commercial banks have been but 6.6%, certainly not an excessive amount. Increased earnings of 8.5% for 1943 and 9.4% for 1944 on total capital funds do not necessarily forecast a continued increase. As a matter of fact, probably the high point was reached in 1944, as future earnings will be adversely affected by (1) a levelling off of increase in deposits, (2) lower interest rates on loans and investments as maturities are being refunded at lower rates, (3) increased taxation as proportion of tax exempt securities decline, (4) increased operating expenses.

The dividend average of 3.4% for the ten year period is very conservative, and it will be noted that the rate has not been increased during the past two years, thus permitting substantial increases to the capital funds.

STATEMENTS OF ALL INSURED COMMERCIAL BANKS IN UNITED STATES

(000,000.00 omitted)

ASSETS	1935	1936	1937	1938	1939	1940	1941	1942	1943	1944
Cash and Due from Banks	13,851	15,731	14,931	17,176	21,875	26,290	25,793	27,594	27,191	29,746
U. S. Securities	13,275	14,750	13,670	14,506	15,567	17,064	21,047	40,712	58,694	75,896
Total Cash and Govts.	27,126	30,481	28,601	31,682	37,442	43,354	46,840	68,306	85,885	105,642
Other Securities	6,841	7,556	6,807	6,944	6,860	7,099	6,985	6,632	5,985	6,157
Loans and Discounts	14,698	15,940	16,717	16,024	16,866	18,398	21,262	18,907	18,843	21,355
Bank Bldgs. and Real Estate	1,747	1,738	1,680	1,769	1,657	1,534	1,430	1,348	1,201	1,079
Other Assets	505	480	416	381	321	335	310	266	332	380
Total Assets	50,917	56,195	54,221	56,800	63,146	70,720	76,827	95,459	112,246	134,613
LIABILITIES										
Commercial Deposits	30,945	35,317	32,517	34,949	40,839	47,716	53,561	71,559	84,956	101,793
Savings Deposits	13,180	13,941	14,674	14,830	15,237	15,753	15,860	16,261	19,160	23,959
Total Deposits	44,125	49,258	47,191	49,779	56,076	63,469	69,421	87,820	104,116	125,752
Other Liabilities	582	609	626	586	546	577	564	583	676	871
Capital Stock	3,300	3,081	3,030	2,982	2,914	2,872	2,849	2,849	2,875	2,912
Surplus	1,946	2,184	2,268	2,347	2,443	2,563	2,686	2,802	3,090	3,402
Undivided Profits	548	666	712	742	789	838	896	972	1,006	1,169
Reserves	416	397	394	364	378	401	411	433	483	507
Capital Funds	6,210	6,328	6,404	6,435	6,524	6,674	6,842	7,056	7,454	7,990
Total Liabilities	50,917	56,195	54,221	56,800	63,146	70,720	76,827	95,459	112,246	134,613

EARNINGS OF ALL INSURED COMMERCIAL BANKS IN UNITED STATES

(000,000.00 omitted)

	1935	1936	1937	1938	1939	1940	1941	1942	1943	1944
Interest on Securities	547	573	572	532	522	500	509	610	861	1,090
Interest on Loans	642	663	708	705	727	768	848	805	692	681
Other Income	294	328	351	347	356	363	373	376	406	444
Operating Income	1,483	1,564	1,631	1,584	1,605	1,631	1,730	1,791	1,959	2,215
Interest on Time Deposits	277	237	235	229	215	201	190	175	164	187
Salaries and Wages	410	437	463	473	483	497	527	564	594	640
Federal and State Taxes	79	98	107	103	107	123	153	177	228	300
Other Expenses	315	353	360	353	355	372	396	387	398	433
Operating Expenses	1,081	1,125	1,165	1,158	1,160	1,193	1,266	1,303	1,384	1,560
Net Operating Income	402	439	466	426	445	438	464	488	575	655
Non-Operating Income	195	84	86	126	57	37	10	48	62	96
Net Income	207	523	380	300	388	401	454	440	637	751
% on Capital Funds	3.3	8.3	5.9	4.7	5.9	6.0	6.7	6.2	8.5	9.4
Dividends	207	223	225	222	232	237	253	227	233	253
% on Capital Funds	3.3	3.5	3.5	3.4	3.6	3.6	3.7	3.2	3.1	3.2
Addition to Capital Funds	-	300	155	78	156	164	201	213	404	498
Number of Banks	14,123	13,970	13,795	13,659	13,535	13,438	13,427	13,347	13,274	13,268

WILL INTEREST RATES REMAIN AT PRESENT LEVELS?

During 1935 the banks were earning 2.7% on some 20 billion dollars of securities. Ten years later, or in 1944, the rate of return had declined to 1.3% on about 82 billion dollars of securities. On loans and discounts the decline has been from 4.4% on 14 billion dollars, to 3.2% on 21 billions. Income from other sources during the same period has gradually increased, but it is not a determining factor in the overall picture.

The Federal Government, through the issuance of more than 250 billion dollars of securities to banks and other investors, has created an interest pattern which, if revised sharply upward would cause a substantial decrease in quoted market values. Furthermore, enormous refunding programs must be carried out within the present rate structure, in order to minimize the burden of carrying this tremendous debt. It seems almost mandatory that the fiscal powers of the government must, and undoubtedly will be utilized so that interest rates will remain at or near the present levels for many years to come.

The profitable functioning of the banking system seems assured through the simple fact that despite a substantially lower rate of interest, banks now have through increased deposits $3.00 to invest for each $1.00 they had for a similar purpose in 1935.

ARE BANK CAPITAL FUNDS ADEQUATE?

In 1935 the banks had $1.00 of capital funds for each $7.00 of deposits. Ten years later, in 1944, banks had $1.00 of capital funds for each $15.00 of deposits. However, due to the fact that the increase in deposits has been largely invested in United States Government bonds, the ratio of bank capital to "risk" assets has not changed in the ten year period.

If the capital funds of the nation's banks were now increased to the ratio of 1935, then earnings would be inadequate to justify the additional investment. Whereas in 1935, banks could make a fair return with a deposit leverage of 7 to 1, today a leverage of 15 to 1 of deposits to capital is required because of the lower yield on loans and investments.

Unless one views the stability of the Federal debt with misgivings, present bank capital, on the average, appears adequate, as there is no factual evidence to support the belief that "risk" assets will increase materially during the coming years, and the policy of retaining one-half to two-thirds of earnings in the capital accounts should offset the percentage gain in assets other than government bonds.

The foregoing analysis has been based on consolidated figures of all commercial banks, and certain average figures which have been quoted will of course be entirely different for each individual bank.

Howard J. Stoddard, President
Michigan National Bank
Lansing, Michigan
September 30, 1945.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date May 3, 1946

To Mr. Thurston

Subject:

From Woodlief Thomas

Mr. Stoddard's request for 100 copies of the bank profits article should certainly be granted. The article should be read widely by bankers and circulation by reprints distributed by one of Mr. Stoddard's standing is a good way to get them to read it.

Mr. Stoddard's own analysis of bank earnings demonstrates that he is a close and thoughtful observer of banking problems. However, he does beg some questions; for example:

1. In concluding that bank profits are not excessive, he ignores the source of the increased earnings.

2. In forecasting a decline in earnings, he overstresses some factors and takes no account of a possible decline in bank deposits resulting from debt retirement and bank credit policies; in fact, he sees no monetary-inflation problem that needs to be controlled at the expense of bank earnings.

3. In concluding that bank capital funds are adequate, he assumes continuation of the present relation of riskless to risk assets, and anticipates no problem confronting banks to increase the proportion of risk assets carried. If deposit growth is checked and deposits perhaps contracted and held at resulting levels by the control of bank reserves, and banks do have to meet a demand for loans from the business and consuming public, there obviously will be a need for additional bank capital. If banks perform adequately their normal peacetime financing functions, this need should grow over the coming years.

W.T.

Yes ✓

2100
1323
777

997
229
768

Confidential May 7, 1946.

Dear Howard:

In accordance with your letter of April 24, I am having sent to you, as you request, 100 reprints of the article from the Federal Reserve Bulletin for April on "Member Bank Profits for 1945."

While I haven't had an opportunity to analyze your own figures for commercial banks, it seems to me that you overlook the fact that almost half of the gross earnings of member banks, as shown in the table on page 2 of our article, comes from interest and dividends on Government securities. As our table shows, the entire increase in member bank earnings since 1940 is accounted for by the increased receipts from Government securities. There is no doubt in my mind that this situation, in which the banks are deriving so much of their revenue from riskless assets, is vulnerable to the criticism in Congress that the taxpayers are being asked to contribute too much to the maintenance of private banks. This is all the more open to attack because total member bank earnings for 1945, which may of course be the peak, are nevertheless very large compared with any time in the past ten years, which is the period your own survey covers.

Our figures in the page 2 table show that the ratio of net profits to capital accounts in 1944 was 9.7 per cent - your figure is 9.4 per cent - and for 1945 it was 11 per cent according to our table. This compares with 4.1 per cent for 1935. While this reflects almost three times as much net profit, in relation to capital accounts, in 1945 as in 1935, it does not on its face reveal the significant fact that in the same ten-year period, capital accounts have been increased, as shown in our table, by $2,125,000,000. Not only were the net profits of $794,000,000 for member banks in 1945 at an all time peak - 1944 net profits of $649,000,000 were also higher than at any time in the past - but the 1945 net profits represent an earning ratio of 15.5 per cent based on 1935 capital.

When it is remembered that the increase in capital has obviously come very largely, if not entirely, out of earnings and profits on Government securities, it is difficult for me to conclude that member bank earnings and profits resulting from war financing can be justified in view of their source. I am perfectly sure that any such subsidy to private banking would not be tolerated in Great Britain or Canada or, for that matter, in any other country.

When Patman and other critics have found fault with this situation in the last few years, I have done what I could to justify and defend it, but facts are facts and I cannot, of course, conceal or try to dress them up to look very different from what they are. I think it would be far better if all of us who want to preserve the private banking system faced up to the facts as they are and then acted accordingly.

Sincerely yours,

Mr. Howard J. Stoddard, President,
Michigan National Bank,
Lansing, Michigan.

ET:b

MICHIGAN NATIONAL BANK

BATTLE CREEK FLINT GRAND RAPIDS LANSING
MARSHALL PORT HURON SAGINAW

LANSING, MICHIGAN

H. J. STODDARD
PRESIDENT

May 17, 1946

Mr. M. S. Eccles, Chairman
Board of Governors
Federal Reserve System
Washington, D. C.

Dear Marriner:

I appreciate your letter of May 7, and also your sending us 100 reprints of the article from the Federal Reserve Bulletin for April, on "Member Bank Profits for the Year 1945." I was also greatly interested on your remarks and analysis on bank earnings, particularly that portion derived from interest on government securities.

In connection with the article, I had our Comptroller prepare comparative figures of our own bank as against the average for the system. I thought you might be interested in seeing how this sets up, particularly so if other banks might wish to make similar comparison of their own figures. (1)

I do not have in my files the ten year comparison of earnings of member banks, but do have such a statement for the insured commercial banks, and note that for the year 1945 the average result was very similar to that of member banks. (2) In looking over the comparative figures which are attached, I am still unable to feel that average bank earnings have been unduly large, with the average on capital funds for the period of only 7.2% and dividend disbursements of 3.4%. (3)

The net return of 11% on capital funds for the year 1945 is probably one of the most profitable years in banking history, (4) but I think you will agree with me that certain factors are now at work, and it is quite probable that the net results for the year 1946 will be substantially less than for 1945. (5) A further analysis of the income shows that more than 20% of bank earnings last year were derived from non-operating income, representing profits from the sale of securities. (6) It is quite probable that this earning factor is non-recurring, and in the future will be of minor importance. If such profits had not been realized last year, the net earnings of banks on capital funds would have been closer to 8% than the 11% actually realized.

Another factor which has contributed materially to bank earnings in the past year has been the substantial balances in the War Loan Deposit Account. It would now appear that substantial reductions are being made in such accounts, and by the end of this year they will likewise become of minor importance. This phase of bank income will thus be reduced. (7)

I have noted that in our section at least, commercial deposits are holding fairly steady, and the increase we are experiencing seems to be largely in our savings accounts. These deposits of course cost us money, and unless they are offset by increased loans, will not add to our earnings. However we have had a very heavy loan demand since the first of the year, and I presume that most institutions are experiencing similarly heavy demands. Due to the fact that less than 1/3 of bank earnings have been paid out in dividends, it means that substantial additions have been made to bank capital and surplus accounts. As you know, such earnings when transferred into these accounts are locked up so far as dividends are concerned, and remain as further protection for the public. In other words, the major portion of bank earnings has been channeled into accounts which benefit the public, and for that reason I do not feel that the taxpayer has simply been subsidizing bank shareholders through the increased earnings from government securities. (8)

I think you will agree that the dollar of 1940 is worth no more than seventy cents today, with the result that even though bank earnings have increased, when reduced to actual purchasing power, the percentage increase would be largely offset by the decrease in the value of the dollar. I think this factor should be considered when bank or any other earnings are up for consideration. (9)

In any event, the year 1946 will be a period of transition in our business, and it seems to me that another six months must elapse before any of us can make a reasonable forecast as to the earning basis for banks as a whole. I see nothing in the present picture to justify any of Mr. Patton's assumptions or proposals. (10)

Sincerely yours

Howard

President

HJS:M

BANK STATISTICS FOR 1945

Description	All FR Member Banks	Michigan National Bank
Ratios to Total Earnings:	%	%
Interest and discount on loans	27.9	41.6
Interest and dividends on securities	54.8	41.0
Other earnings	17.3	17.4
Salaries and wages	27.9	31.6
Interest on deposits	8.6	10.4
Other current expenses	23.8	29.1
Total Expenses	60.3	71.1
Other Ratios:		
*Net earnings to Capital Funds, before Federal taxes	11.5	17.5
xNet profits to Capital Funds, after Federal taxes	11.0	11.8
Interest and discounts on loans to loans	3.0	4.5
Interest and dividends on securities to securities	1.5	1.6
Interest on time deposits to time deposits	.8	.8
Cash Dividends to Net Profits	31.0	30.6
Average Yield on U. S. Government Securities		
New York City Banks	1.29	1.63
Chicago Banks	1.32	1.63
Reserve City Banks	1.37	1.63
Country Banks	1.49	1.63
All Member Banks	1.39	1.63
Average Number and Average Salary of Officers & Employees		
Number - Percentage Officers	16	12
- Percentage Employees	84	88
Salary - Percentage paid to Officers	34	37
- Percentage paid to Employees	66	63
Officers Average Salary	$5,200	$7,368
Employees Average Salary	$1,930	$1,627
Officers and Employees Average Salary	$2,459	$2,294
Ratio of Net Profits to Capital Accounts		
Central Reserve City Banks	10.6	11.8
Reserve City Banks	11.2	11.8
Country Banks	11.1	11.8
All Member Banks	11.0	11.8

* Does not include non-operating Profit or Loss items.
x Includes non-operating Profit or Loss items.

4-25-46

EARNINGS OF ALL INSURED COMMERCIAL BANKS IN UNITED STATES
(000,000.00 omitted)

	1936	1937	1938	1939	1940	1941	1942	1943	1944	1945
Interest on Securities	573	572	532	522	500	509	610	861	1,090	1,314
Interest on Loans	663	708	705	727	768	848	805	692	681	722
Other Income	328	351	347	356	363	373	376	406	444	443
Operating Income	1,564	1,631	1,584	1,605	1,631	1,730	1,791	1,959	2,215	2,479
Interest on Time Deposits	237	235	229	215	201	190	175	164	187	230
Wages and Salaries	437	463	473	483	497	527	564	594	640	697
Federal and State Taxes	98	107	103	107	123	153	177	228	300	396
Other Expenses	353	360	353	355	372	396	387	398	433	493
Operating Expenses	1,125	1,165	1,158	1,160	1,193	1,266	1,303	1,384	1,560	1,816
Net Operating Income	439	466	426	445	438	464	488	575	655	663
Non-Operating Income	84	86R	126R	57R	37R	10R	48R	62	96	248
Net Income	523	380	300	388	401	454	440	637	751	911
% on Capital Funds	8.3	5.9	4.7	5.9	6.0	6.7	6.2	8.5	9.4	10.9
Dividends	223	225	222	232	237	253	227	233	253	274
% on Capital Funds	3.5	3.5	3.4	3.6	3.6	3.7	3.2	3.1	3.2	3.3
Addition to Capital Funds	300	155	78	156	164	201	213	404	498	637
Number of Banks	13,970	13,795	13,659	13,535	13,438	13,427	13,347	13,274	13,268	13,302

5-15-46

Average earnings on Capital Funds for 10 year period 7.2%
Average dividends " " " " " " 3.4%

MICHIGAN NATIONAL BANK

BATTLE CREEK FLINT GRAND RAPIDS LANSING
MARSHALL PORT HURON SAGINAW

LANSING, MICHIGAN

August 5, 1946

The Presidents
Commercial Banks
United States of America

"Bank Earnings"

Gentlemen:

In the business statistics which come across my desk, I have always been interested in those figures showing the comparative balance sheet and earning statements of all commercial banks in United States. It has been my practice to compare these figures with similar reports over a ten year period. I believe the picture they present is sufficiently important that you would like to have a copy for your files.

The spectacular increase of 133% in total deposits which occurred during the past five years exceeds anything previously known in American banking history. Obviously, when any of us is inclined to feel a measure of pride in our own bank's expanded resources, we should, after reviewing the following figures, realize that it was war-time financing which occasioned this tremendous growth, rather than any individual accomplishment.

The reconversion of the banking industry is now in progress, and the reduction of the Federal debt by drawing down the War Loan deposit account is reversing the previous upward trend. In all probability, the total deposits at the end of 1946 will be lower, and a substantial part of the 22 billion dollars or 18% increase in 1945 will be cancelled out. It would seem that deposits will thus tend to level off unless there is a marked expansion in the loan demand, which will of course result in the creation of additional bank deposits.

Current reports as to excessive bank earnings seem to have been exaggerated because of the non-operating profits, realized largely through the sale of securities at amounts substantially in excess of their costs. The average earning for all banks in 1945, exclusive of such profits, was about 8%, or certainly not an excessive amount.

With these figures before you, I believe you can profitably spend some time in using them as a basis for whatever personal analysis you may care to make of the trends in our American banking system.

Cordially yours

H J Stoddard

President

HJS:M

STATEMENTS OF ALL INSURED COMMERCIAL BANKS IN UNITED STATES

(000,000.00 omitted)

ASSETS	1936	1937	1938	1939	1940	1941	1942	1943	1944	1945
Cash and Due from Banks..	15,731	14,931	17,176	21,875	26,290	25,793	27,594	27,191	29,746	34,303
U. S. Securities...........	14,750	13,670	14,506	15,567	17,064	21,047	40,712	58,694	75,896	88,933
Total Cash and Govts....	30,481	28,601	31,682	37,442	43,354	46,840	68,306	85,885	105,642	123,236
Other Securities..........	7,556	6,807	6,944	6,860	7,099	6,985	6,632	5,985	6,157	7,133
Loans and Discounts......	15,940	16,717	16,024	16,866	18,398	21,262	18,907	18,843	21,355	25,769
Bank Bldgs. and Real Estate	1,738	1,680	1,769	1,657	1,534	1,430	1,348	1,201	1,079	1,003
Other Assets.............	480	416	381	321	335	310	266	332	380	441
Total Assets...........	56,195	54,221	56,800	63,146	70,720	76,827	95,459	112,246	134,613	157,582
LIABILITIES										
Commercial Deposits......	35,317	32,517	34,949	40,839	47,716	53,561	71,559	84,956	101,793	117,848
Savings Deposits..........	13,941	14,674	14,830	15,237	15,753	15,860	16,261	19,160	23,959	29,963
Total Deposits.........	49,258	47,191	49,779	56,076	63,469	69,421	87,820	104,116	125,752	147,811
Other Liabilities..........	609	626	586	546	577	564	583	676	871	1,099
Capital Stock............	3,081	3,030	2,982	2,914	2,872	2,849	2,849	2,875	2,912	3,032
Surplus	2,184	2,268	2,347	2,443	2,563	2,686	2,802	3,090	3,402	3,785
Undivided Profits.........	666	712	742	789	838	896	972	1,006	1,169	1,293
Reserves	397	394	364	378	401	411	433	483	507	562
Capital Funds..........	6,328	6,404	6,435	6,524	6,674	6,842	7,056	7,454	7,990	8,672
Total Liabilities	56,195	54,221	56,800	63,146	70,720	76,827	95,459	112,246	134,613	157,582

EARNINGS OF ALL INSURED COMMERCIAL BANKS IN UNITED STATES
(000,000.00 omitted)

	1936	1937	1938	1939	1940	1941	1942	1943	1944	1945
Interest on Securities......	573	572	532	522	500	509	610	861	1,090	1,314
Interest on Loans.........	663	708	705	727	768	848	805	692	681	722
Other Income...........	328	351	347	356	363	373	376	406	444	443
Operating Income......	1,564	1,631	1,584	1,605	1,631	1,730	1,791	1,959	2,215	2,479
Interest on Time Deposits..	237	235	229	215	201	190	175	164	187	230
Wages and Salaries.......	437	463	473	483	497	527	564	594	640	697
Federal and State Taxes...	98	107	103	107	123	153	177	228	300	396
Other Expenses...........	353	360	353	355	372	396	387	398	433	493
Operating Expenses.....	1,125	1,165	1,158	1,160	1,193	1,266	1,303	1,384	1,560	1,816
Net Operating Income.....	439	466	426	445	438	464	488	575	655	663
Non-Operating Income....	84	86	126	57	37	10	48	62	96	248
Net Income..............	523	380	300	388	401	454	440	637	751	911
% on Capital Funds.......	8.3	5.9	4.7	5.9	6.0	6.7	6.2	8.5	9.4	10.9
Dividends...............	223	225	222	232	237	253	227	233	253	274
% on Capital Funds.......	3.5	3.5	3.4	3.6	3.6	3.7	3.2	3.1	3.2	3.3
Addition to Capital Funds..	300	155	78	156	164	201	213	404	498	637
Number of Banks.........	13,970	13,795	13,659	13,535	13,438	13,427	13,347	13,274	13,268	13,302

Average earnings on Capital Funds for 10 year period..... 7.2%
Average dividends on Capital Funds for 10 year period..... 3.4%

Mr. Kennedy:

Attached is a draft of a letter to Mr. H. J. Stoddard based on (1) his circular letter on bank earnings of August 5, and (2) some of the major points in his letter of May 17, 1946 to Mr. Eccles. I notice that no reply to the letter of May 17 was considered necessary at the time it was received. I assume, on the same basis, no answer would be needed to the circular except on the grounds that the circular is being distributed widely and for this reason some of the ideas expressed in it deserve to be commented upon. Since the points mentioned in the letter are a part of the basic thinking of Mr. Stoddard on the subject of bank earnings, I thought it was desirable to cover them in the letter.

Caroline Cagle

Draft of letter to H. J. Stoddard (CHC/ls, 8-16-46)

Dear Howard:

Thank you for the copy of your circular of August 5 on earnings of all insured commercial banks. As you know, this is a subject in which I have considerable interest.

A few points occur to me in connection with your comments on the figures. You state that current reports as to excessive bank earnings seem to have been exaggerated because of the inclusion of nonoperating profits. The exclusion of these profits, you say, would mean that bank earnings in 1945 were only about 8 per cent. Do you feel that this figure has any significance unless you make past and future comparisons on the same basis? Logically, if you exclude nonoperating profits from total earnings in 1945, you must ignore losses incurred by banks in the '30's. Regardless of their source and of their nonrecurring nature, profits on the sale of securities must be included in bank earnings just as surely as losses must be deducted from earnings in arriving at a true picture of the net profits of banks.

The terms "high" or "excessive" when referred to bank earnings can have significance only if there is a standard or norm with which to make comparisons. Perhaps the best standard with which to compare bank profits is what other businesses earned during the same period. Moreover, the comparisons are even more significant when made with other businesses, which like banks are vested with a public interest, such as transportation and public utilities. I believe the period of comparison is also important. A ten-year period is not necessarily the most significant for comparative purposes. It is desirable to use an interval where the dominant economic forces at work are as nearly alike as possible. For example, in the article on bank earnings in the <u>Federal Reserve Bulletin</u> for April of this year we used the period 1940-1945 for comparing profits of different industrial groups because during this time defense and war activities dominated the economic picture.

A comparison of bank profits with those earned by transportation companies and public utilities in the period 1940-1945 (shown on page 381 of the April 1946 Federal Reserve Bulletin) indicates that bank profits have been higher in all years except 1942 in the case of transportation and 1940 and 1941 in the case of public utilities; they have been substantially higher since 1942. Moreover, in 1944 and 1945 bank profits exceeded the average profits for all business groups combined and in 1945 they were topped by only one other industrial group -- service and construction.

High profits for service and construction companies can be justified from a public standpoint more readily than for banks or public utilities. Service and construction is a high-risk industry. If bank earnings were derived largely from making loans and thereby assuming risk, there would be little room for public criticism; but, as you know, nearly half of bank earnings in 1945 were derived from interest on Government securities, a practically riskless investment. I am sure you will agree that there is danger for banks in this situation. We do not permit railroads and public utilities to charge exorbitant rates to customers, and in this way we regulate their earnings and the return which stockholders receive on their investment. While banks are not regulated to this extent, from a public-interest standpoint, it would be undesirable for them to continue to build up large profits for stockholders. The public may soon question whether it is desirable to continue to pay bank stockholders so large an amount for performing a patriotic service.

Certain factors are at work which may produce bank profits in 1946 ~~which in dollar amount are~~ as high or somewhat higher than in 1945, although the ratio of net profits to capital accounts may be lower because of the substantial increases in capital accounts in recent years. Total loans of member banks expanded in the first half of this year by half a billion dollars in spite of substantial declines in loans on Government securities. Offsetting increases occurred in commercial and industrial, consumer, and real estate loans. This should increase earnings on loans substantially because loans on Government securities bear a fairly low rate of interest while the yield on the expanding portion of the loan portfolio is much higher. In spite of the decline in holdings of Government securities which occurred during the first half of this year and which will probably continue in the second half as a result of the debt retirement program, average holdings of Governments in 1946 may be higher than in 1945 and the average yield on these securities may also be somewhat higher because there will be a larger proportion of long-term securities held in 1946 than in 1945. As a result earnings on Governments may be equal to and could be somewhat greater than in 1945. Other securities held by member banks increased in the first half of 1946 and this should also contribute to higher bank earnings. Offsetting these increases, salaries and wages of banks will undoubtedly be higher this year than last and other expenses may also increase. While recoveries, profits on securities, etc., will no doubt be lower in 1945 than in 1946, they will probably exceed losses and charge-offs by a sizable amount and, in addition, taxes on net income will be lower. As you can see, there is a good possibility that bank profits in 1946 will continue to be high.

As you indicated in your letter of May 17 and as we pointed out in our Bulletin article, banks have followed a conservative policy with respect to dividend payments. This is commendable but it does not justify high bank earnings. You state in your letter that the major portion of bank earnings in recent years has been channeled into accounts which benefit the public.

~~This in a sense "protects" the public, but~~ It is difficult to see how the public benefits from retention of earnings in the form of capital accounts. When a bank fails, the public looks to the Federal Deposit Insurance Corporation for the protection of its deposits. Where the bank ~~does not fail but~~ incurs large losses, it is the stockholders' original investment that is cushioned by the accumulation of earnings in capital accounts.

Another comment in your letter of May 17 appears to justify the present level of bank earnings. You state that "the dollar of 1940 is worth no more than seventy cents today, with the result that even though bank earnings have increased, when reduced to actual purchasing power, the percentage increase would be largely offset by the decrease in the value of the dollar~~s~~." It seems to me that you overlook the fact that net profits are profits after deduction of higher expenses, which reflect the decline in the purchasing power of the dollar. Perhaps you are referring to the fact that the stockholders' dividend has less purchasing power. This is true. Does this mean that you favor higher dividends? This would appear to be in conflict with the statement in the preceding paragraph of your letter in which you call attention to the public benefits associated with the conservative dividend policy banks have followed.

Sincerely yours,

M. S. S.

Mr. Kennedy

1. They get something much better--by size of bank--from Federal Reserve Banks.

2. Of course--member banks dominate insured banks.

3. But see recent year comparisons with other ~~comparisons~~ companies in Bulletin article.

4. It is.

5. Certain factors may, on balance, result in profits as large as 1945.

6. Just as proper to include non-operating income in 1945 as to "cry" about losses in bad years. My guess also that such income will be less in 1946. But so will taxes. And loan income will be higher.

7. I don't get this. The deposits thus created will still be in banks, (except as debt is retired from bank holdings).

8. Substantially so.

9. The net profits are ~~often~~ after higher expenses. Does he mean dividends should be higher?

10. Amen! It all depends--high earnings from loans is one thing; on U. S. securities, another.

J. E. Horbett

June 12, 1946

August 22, 1946

Mr. Howard J. Stoddard,
President,
Michigan National Bank,
Lansing, Michigan.

Dear Howard:

Thank you for the copy of your circular of August 5 on earnings of all insured commercial banks. As you know, this is a subject in which I am deeply interested, and in view of its importance to the banks themselves, I want you to have my personal reaction to your circular.

First let me say that your comments about the factors responsible for the tremendous growth in deposits are certainly well taken. Too many bankers, I am afraid, are of the impression, or at least they talk as though they are of the impression, that it was the individual accomplishment of each bank that resulted in the tremendous growth of its deposits. It is a good thing to remind them also, as you have, that the reduction of the Federal debt will automatically result in a considerable reduction in bank deposits, except to the extent that it is offset by an expansion in bank loans.

You state that current reports as to excessive bank earnings seem to have been exaggerated because of the inclusion of non-operating profits. Logically, if you exclude such profits from total earnings in 1945 you must ignore losses incurred by banks in other years, e.g. in 1938. Profits on sales of securities must be included as part of bank earnings, just as surely as losses must be deducted, in arriving at a true picture of the net profits. If this procedure were not followed, comparisons of bank earnings over a period of time would lose much of their significance. Moreover, under the conditions that have prevailed in recent years and which may continue for some years to come, market operations in securities are a substantial part of the average bank's operations. Therefore, profits realized on sales of securities, whether through shrewd operations or because of fortuitous circumstances resulting from declining interest rates are in a broad sense as much a part of the current income in the case of banks as in the case of out-and-out investment companies. Incidentally, if banks held their securities to maturity, they would not make these profits, so they ought not to "eat and still have the cake" resulting from transactions in securities.

You say that, if profits on sales of securities are excluded, bank earnings in relation to capital accounts were only about 8 per cent and "certainly not an excessive amount." The terms "high" or "excessive", when applied to bank earnings, are significant only if there is a standard or norm with which to make comparisons. Perhaps the best standard with which to compare bank profits is what other business earned during the same period. The comparisons are even more significant when made with other businesses, which like banks, are vested with a public interest, such as transportation and public utilities. I believe the period of comparison is also important. A ten-year period is not necessarily the most significant for comparative purposes. It is desirable to use an interval where the dominant economic forces at work in all fields of endeavor are as nearly alike as possible. Thus, in the article on bank earnings in the <u>Federal Reserve Bulletin</u> for April of this year, we used the period 1940-1945 for comparing profits of different industrial groups because during this time defense and war activities dominated the economic picture.

A comparison of bank profits with those earned by transportation and public utilities in the period 1940-1945 (shown on page 381 of the article) indicates that bank profits have been higher in all years, except 1942 in the case of transportation and 1940 and 1941 in the case of public utilities. Moreover, in 1944 and 1945 bank profits exceeded the average profits for all business groups combined and in 1945 bank profits were topped by only one other industrial group--service and construction.

High profits for service and construction companies can be justified from a public standpoint more readily than for banks. Service and construction is a high risk group. If bank earnings were derived largely from making loans and thereby assuming risk, there would be little room for public criticism; but, as you know, a billion dollars, or nearly half of bank gross earnings in 1945, were derived from interest on Government securities, a riskless investment and an additional 235 million net profits resulted from sales of securities. Bank earnings from Government securities will continue to be large for some time to come, whereas profits by other businesses from the war were only temporary. I am sure you will agree that there is danger for banks in this situation. The public has already begun to question whether there is any justification for continuing to pay banks so large an amount for providing deposit money. After all, the reserves that were necessary to support the commercial bank purchases of Government securities during the war were furnished by the Government through Federal Reserve open market operations. Incidentally, since a bank's liability to its depositor is merely to return to him the same number of dollars as he deposited, regardless of any loss in their purchasing power, under present conditions banks (unlike other businesses whose principal assets consist of commodities, plant, etc.) will be able to meet most of their liabilities simply through the redemption by the Government of its obligations.

Certain factors are at work which may produce bank profits in 1946 which in dollar amount may be as high or somewhat higher than in 1945, although the ratio of net profits to capital accounts may be lower because of increases in capital accounts. Total loans of member banks expanded in the first half of this year by half a billion dollars in spite of substantial declines in loans on Government securities. Offsetting increases occurred in commercial and industrial, consumer, and real estate loans. This should increase earnings on loans substantially because loans on Government securities bear a fairly low rate of interest while the yield on the expanding portion of the loan portfolio is much higher. In spite of the decline in holdings of Government securities which has occurred as a result of the debt retirement program, average holdings of Governments in 1946 may be higher than in 1945 and the average yield on these securities may also be somewhat higher because of a larger proportion of long-term securities than in 1945. As a result earnings on Governments may be somewhat greater than in 1945. Other securities held by member banks increased in the first half of 1946 and this should also contribute to higher bank earnings.

Offsetting these increases, salaries and wages of banks will be higher this year than last and other expenses may also increase. While recoveries, profits on securities, etc., will no doubt be lower in 1945 than in 1946, they will probably exceed losses and charge-offs. In addition, taxes on net income will be lower. All in all, there is a good possibility that net bank profits in 1946 will continue high.

As indicated in your letter of May 17, banks have followed a conservative policy with respect to dividend payments. This is commendable but it does not justify high bank earnings from Government securities. The addition of earnings from Government securities to capital accounts in fact distorts the earnings picture when a ratio to capital accounts is used as a measure instead of a dollar figure of net profits. For example, in 1940 total capital accounts amounted to 6.7 billion dollars and by 1946 these had increased through retained earnings (principally earnings on riskless Government securities purchased with reserves furnished by the Federal Reserve) to 8.7 billion dollars. If the rates of net profits to capital accounts were based on total capital accounts in 1940, prior to the war, the ratio for 1945 would be 13.6 per cent instead of 10.9 per cent. Perhaps a stronger way to make this point is to say that if net profits which amounted to 911 million dollars in 1945 should continue at that dollar figure and if 637 million of those profits continue to be added to capital accounts, each year the net profits to capital ratio would decline until in a few years it would be so ridiculously low that there would be considerable pressure by banks for Government subsidies to provide a fair return based on capital. Don't you think that before that point is reached the public will want to know why the Government is paying the banks in the neighborhood of a billion dollars each year for holding a riskless asset, the funds for the purchase of which were provided to the banks by the Governments itself?

In view of your interest in bank earnings statements which enable individual banks to compare their earnings' experience with other institutions, I wonder whether you have seen the 1945 average operating ratios of member banks published by each of the Federal Reserve Banks covering banks in their Districts. These ratios make it possible for any member bank to compare its earnings' experience not only with the average for all members but with banks of similar size located in the same geographic area. The ratios are averages of individual bank figures rather than ratios based on aggregate dollar figures for a group of banks. This type of ratio assigns an equal weight to each bank regardless of size or importance, and is particularly useful in studying the operations of individual banks. You have no doubt received a copy of the figures for your District from the Federal Reserve Bank of Chicago. The enclosed compilations by districts, size of bank, and proportions of time deposits, made by the Board staff, may be of interest to you.

With best wishes, I am

Sincerely yours,

M. S. Eccles,
Chairman.

DHK:rms