CONFIDENTIAL

January 17, 1946
Draft

PROSPECTS FOR BANK EARNINGS

Summary.--Bank earnings have increased rapidly in wartime years as a direct result of expansion in holdings of Government securities and notwithstanding a sharp decline in interest rates, a decrease in the volume of high interest rate types of loans, and an increase in bank expenses. The net profits of banks, both in dollar aggregate and as a ratio to bank capital, are now larger than at any time in the past two decades. With the public debt no longer increasing there will be no need for further expansion of bank holdings of Government securities and the growth in bank profits might cease.

In appraising prospects for bank profits a variety of conflicting factors need to be considered. It seems fairly certain that profits in 1946 will be somewhat higher than those in 1945, in part because of the increase in bank assets -- U. S. Government securities and other investments -- that occurred late in 1945. Removal of the excess profits tax will also cause some increase, particularly at the money market banks. The difference in net profits is not likely to be great -- from about 10-1/2 per cent of capital in 1945 to between 11 and 11-1/2 per cent in 1946.

Certain factors that are operating to reduce profits will become increasingly important and it is likely that in 1947 profits may be smaller than they were in 1945. The factors

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

tending to reduce profits are:

(1) the refunding of high coupon maturing security issues into lower rate issues and,

(2) a possible increase in operating expenses, particularly salaries and wages, and

(3) a likely decline in profits on securities sold as a drying up of new Treasury issues reduces bank trading in securities.

Banks could also reduce service charges and raise interest rates on time deposits, but there seems to be no tendency in that direction as yet and in the computations presented later no allowance has been made for such changes. Offsetting the decline in earnings from these sources, there may be an increase in the higher interest-rate types of loans, specifically consumer credit, mortgages, and loans to smaller business enterprises.

Bank profits will be affected, to some extent, by monetary policies governing reserves made available to banks and by the consequent investment policies that banks may follow. If the present level of interest rates is maintained and banks do not increase further their holdings of Government securities, and there is no substantial expansion in loans, bank earnings will decline after 1946. The second possibility, and one that is more likely if existing monetary policies are continued, is that banks will continue to sell short-term securities to Reserve Banks to create additional reserves and expand both the total volume of bank credit and their holdings of higher interest rate securities. In this event bank profits will tend to increase.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A third possibility is that monetary policies will be changed so as to curb active bank buying of Government securities. This would mean some increase in short-term interest rates. If this should occur there would be some increase in bank profits. Even a rather considerable firming of short-term interest rates, however, probably would not push bank earnings above 12 per cent of capital.

A more active credit policy would increase the service cost on the public debt above what it would otherwise be. Because of many difficulties in foreseeing the exact shape and effects of a firmer credit policy, its effects cannot be estimated precisely. It can be guessed roughly, however, that each 1/8 of one per cent added to the short-term rate should increase the service cost on the public debt no more than 100 million dollars.[1]

Wartime level of bank profits.--In the period of defense preparation and in the first year of war, banking profits did not increase as rapidly as profits of industrial concerns and other business lines. While holdings of U. S. Government securities were increasing, there was some lag in the booking of the earnings from them. At the same time expenses were growing and banks, particularly small ones, were losing high interest-rate loans. Starting in 1943, however, bank profits increased and this increase is still proceeding.

Bank profit outlook for 1946 and 1947.--The prospects for bank profits now depend on Treasury financing and credit

---

1 Assuming that there would be no effect on the rates at which the Treasury would market intermediate and long-term issues.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

policies more than on any other set of factors. The only orderly way in which these profits can be forecast is to start with the assumption that present Treasury financing and credit policies are continued and then to find out how variations of these assumed conditions modify these basic forecasts.

Forecasting bank earnings is certainly as hazardous as other types of forecasting. Even if the present passive credit policy is assumed, many other factors are variable -- the volume of loans, the rate of return on loans, the number employed at banks when manpower is more available, the rate of pay, and profits from the sale of securities. The following table presents the expected range of bank earnings with the assumed continuation of present credit and financing policies. It will be noted that the ranges are relatively narrow so that the realized profits could easily fall outside if unforeseen conditions emerge. The period for which these forecasts have been made are through 1947 only, because it is believed that projections beyond that point would be purely speculative. In the opinion of the writer, the higher of the estimates in each of the two years is rather more likely than the lower.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table 1.
MEMBER BANK EARNINGS

(Earnings figures are those reported for 1943 and 1944; estimated for 1945; and forecast for 1946 and 1947)
(In millions of dollars)

	1940	1944	1945 (est)	Range of forecasts 1946 Low	1946 High	1947 Low	1947 High
Earnings	1,323	1,874	2,089	2,230	2,370	2,250	2,505
On securities -							
U.S. Govt.(est.)	231	802	953	966	1,001	920	1,048
Other	200	158	167	173	183	178	201
On loans	595	563	578	682	759	736	816
Other	297	351	391	409	425	416	437
Expenses	921	1,127	1,238	1,285	1,365	1,295	1,435
Salaries and wages	400	525	560	585	625	595	665
Interest on time time deposits	147	144	185	190	210	190	220
Other	373	458	493	510	530	510	550
Net current earnings	402	747	851	945	1,005	955	1,070
Recoveries, prof. on securities, etc.	303	318	405	290	360	210	290
Losses and charge-offs	356	232	200	165	205	155	180
Net profits before income taxes	*	833	1,056	1,070	1,160	1,010	1,180
Taxes on net income	*	184	285	215	245	200	250
Net profits	349	649	771	855	915	810	930
Cash dividends	210	226	250	275	300	275	310
Net profits as % of capital accounts	6.2	9.7	10.6	11.0	11.4	9.8	10.8

* - Taxes on net income were included in "other" expenses in 1940.

Aside from the over-all assumption that present Treasury financing and credit policies are continued these forecasts lean on the following more detailed assumptions:

(1) The "low" forecasts assume no increase in <u>Government security holdings</u> beyond the level of the 1945 year-end in 1946 or 1947. The "high" forecasts assume that member banks add 5 billion dollars in each year. This is equivalent to about 6 billion

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

dollars forall commercial banks in each year or a total of 12 billion for the two years.

(2) The average yield on Government securities realized by banks is assumed to fall as maturing issues are refunded with 7/8's certificates. Market purchases are assumed to be at present yields. In recent months outstanding issues on the market have been steadily bid down in yield and up in price and this process may go further, so these estimates may be slightly on the high side. It has been estimated that in 1945 the average realized yield on Government securities for member banks was about 1.33 per cent with a range of error probably not more than ±0.05 per cent. (The average coupon rate paid by the Treasury on the securities held by member banks is about 1.65 per cent). It is estimated that in 1946 this average realized yield would, with present policies, probably sink to about 1.25 per cent and by 1947 to 1.20 per cent.

(3) In the "low" forecast" it is assumed that total loans will increase 2 billion dollars in 1946 and in the "high" forecast 3 billion dollars. In 1947 both forecasts assumed a further expansion of 1 billion dollars. These are admittedly optimistic assumptions in view of war and Government security loans to be liquidated, but they can be defended in view of recent commercial loan experience and consumer credit expectations.

(4) The average earnings rate on loans is assumed to rise moderately. The average realized return on loans declined from 4.0 per cent in 1941 to only a little more than 3.0 per cent in 1945, but the decline was not so much a change in interest

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

quotations as a change in the structure of loans. There was more big business borrowing at the city banks and more borrowing for the purchasing and carrying of Government securities. It is expected that with the revival of lending to more moderate-sized businesses and of consumer lending, the average rate realized by banks will increase even though the structure of interest rates on loans does not change. How far this increase in realized rates will go, assuming that it occurs at all, is purely speculative, but for these forecasts it is assumed that the increase in the average is about one-third of the distance back to the 1941 level. If consumer borrowing should predominate, this increase could be even greater and earnings would be raised correspondingly. An expansion of mortgage credit would also help to raise the average, but not very much.

(5) No changes in gold stock or money in circulation are allowed for. If it is assumed that Federal Reserve open market sales would offset any gold or currency inflow, each billion dollars of inflow should raise the net profits-capital ratio by less than 1/10 of one per cent.

(6) It is assumed that "other" security holdings will continue to increase moderately as they have in the past year.

(7) It is assumed that <u>profits from sale of securities</u>, which have been considerable during the period of war financing, will decline. These profits appear primarily from trading, but with the public debt no longer expanding, banks are more likely to hang onto existing holdings. As a result fewer trading profits may be realized.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

(8) It is assumed that the number of bank officers and employees will increase slightly as manpower becomes available. Average salaries are almost sure to increase in the next two years. It is estimated that average salaries of officers may increase from $5,100 in 1945 to a range of $5,200-$5,300 in 1946 and $5,300-$5,500 in 1947. Average wages of employees may increase from $1,800 in 1945 to $1,900-$2,000 in 1946 and $1,950-$2,100 in 1947.

(9) Average time deposits for the month of December at member banks will be about $24~~,000~~ billion. It is assumed that the increase in 1946 may be about 2 billion dollars and in 1947 another billion. These increases are considerably less than the increase in 1946 of 4.3 billion. The rate of interest paid on time deposits in 1945 was 0.84 per cent. It is estimated that the rate in 1946 may vary between 0.80 - 0.84 per cent, and in 1947 from 0.75 - 0.84 per cent.

(10) It is assumed that taxes will decline in both 1946 and 1947 as a result of the repeal of the excess profits tax and the reduction in rate on the surtax in the Revenue Act of 1945. The decline of rates is offset somewhat by estimated increases in taxable income in the next two years.

(11) It is assumed that bank capital will continue to increase in 1946 and 1947 by the amount of retained profits plus a small allowance for sales of stock to investors. The increase in 1945 appears to have been about 600 million. The increase in 1946 and again in 1947 may range from 400-800 million.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Are bank earnings excessive now?--It is undeniably true that the present level of bank earnings is very high. In 1944 net profits after income taxes to capital accounts amounted to 9.7 per cent and for 1945 it appears that this figure will be 10½ per cent. At this level, banks are above the average of corporate earnings. As shown in the following tabulation, bank earnings in 1945 probably exceeded those of virtually every industrial group except trade, and service and construction. They have been far above such stable earning industries as the public utilities and transportation.

Banks are better assured that these ample earnings will continue than most other lines of business. Large holdings of Government bonds largely insure banks against any material decline in earnings if deflationary circumstances should arise. With earnings depending on Government securities rather than on loan credits, and with prices of Government securities more likely than not to advance during depression periods, the recurrence of a sharp decline in bank earnings such as in 1930-1934 no longer is very likely.

Table 2.
BANK PROFITS COMPARED WITH PROFITS OF OTHER LINES OF BUSINESS
(Ratio of net profits to invested capital in per cent per annum)

Business	1942	1943	1944	1945
Banking: All member banks	6.4	8.8	9.7	10½
Manufacturing	9.9	9.6	9.8	
Mining and quarrying	7.4	7.2	7.6	
Trade	9.9	10.1	10.2	
Transportation	8.2	7.7	5.8	
Public utilities	6.2	6.6	6.5	
Service and construction	11.1	12.5	11.7	
Finance	6.9	8.0	7.7	

Source: National City Bank letter.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Not only are bank earnings high, but banks are materially different from other industries in that virtually every bank in the country is making some profit. In 1944 less than 1 per cent of the member banks failed to earn a profit of some amount. This is in contrast with other industries such as manufacturing, trade, and service, in which even in good times appreciable numbers within the industry -- ranging from 20 per cent to 50 per cent -- suffer losses. Although the war has reduced the number of unprofitable banks, the proportion during the 1930's was also less than in other lines of business.

An industry in which virtually every unit is profitable does not have an equitable claim to as high average earnings as one in which the dangers of loss are greater. With minor exceptions, the nearly universal profitability of banks is true for all sizes of banks.

Table 3.
RELATIVE PROFITABILITY OF BANKS
(Percentage distribution of member banks in the year 1944)

	100.0
Banks sustaining losses	0.8
Banks with net profits as a percentage of average capital accounts: Total	99.2
0 - 5 per cent	10.6
5 - 10 per cent	43.5
10 - 15 per cent	32.8
15 per cent and over	12.3

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Would a credit policy which curbed further deposit expansion expand bank earnings excessively?--Although there are various degrees by which the almost purely passive credit policy of wartime might be firmed, the most meaningful degree would be one sufficient to stop the growth in deposits. What such a policy means in terms of money rates is purely speculative. The primary conditions of such a policy would be that the Federal Reserve System would no longer make reserves freely available to banks. Federal Reserve credit then would vary only with changes in money in circulation together with some allowance for the size of Treasury balances both in commercial and Reserve Banks.

What such a credit policy means when translated into money market rates is very debatable. Some aver that an increase in the certificate rate to 1 per cent would be the net effect of putting a curb on the expansion of member bank reserves. Others, while admitting that such action might be adequate temporarily, believe that the differential between short- and long-term rates would have to be even less, unless long-term rates are permitted to fluctuate up as well as down. The latter group might, for example, believe a certificate rate of at least 1-1/4 per cent would be needed.

The effect of such rate changes on bank earnings also depends, of course, on the financing policy that would accompany it, i.e., whether refundings would still be all in short-term form. Assuming that refunding would be primarily in short-term

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

form the range of certificate rates discussed above would have about the following effect on bank profits:

Member Bank Earnings, 1947
(In millions of dollars)

	Assuming a 1 per cent certificate rate	Assuming a 1¼ per cent certificate rate
Gross earnings	2,375	2,550
On securities		
U. S. Government	1,000	1,120
Other	205	210
On loans	750	800
Other earnings	420	420
Expenses	1,300	1,300
Net current earnings	1,075	1,250
Recoveries, profits on securities, etc.	175	150
Losses, etc.	150	150
Net profits before income taxes	1,100	1,250
Taxes on net income	220	250
Net profits after income taxes	880	1,000
	Per cent	
Net profits as a ratio to capital accounts	10.6	12.0

(Adapted from table 1 above)

If the contrast is drawn between (1) higher short-term rates with no expansion in bank holdings, and (2) present rates with the bank buying that is likely to accompany these rates, the difference is not very great. If 6 billion dollars of Government securities are added to bank holdings in each of the next two years at present money rates gross bank earnings increase by 150 million dollars. If, on the other hand, a short-term rate of 1-1/4 per cent would be required to control bank reserves, bank earnings would increase only about 230 million dollars.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The difference between the two policies in terms of the ratio of net profits to capital accounts would be only about one percentage point.

The cost to the Treasury of a revision in short-term rates cannot be dismissed quite as easily. While not large, the effect is material. Close estimation of this cost is impossible without making a complex set of conditioning assumptions. As a rough rule of thumb, each 1/8 per cent in the short-term rate is roughly equal to increased service cost on the public debt of 100 million dollars. The increase in cost, however, would be less than a substantial refunding of short- into long-term debt, probably the only way the present interest-rate differential could be maintained for very long. The "unfunding" of the debt which is now proceeding cannot continue without driving the long-term interest rate down even below the present low levels. The differential between short-term and long-term money rates ultimately depends on the amount of insecurity felt in the money markets. During the war a very considerable spread between the rates could be sustained because there was some doubt as to interest-rate policy following the war. In the early postwar period some differential, though a much smaller one, might still be sustainable because of doubts in the investment market as to the ability and intention of the Government to continue the stability of interest rates at present levels; also doubts as to whether future administrations would continue the policy. But after five or ten years of stable rates, the banks and

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

other investors might become fully convinced that low and stable interest rates would be continued indefinitely. In such circumstances, the differential between rates that could be sustained would be negligible. If the whole interest rate structure thus converged at 1-1/2 to 1-3/4 per cent, the service cost on the whole public debt would not be far different from the present level. Bank earnings, however, would under such circumstances be materially higher. They would run anywhere from 15 to 20 per cent on total capital accounts.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis