

**FOR RELEASE ON DELIVERY
THURSDAY, MARCH 27, 1980
9:00 A.M. EST**

BANK PROFITS AND INFLATION

Remarks by

**Henry C. Wallich
Member, Board of Governors of the Federal Reserve System**

at the

**Bank Administration Institute's
Accounting and Finance Conference**

Kissimmee, Florida

March 27, 1980

SUMMARY

1. Reported bank profits have been strongly rising, yet bank stocks are selling at relatively depressed prices.
2. Inflation may be a reason for the market's low valuation of bank stocks. Banks are net creditors and creditors usually lose during inflation.
3. When the purchasing power loss from inflation is included, according to FASB recommendations, bank earnings do not look nearly as good.
4. There has been resistance to the idea of "inflation accounting" for banks, but it is a useful concept. The inflation loss on banks' monetary assets is very real.
5. Taking full account of inflation means recognizing its effects on maintaining bank capital and increasing bank income taxes, and its implications for the pricing of bank services.

* * * *

BANK PROFITS AND INFLATION

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

Bank Administration Institute's
Accounting and Finance Conference

Kissimmee, Florida

March 27, 1980

Reported bank profits have been in a strongly rising trend. The rate of return on equity, at about 14 percent, is close to a post-World-War-II high. Bankers are congratulating themselves on their fine performance, and the frowns that bank regulators used to wear when bank loan losses were escalating some years back have changed back to deadpan. Only the stock market is striking a sour note. The growth of bank earnings has exceeded that of most corporations. Nevertheless, the market prices the stocks of many large American banks at four to six times earnings, well below the average for industrials. Quite a few large banks are selling at sharp discounts from book value. Does the market see something that the bankers and the regulators do not see?

The Stock Market's View

The market could be skeptical of the condition of banks. Banks have had their share of troubles in the past, as with Real Estate Investment Trusts (REITs) and tanker loans. Today, concern might stem, for instance, from bank involvement in loans to developing countries. But past bad loans have on the whole been worked off quite satisfactorily. Present loss experience in international lending has been substantially better than at home. While concern about the condition of the banks was justified at the time of the Franklin and Herstatt failures in 1974, there is no obvious reason for it now.

The market could be skeptical also of the quality of bank management. However, with the high regard that I have for the many bankers I have been privileged to meet, I can see no reason why their performance, as a group, should be evaluated by the market less favorably than the performance of industrial executives. So there must be some other reason.

Bankers' Doubts

Inflation might account for the low esteem in which banks are held by the stock market. On the surface, it could be argued that inflation must have been good for banks. Their reported assets have risen faster during inflation than during ordinary times. After all, the essence of inflation is an increase in credit and money, including bank credit and bank deposits. Interest rates are high, and many people believe that bankers profit from high interest rates. Of course, the banks lose something on their assets as money depreciates. But don't they gain it back

from the depreciation of their liabilities? So it looks as if inflation is just money-in-money-out, and of no concern to the banker. That seems to be the view of the casual observer.

That inflation doesn't hurt banks seems to be argued on still other grounds. Bankers are blissfully free from the accounting problems of capital replacement and inventory that trouble industrial executives during inflation. They know that inflation distorts corporate accounting by generating fictitious profits from inventories and underdepreciation. Banks, having next to no inventory or fixed assets, are immune to these pitfalls. So why should inflation hurt them?

Banks Are Net Creditors

What some people seem to overlook is that bankers are net creditors. Once we focus on that fact, suspicion is bound to mount that it is indeed inflation that is ailing the banks. The banks are creditors, and creditors are born losers in inflation. Their paper assets are larger than their liabilities. Their capital, therefore, except for what little real estate and equipment they have, is also invested in paper assets. These paper assets depreciate with inflation. The bank's capital depreciates with them.

The banks add to their capital each year, of course, through retentions of profits. Recently these retentions have amounted to some 8-10 percent of equity, after dividends of about 4-5 percent of book value. If these retentions exceed the rate of inflation, the book value of banks will rise in constant dollars. From 1972 to 1979, book value rose from

\$55 billion (equity and reserves) to \$99 billion. Part of this 80 percent increase, although only a small part, is due to new stock issues and the like, but the great bulk is due to retention of profit. But during the same period the price level rose by 74 percent. Thus, almost the entire increase in book value, and certainly all the retentions, were swallowed up by inflation.

Bankers sometime point out that the same calculation can be made with respect to the book value of any industrial corporation. Since inventories and fixed assets are carried at cost, book value rises only with retentions unless there are new stock issues. So why single out banks for this calculation? Nobody worries much about the book value of corporations. Earning power is what counts. Why should banks be any different?

Bank Book Value Means Something

The answer is that the book value of an industrial corporation and of a bank are indeed very different creatures. The present value of the fixed assets and inventories of a corporation can fluctuate widely. Carrying these assets on the books at historical cost is simply an accounting convention. Particularly with inflation, the market value of these "hard" assets, or at least their replacement cost, is bound to rise. When the price level has doubled or quadrupled, as it has in the United States since 1969 and 1945, respectively, the book value of fixed assets has indeed become meaningless.

A bank is very different. Its assets are primarily monetary. Its book value, therefore, is a fairly meaningful description of its value as an enterprise. Of course, the bank's market value may fluctuate above or

below book value. If earnings provide a high return on book, the market will pay more than book. For poor earnings, it will pay less, as it is doing today for a number of larger banks. Unfriendly critics have been heard to say that such banks are worth more dead than alive, i.e., they could be liquidated at a profit above their market value. Market value can and does differ from liquidating or book value, because nobody thinks of liquidating banks. But book value nevertheless is a much more meaningful indicator of underlying value for a bank than it is in the case of a corporation.

That is why it makes some sense to measure a bank's book value in terms of constant dollars. If over a period of years it has not changed significantly, this means that all the additions to capital, from retentions and otherwise, have just been sufficient to preserve its real value. In other words, the loss to bank capital from inflation has been about equal to the retentions.

How to Calculate the Inflation Loss

This very summary calculation can be made a little more sophisticated by allowing for the fact that banks usually own their buildings and perhaps some other real estate and equipment. For a large bank, these hard assets typically amount to about one percent of total assets or a little more than one-fifth of net worth. During inflation, the market value or at least the replacement cost of hard assets rises. The exact change may be difficult to measure, and in any case will vary among banks. But a not unreasonable approximation suggests that they rise with the general price level. One can

reasonably argue, therefore, that the part of the bank's net worth that is matched by hard assets is in some degree protected against inflation. This means that about one-fifth of net worth of the average large bank is protected against inflation, while about four-fifths are exposed. Some banks may be able to improve on these relationships by making other "non-monetary investments."

Given these premises, it is difficult to avoid making the following rough calculation. If inflation is 10 percent, and if a bank's net worth is protected only to the extent of one-fifth against inflation, the inflation loss on the real value of the bank's equity amounts to 8 percent of net worth. This loss needs to be deducted from the bank's rate of return on net worth. This, as noted before, recently has been about 14 percent of net worth. Therefore, about 6 percent is what is left after this inflation adjustment. If the bank paid a dividend of about one-third of its earnings, i.e., 5 percent on capital, it was paying out in fact most of its real earnings. The 9 percent that it thought it was adding to net worth was almost all absorbed by inflation.

The Painful Truth

Many bankers may have been able to ignore these unpleasant implications. The stock market has not. The stock market seems clearly to have observed the damage that inflation is doing to banks, and has remained quite unimpressed by the seemingly glowing earnings reports.

I need hardly tell you that, if I were a banker, I, too, would prefer not to take account of these unpleasant matters. It is discouraging, having worked hard, to find that the results, inflation-adjusted, are poor.

It is even harder if my pay or bonus were to be based on inflation-adjusted earnings. I would much prefer to believe that the damage that the stockholder had suffered, in terms of the price of his stock, was due to the vagaries of the stock market than to anything I had done or failed to do.

Efforts to ignore the impact of inflation and reject the adjustment of bank statements and particularly earnings for inflation have, of course, a very respectable ancestry. In 1977, the Inter-Association Committee on Bank Accounting (IACBA) undertook a massive study of inflation accounting for banks, employing the research of three separate advisory groups (Arthur D. Little; Peat, Marwick, Mitchell & Co.; and Robert Morris Associates). The IACBA arrived at the conclusion that there was no need for any changes in bank accounting to reflect inflation. Characteristic of this view is the following quote from one of the study papers (Peat, Marwick, Mitchell & Co., page 3): "General purchasing power reporting is neither necessary nor desirable in the financial statements or as supplemental data." "The capital maintenance concept appropriate for bank accounting and reporting is financial capital in units of money." If this is accountants' language to say that a bank is maintaining its capital if, after years of inflation, the equity account shows an unchanged number of dollars, some bankers and some accountants will one day have an unhappy awakening.

Enter FASB

More recently, however, the Financial Accounting Standards Board (FASB) added to their accounting standards a requirement that large banks make a supplementary statement in their annual reports showing selected

financial data adjusted for the effects of changing prices. This mandate applies to about 150 bank holding companies and 20 savings and loans or savings and loan holding companies with assets over \$1 billion. Annual statements now becoming available contain this information, usually somewhere in the back pages and sometimes accompanied by cautionary language explaining that it does not mean anything. The classical comment along these lines that sticks in my mind is: "We believe these numbers are not relevant in managing the business of the corporation."

What is the nature of the adjustments required by FASB, and why are they so sharply resisted by some of the reluctant practitioners? Every stock market analyst has been able to make these calculations for himself for many years. I am reminded of the words of Bishop Joseph Butler spoken in 1726 and recently unearthed in Foreign Affairs: "Facts and actions are what they are, and the consequences of them will be what they will be. Why then should we wish to be deceived?"

FASB's principal inflation adjustment technique applicable to banks, known as constant-dollar accounting, does in a sophisticated way what my simple rules of thumb employed at the outset have attempted to do. They take account of the net creditor position of the bank, known as the net monetary assets position, and arrive at a broad measure of the inflation loss by applying the consumer price index to this magnitude. As noted, the net monetary asset position broadly speaking is equal to the bank's capital minus hard assets (and also minus certain financial assets treated as the equivalent of hard assets). A second and much smaller adjustment is added,

in the form of an upward revaluation of the small volume of a bank's nonmonetary assets -- building, equipment, and a few others -- and an upward restatement of depreciation on the revalued nonmonetary assets. The net effect of these adjustments is that allowance for the hard assets improves the bank's profit picture but that this improvement is far outweighed by the relatively large loss on the net monetary asset position and the -- usually minute -- increase in depreciation charges.

What are the reasons that so many of the critics and mandated practitioners give for their apparent rejection of these techniques, other, of course, than that they do not like the results? One is that the techniques were developed for industrial corporations with heavy fixed assets and/or inventories. Many though not all such corporations are net debtors. That is, financial (monetary) assets are less than their debt; their (nonmonetary) fixed assets and inventory, therefore, are larger than their net worth. Applying the inflation adjustment to this negative net monetary asset position, therefore, produces a gain from inflation. The adjustments made to fixed assets, by raising depreciation, and to inventories, by putting them, in effect, on a LIFO basis, reduce profits. Which of the two adjustments outweighs the other varies from corporation to corporation, in accordance with the degree of leverage. Heavily leveraged corporations usually show an inflation gain from this method.

Bank accountants seem to be of the opinion that this technique is appropriate for corporations but inappropriate for banks. Banks lack sizable nonmonetary assets and, therefore, tend to be net creditors. In my opinion, the opposite is correct. I have grave doubts about the appropriateness of considering the gain from a negative net monetary

asset position, i.e., from being a debtor, as a true gain worthy of being included in the income account. It produces no cash flow, cannot be used to pay taxes or dividends, and is at best a factor enhancing the corporation's market value in a very broad sense.

For a bank, these considerations are irrelevant. There are no significant nonmonetary assets to revalue and depreciate. But the inflation loss on the bank's net monetary asset position is very real. A bank stockholder is very much like a stockholder in a bond fund or money market mutual fund, except that he is heavily leveraged. The latter knows that the underlying assets are losing their purchasing power and that he can preserve the purchasing power of his own investment only if these assets produce a rate of return in excess of the rate of inflation. The same is true of the bank stockholder: Unless the return on equity exceeds the rate of inflation -- with some allowance for hard assets -- his investment is losing purchasing power. That is why the supplementary inflation-adjusted statements for banks make a good deal of sense.

Some Concluding Questions

These conclusions, if they are valid, pose a vast range of questions, running from the value of bank stocks to regulatory policy

with respect to bank capital and bank expansion and to the financing of our economy. Here I shall deal only with the narrowest implications concerning bank profits.

One very obvious implication about which the banks unfortunately are unable to do anything relates to taxes. If bank profits adjusted for inflation are smaller than unadjusted profits, banks obviously pay out more in taxes than the legislator, unaware of inflation, intended them to pay. Banks share this fate with nonfinancial firms. Since banks already pay a lower effective tax rate than most nonfinancial firms, it would come with poor grace from them to be the first in demanding relief. On the other hand, the tax overload from inflation is well known in the case of corporations. Legislators have tried to compensate by devices such as accelerated depreciation and the investment tax credit, neither of which is of significant value to banks.

Larger holdings of hard assets on the part of banks might be a means of defending their capital at least in an accounting sense. Since banks must not become manufacturing corporations, such hard assets presumably would have to be limited to real estate -- except perhaps for assets that can be owned for leasing purposes. The historical record of bank real estate investments is not particularly encouraging. Moreover, regulators have strongly discouraged investment in bank buildings, at least initially, in excess of 40 percent of capital, although member banks are allowed to invest in their bank premises to an amount equal to their capital stock. Even poorly selected investments would give banks some protection against the

adjustments required by FASB, because they would reduce the net monetary asset position, but they would be a meance to both a bank and its depositors and stockholders.

Inflation-oriented pricing of bank credit and services is another possibility. Banks could achieve a rate of return sufficient to compensate for capital attrition from inflation if they were to price accordingly. There is some evidence, in the recent gradual upcreep of the rate of return, that banks are trying to cope with the problem of capital attrition in this manner. But at present rates of inflation they are still far from achieving this objective. On the contrary, there is a widespread impression among the public (and some regulators) that banks are making enormous profits. Higher profits, even though modest after adjustment for inflation, might arouse widespread public criticism. Bankers are doing themselves little favor by not educating the public (and themselves) to the realities of bank inflation accounting.

Lower dividends would be still another line of defense. Retentions could be raised, in the unrealistic case of total omission of dividends, up to equality with the rate of return. This would protect bank capital at least so long as the rate of return on capital remained in excess of the rate of inflation. It would be poor comfort for the stockholder, of course, to know that his principal was protected only by denying him the fruits of it. However, so long as the payment of dividends does not lead to price levels for bank stocks at which new equity issues become a realistic possibility, dividends seem to serve no functional purpose from the point of view of the bank.