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Remarks by

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

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Roundtable on Credit Systems in the 1970's

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Ente per gli Studi Monetari Bancari e Finanziari "Luigi Einaudi

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When American bankers look back upon the decade of the 1970's, they can add up a number of impressive achievements. American banks have innovated vigorously, both abroad and at home. Abroad they have played a pioneering role in the financing of developing countries and particularly in the recycling of OPEC funds. At home new techniques of lending, of raising funds, and particularly of serving the consumer have been developed. Through the bank holding company device, banks have been able to break out of their geographical confinement at least in limited fields such as consumer and mortgage financing. They overcame the difficulties of 1974-75 which incidentally provided a positive test of the effectiveness of American institutional arrangements for dealing with a major bank failure.

At the same time, American banks have experienced trends that are less constructive and call for careful analysis. Large American banks have embarked on a program of heavy lending to developing countries, which carries them into an only partially charted risk area. As a group, these banks

nevertheless have fallen behind in the race against foreign competitors for market shares worldwide. Domestically, the share of banks in the total supply of credit has diminished. The dependence of particularly the largest banks on purchased funds of a volatile character has increased. The value assigned to the largest banks by the stock market has fallen to levels at which it becomes very difficult for them to issue new stock. Meanwhile their capital has not kept up with the rise in their assets.

These generalizations, to be sure, apply to different U.S. banks in very different degree. It is principally the money center banks that have experienced the problems just noted, and in lesser degree the large regional banks. Small local banks have been affected far less.

These differences are crucial to an evaluation of the American banking scene. Local banks, with assets of up to perhaps \$100 million, typically have had good earnings, of the order of one percent on assets or more, compared to one-half to three-quarters of one percent for the money center banks. Their capital averages 8 percent of assets, contrasted with 4 percent or less for the money center banks. Their stock typically sells at a sizable premium over book value, contrasted with a discount from book value for many money center banks that has begun to be corrected in a few cases only recently. Considerable regional differences are observable in the experience of small banks during the 1970's, and it is conceivable that increasing competition, especially with thrift institutions and perhaps with larger banks more aggressively deploying innovative techniques, may change the picture for small banks during the 1980's.

In any event, the following observations concerning American banks must be understood as applying principally to the money center banks, a term usually applied to a group of nine banks, and in diminishing degree only to

large regional banks, comprising a group of perhaps 15 major institutions. I shall examine some of the factors giving rise to concern. From what I have already said it should be clear that I regard these as compensated by many positive aspects on which I do not intend to dwell here.

LDC Lending

American banks have pioneered in the development of lending to developing countries. This lending began well before the 1973 rise in the price of oil. It increased in volume and economic significance as recycling of the OPEC surplus became necessary. The developing countries in large part were unable to maintain a good rate of growth during the difficult years that followed. It is not easy to visualize how that result could have been achieved without the activities of American banks, in which banks of other countries soon began to join.

LDC lending was seen to involve a new kind of risk -- "country risk." For many developing countries, however, the market's evaluation of risk in the course of time became very low, under the pressure of competition and the ready availability of funds in the Euromarkets. In justification it was sometimes argued that developing countries constituted a relatively good credit risk because they could not go out of business and would always have to meet their obligations or reschedule them in an acceptable way in order to continue essential development programs.

The validity of this reasoning remains to be tested. So far the record of loan losses of American banks in LDC lending has been very good and certainly much superior to domestic experience. Nevertheless, during the last few years, American banks have tended to limit their activities in LDC lending, leaving a growing share to banks of other countries. This

has somewhat reduced their comparative exposure, although for the money center banks, which have done the bulk of this business, non-OPEC LDC exposure continues to be higher than for banks of other countries, averaging 176 percent of capital for the money center banks.

American bank regulators have been concerned to limit concentration of exposure in particular countries. An examination system has been established which focuses on the percentage of capital exposed in each country. So far this emphasis on diversification has been justified in that a domino effect among borrowers which one might anticipate has not so far materialized. Research seems to indicate that the circumstances influencing the ability to pay of particular countries are sufficiently different to limit significantly any correlation in their debt service behavior. At the same time, however, the low level of spreads has made LDC lending a seriously unremunerative form of risk. It seems clear that LDC lending has proceeded at a pace that cannot be sustained, at least by the U.S. banks that have carried a large part of the burden until now, and that eventually other banks or other sources of finance will have to be opened up for the developing countries to supplement bank lending.

The Diminishing Role of American Banks

In 1956, 44 U.S. banks ranked among the world's top hundred banks, measured by deposit size, and accounted for 52.4 percent of the deposits of these hundred banks. In 1978, the number of U.S. banks among the top hundred had dropped to 15, with 14.8 percent of deposits. These data, developed by The American Banker and quoted from the Comptroller of the Currency,^{1/} are subject, of course, to numerous qualifications.

^{1/} C. Stewart Goddin and Stephen J. Weiss, U.S. Banks Loss of Global Standing, Comptroller of the Currency, Staff Paper, June 1980, p. 2.

They are not, however, at all surprising. The American economy has been growing more slowly than most others. The role of American banks in international lending has been diminishing relatively recently. The devaluation of the dollar, while conceptually offset by the higher rate of U.S. inflation which was one of its causes, probably contributed on balance to the reduction in the U.S. share. The difficulties that American banks have had in increasing their capital likewise may have played a role. So did the diminishing demand for noninterest-bearing money, relative to income, i.e., the rapid increase in velocity, in the face of mounting inflation.

More fundamental, however, than the foregoing factors, because it is more closely related to the structure of the American banking system, is the constraint placed upon the expansion of banks by U.S. banking legislation. The Glass-Steagall Act and the Bank Holding Company Act closely limit the financial activities the banks can undertake, especially with respect to the securities business, and so restrict product extension. The McFadden Act and the Douglas Amendment restrict geographic market extension -- the McFadden Act, by prohibiting interstate branching, and the Douglas Amendment by restricting interstate acquisition of banks by bank holding companies. These are the principal expressions of U.S. structural policy in the field of banking. Other countries have been far more generous regarding the ability of banks to move into other fields of activity and in allowing them to merge and branch on a nationwide basis.

Geographic restrictions on expansion are, in part at least, also responsible for the diminishing share of the money center banks in the total domestic banking business in the United States. The demand

deposits of large corporations, which at one time were their principal source of funds, have shrunk drastically as interest rates have risen and cash management techniques have improved. The money center banks do not have access to small business and household deposits beyond their operating area. As a result, regional banks and, even more, smaller local banks have increased their share of the commercial banking business at the money center banks' expense.

Even more, however, commercial banks as a group have fallen behind as suppliers of credit in the United States. Thrift institutions, other financial and nonfinancial institutions, and the federal government all have cut into the share of the banks which has gone from 33.0 percent in 1970 to 30.9 percent in 1980 (Q1). While this development may have many roots, one obvious factor is the impact of legal and regulatory restraints on market and product extension in a rapidly changing world.

Purchased Funds

The regional segmentation of the U.S. banking system not only limits growth, but also makes it more difficult to create a national deposit base. Funds that in other countries are channeled to a bank's head office via a nationwide branch system, in the American environment must be purchased in the federal funds market or through repurchase agreements. Together with funds raised through large certificates of deposit and through the Euromarket, purchased funds account for as much as half the total funds available to some American money center banks. Such funds often are interest sensitive and volatile to a high degree.

The prohibition of interest payments on demand deposits also works to limit the deposit base. However, such funds are not necessarily lost to the banking system. Banks may be able to attract corporate funds in the

form of repurchase agreements and similar devices. They may also retrieve funds of small personal holders through the sale of CDs to money market mutual funds. In this way, large banks may attract some funds that would be held as demand deposits in small local banks if interest could be paid on them.

The interest rate sensitivity of these managed liabilities imposes certain constraints on banks in terms of the assets financed from such sources. Fixed interest loans, such as most mortgage, consumer, and also many small business loans, have less interest flexibility than would be desirable for the safe investment of these funds. However, floating rate loans, accounting for about one-half of total loans, provide enough flexibility to effectively limit interest rate risk.

Funding risk is another matter. Compared to a bank with a strong base of core deposits, a bank relying heavily on purchased funds must continually meet the market test. Difficulty in rolling over purchased funds is a sign of incipient trouble. In one sense, this imposes a wholesome discipline upon banks, but it also increases the overall risk element.

Compared to large foreign banks operating in the Eurodollar market, American banks have the advantage of operating almost exclusively in their own currency. They do not face the risks inherent in having to meet rollover maturities in a foreign currency. Accordingly, the risks of maturity transformation are of a different order for them than for their foreign competitors. They do not face the possibility of a run-off of purchased liabilities without recourse to a dollar base or a dollar lender of last resort. Nevertheless, no bank, whether operating in its own or a foreign currency, can regard any short-term liability and especially, of course, demand deposits, as entirely stable. Clearly the growth of liability management and consequent reliance


on purchased funds by large American banks must be regarded as an element of flexibility more than of strength.

Liquidity

Liability management is only one part, of course, of the total picture of a bank's liquidity. It used to be said that liability management had totally changed the problem of providing liquidity for a bank. Instead of holding liquid assets to meet withdrawals or take advantage of opportunities, liability management supposedly allowed banks to buy money whenever it was needed. Meanwhile it has become apparent that the ability to buy money is itself dependent on the market's view of the soundness of the bank, as reflected mostly by earnings and asset quality, but in which liquidity also plays a part.

American bank supervisors have placed additional emphasis on liquidity in recent years, by including an evaluation of it in their so-called CAMEL rating system for banks, which focuses on capital adequacy, asset quality, management quality, earnings, and liquidity. In this framework, liquidity is evaluated in terms of capabilities and performance, rather than numerical standards. The rating recognizes that the circumstances of particular banks vary widely and that quantitative measures would not adequately capture these disparities.

It is worth noting that, of the five criteria by which liquidity is evaluated in the CAMEL system, four deal with liabilities: (1) volatility of deposits, (2) reliance on interest-sensitive funds, (3) technical competence relative to the structure of liabilities, and (4) access to money markets. Only one -- (5) availability of assets readily convertible into cash -- focuses on the asset side. The degree of maturity mismatching is not specifically included among the liquidity criteria.



The system has not been in effect long enough to observe the evolution of liquidity of U.S. banks over time. During a period of economic and financial expansion, liquidity must be expected to decline, but the available data do not suggest deterioration among the nine money center banks.

Not quite as favorable an impression is derived from a tabulation of four tests of liquidity for a group of 35 large banks, taken from a study by Salomon Brothers, and shown in Table 1.

TABLE 1.--Measures of Liquidity

	1975	1976	1977	1978	1979
Loans as percent of total assets	56.2	55.4	55.4	56.3	56.6
Net purchased liabilities as percent of total assets	36.6	34.9	36.1	39.7	40.1
Investment securities maturing in one year or less, as percent of total investment portfolio	35.3	30.8	32.1	23.7	17.9
Depreciation of investment portfolio (percent of book)				4.0	5.9

Source: Salomon Brothers, A Profile of Commercial Banking in the United States, 1980 edition, pp. 52-55.

While there has been no significant deterioration in the loan/asset ratio, there is evident a weakening in the purchased liabilities ratio, the short-term investment securities ratio, and the overall value of the portfolio. It should be noted that these data, as far as the year 1979 is concerned, reflect relatively high interest rates which since have come down and probably have improved the value of the investment portfolio.

Liability management tends to blur the ancient distinction between liquidity and solvency. A bank whose solvency is beyond question is unlikely to find itself strapped for liquid funds, because it can buy money. However, if its solvency comes into question, this source of funds will begin to dry up, creating a liquidity problem. If the bank then is compelled to liquidate assets at depreciated prices, as many happen if interest rates have been rising, these efforts to provide liquidity may further endanger solvency.

The environment of high and volatile interest rates that has prevailed in the United States in recent years has confronted the banking system with many new challenges in the area of liquidity policy. Attention to the interest sensitivity of assets and liabilities becomes very important. Matching the volume of interest-sensitive assets and liabilities helps to reduce the impact of interest rate fluctuations upon earnings. A net long or short position in interest-sensitive assets becomes a speculation on the movement of interest rates.

It is becoming apparent that even the voluminous data provided by U.S. banks on their quarterly call reports are not sufficient to permit a definitive analysis of interest-rate sensitivity. Breakdowns of maturities within the one-year range would be needed for a more accurate assessment. It is worth noting that from the end of 1978 to March 31, 1980, most of the banks in the above-mentioned sample of 35 large banks kept their ratio of

interest-sensitive assets to interest-sensitive liabilities within the range of 85 to 115 percent.^{2/} There was a slight shift, during this period, toward the lower direction. Given the upward trend of interest rates during this period, this was scarcely a profitable move at the time. But it may have turned profitable once interest rates began to come down.

Analysis of interest sensitivity, however, is not enough in today's banking climate. The nature of "interest-insensitive" assets and liabilities is even more important. While their interest yield or cost may be fixed, they respond to interest rate movements in other ways. Demand deposits and savings deposits, whose interest rate ceilings are fixed, respectively, by law at 0 and 5-1/4 percent may be disintermediated as interest rates rise. Marketable securities with longer maturities will depreciate under these conditions, even though they can continue to be carried at cost if their quality is above question. Mortgages and other medium- and long-term fixed rate loans have no market quotation, and, of course, continue to be carried at book value, but their economic value nevertheless is depressed by rising interest rates.

For these reasons, the meaning of large investment portfolios on bank balance sheets has changed significantly. Where in years gone by such holdings were regarded as elements of liquidity and strength, particularly if invested in government securities, today they are looked upon by some analysts as sources of potential or actual weakness. For mutual savings banks and savings and loan associations, the depreciation of mortgages

^{2/} "Rate Sensitivity Ratios: Tilting to the Liability Side," Salomon Brothers, Bank Stock Department, June 13, 1980.

with low interest rates in the face of the rising cost of liabilities created considerable tensions in some instances before interest rates came down in April of 1980.

Capital

The capital stated on the balance sheet of American banks is more meaningful than its counterpart in most other countries. U.S. banks have no hidden reserves in the usual sense of the word. They are fully consolidated worldwide, at the 50 percent level, so that the assets and liabilities of subsidiary concerns at least 50 percent owned are included in the balance sheet of the bank. There are no trustee or similar accounts. Nevertheless, valuation differences can arise between the book value of the investment portfolio, which can be carried at cost if the assets are of sound quality, and its market value. Mortgages, likewise of course, are carried at cost. Thus, at times of rising interest rates, these assets, although booked according to generally accepted accounting principles, may represent an overvaluation. At times of falling interest rates, they would be undervalued.

Large American banks carry valuations to meet loan losses of the order of one percent of loans, which are in excess of historical loss experience and may therefore to some extent be considered equity. Since all large banks have adopted the character of bank holding companies, and since the holding company usually has some debt outstanding, thereby giving a double leveraging to the banks' capital, it is the capitalization of the holding company rather than that of the bank which is relevant for international comparison and as a measure of the strength of the bank.

The capital ratios of American banks, usually measured as equity capital/total assets, have followed a declining trend for many years. For the money center banks, the range is approximately from 3 to 4.5 percent. International comparisons are difficult to make, because of such factors as incomplete consolidation, hidden reserves, valuation of assets, and the use of trustee accounts. In a recent paper,^{3/} Wilfried Guth placed the capital/assets ratios of the three major German banks at 3.93 percent compared with four British clearing banks at 6.02, and four leading American banks at 3.58 percent. American banks appear at the low end of this distribution, while the entire three country group would be out-ranked by the leading Swiss banks. On the other hand, French and Italian banks would probably rank lower, with the leading Japanese banks at about the same level.

For nine U.S. money center banks, the average capital ratio declined from 5.36 in 1970 to 3.90 in 1979, with a brief interruption in 1975 and 1976, when the expansion of the banking system diminished. The expansion of bank assets underlying this decline was more a function of inflation than of expansionary policies on the part of the banks. This is particularly true with respect to the money center banks, whose share in total domestic commercial bank assets dropped from 19.1 percent in 1970 to 18.2 percent in 1979. These banks compensated in some measure for their relative decline at home by faster expansion abroad.

The downward trend in capital ratios has been a serious concern to U.S. bank regulators. They see bank capital principally as a means

^{3/} Wilfried Guth, "Problems Raised by the Growth of International Bank Lending" delivered at the International Monetary Conference, June 1-4, 1980, New Orleans.

of protecting bank depositors and other creditors against possible losses. Some banks, to be sure, seem to believe that losses even of a size very unlikely to occur could and should be taken care of out of earnings. With pretax earnings of leading banks in the range of 20-30 percent of capital, there is indeed much scope for absorption of losses before capital would have to be invaded. Nevertheless, capital remains the ultimate source of solvency.

U.S. bank regulators -- the Comptroller of the Currency, the Federal Reserve, and the Federal Deposit Insurance Corporation (FDIC) -- from time to time have urged particular banks to strengthen their capital. The Federal Reserve has also at times slowed down the merger and acquisitions process of all bank holding companies in order to encourage consolidation rather than expansion. For smaller banks, the Federal Reserve has been somewhat more demanding than for large banks as regards the level of capital required for approval of bank holding company applications, on the grounds that smaller banks, with their less broadly based business, have less opportunity for risk diversification. Recently, the Comptroller of the Currency has urged individual banks to strengthen their capital from existing levels. Hard numerical capital ratios, however, have never been applied to large banks.

Uniform ratios could probably be enforced by the regulators even without statutory backing because of their wide range of supervisory and regulatory powers, including the control of mergers and bank holding company acquisitions. Proposals for establishing uniform ratios have nonetheless always come up against the fact that banks not only have very different ratios at the present time, but by the nature of their circumstances can

justify differences within a considerable range. Uniform ratios might limit the credit expansion of strong banks while perhaps leaving scope for undesirable expansion of less strong institutions.

The most obvious way of augmenting bank capital -- issuance of new stock -- is made very burdensome for most of the large banks by the low price of their stock, in most cases selling below book value and equal to 4-5 times annual earnings. Moreover, given the damage that inflation does to bank capital, which I shall spell out in the following section, the question can be asked whether raising new capital would not be throwing good money after bad. Alternative techniques would be to deliberately slow the rate of credit expansion of undercapitalized institutions or to reduce dividends. Both approaches, however, would probably further depress the price of bank stocks and thus further reduce prospects for new stock issues in the future. A widespread slowing of bank credit expansion, moreover, would probably have macroeconomic effects, even though the relative reduction in bank credit could to some extent be made up by faster expansion of other forms of credit. Still another approach would be an increase in the coverage of deposit insurance, perhaps to 100 percent of bank liabilities. The drawback of this seemingly very rational approach is the probable relaxation of market discipline over banks and prospect of much greater government control over banks' affairs.

Probably the most economic and natural solution to the problem of bank capital would be an increase in bank earnings, which would lead to higher retentions of profit as well as better chances for new stock issues. I shall comment presently on some aspects of this solution. Over the last

three years, the earnings of the banks have indeed grown sufficiently to raise the rate of return on capital. For a group of 35 leading banks, the return on equity rose from 12.5 percent in 1977 to 15.2 percent in 1979. With dividend payout close to one-third, this allows retentions equal to about 10 percent of capital. The earnings picture, however, is far more complex than this and needs to be examined separately.

Earnings

Bank earnings suffer from inflation in a way that bankers, regulators, and even some analysts find hard to appreciate. Some analysts seem to take the view that all that is needed to adjust bank earnings for inflation is to divide them by a price index, yielding an earnings series in constant dollars. Unfortunately, inflation accounting, whether by the constant dollar technique (also known as general price level accounting), or by the current cost technique (also known as the current value method) is not as simple as that and the outcome more damaging than that. Some seem to take the view that, since bank assets and bank liabilities both depreciate at an equal rate during inflation, bank capital and earnings are altogether unaffected. They overlook that the bank's capital is also invested in depreciating paper assets, except for a small portion that may be invested in nonmonetary assets such as real estate. In the United States, banks' nonmonetary assets, usually the bank building and a small amount of equipment, account for about one-quarter of the banks' capital. If that part is regarded as protected, at least conceptually, against inflation, about three-quarters of the capital remain vulnerable. The loss that the bank and its stockholders suffer on this part of the capital must be deducted from

the rate of return in order to arrive at inflation-adjusted earnings. At a rate of inflation of 10 percent, this means a "hair cut" of about 7.5 percent or one-half of a 15 percent nominal rate of return.

This form of inflation adjustment has become more widely understood since it was mandated, in a more elaborate form, by the Financial Accounting Standards Board. Major banks must now provide inflation-adjusted earnings data in their annual reports. Nevertheless, these adjustments do not yet seem to have been fully accepted by bank management or bank stock analysts. The market, however, seems to understand them since it places so low a valuation on bank stocks, although conceivably this could have other reasons such as concern about LDC lending.

Given the low level inflation-adjusted bank earnings, it seems clear that earnings will have to rise further if banks are to protect themselves effectively against inflation. This increase could, of course, take the form of a further lowering of capital ratios, but that would be highly undesirable. On the contrary, one of the principal reasons for increased earnings, as noted earlier, would be to raise retentions in order to overcome the attrition of capital by inflation. Questions would likewise have to be raised if banks were to attempt to reduce their positive net monetary asset position by acquiring more ~~nonmonetary~~ assets not strictly germane to their business. Conceivably, after-tax earnings could be improved if the tax were made to apply to inflation-adjusted earnings. There would be justification for such legislation, because the tax rate on the adjusted earnings is far higher than the stated rate -- as is, incidentally, the dividend pay-out ratio. But such legislation would probably have to be part of a more general adaptation of the tax system to inflation.

Earnings could be raised also if reserve requirements were to be reduced, a measure justifiable in terms of their high interest cost under inflation. A substantial reduction in reserve requirements already has been legislated under the Monetary Control Act, over a period of eight years. This does not make a decisive difference, however, in the banks' ability to raise their earnings and retentions.

A more likely alternative is wider interest-rate margins, as noted earlier, which would mean lower returns to depositors and higher costs to lenders. For the banks it would mean slower growth and a diminishing share of banking in total credit. Such shrinkage indeed is the expectation one must have about the future of the banking system and the entire financial sector in an inflationary economy. There would also be political difficulties about an increase in bank earnings that, before adjustment for inflation, might appear excessive. Nevertheless, it seems to be the economically most plausible and the most feasible way in which banks could defend themselves against progressive decapitalization by inflation.

Conclusions

1. American banks during the 1970's have encountered both successes and problems. The present paper focuses on the problems, in the belief that even though they are outweighed by the successes, problems need to be analyzed before they can be effectively dealt with.

2. The large money center banks, by lending to LDCs, have assumed a new and not well explored form of risk -- country risk. While loss experience so far has been very good, the financial returns have been unrewarding and the banks have tended to limit their participation in this area.

3. American banks have been limited in their growth by legislative and regulatory restrictions, principally by the Glass-Steagall Act and by the McFadden Act and the Douglas Amendment, which impede product extension and market extension respectively. As a result, their rank among the world's largest banks has declined, the share of the money center banks in the total U.S. banking system has declined, and the share of the entire banking system in total domestic credit has declined. Inability to acquire a larger volume of core deposits through a wider branch system has pushed the money center banks toward increasing liability management. Easing of restrictive banking legislation would improve the position of the money center banks and strengthen the financial system and perhaps also improve the share of the entire banking system in total credit.

4. The capital ratios of large banks have trended downwards, under the impact principally of inflation. Sales of new stock have been difficult because of the depressed price of the stock of large banks. Earnings have been inadequate to maintain capital ratios through retentions. Among the possible remedies would be a slowing of expansion imposed by the regulators (which would be painful for the banks and for the economy), a move toward 100 percent deposit insurance (which carries with it the threat of government domination), and action by government or the banks themselves to improve the banks' after-tax earnings.

5. Bank earnings are grossly distorted by inflation and typically overstated by 50-100 percent. Inflation-adjusted accounting has been mandated by the Financial Accounting Standards Board, but has not found full acceptance. Among the consequences of the overstatement of profits are low price/earnings ratios, market values below book values, excessive effective tax and dividend payments, and inadequate profit retentions.

Inflation adjustment of taxes would be economically justified but is unlikely. Regulatory encouragement of greater investments in nonmonetary assets would be undesirable. The most promising remedy would be the widening of profit margins sufficient to produce adequate inflation-adjusted profits, which would restore the ability of banks to sell stock, limit and preferably reverse the shrinkage of capital ratios, and end the decapitalization of banks by inflation.

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