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BANK PROFITS, REGULATION, AND MONETARY POLICY

Remarks by

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

at a meeting sponsored by the

West Virginia Bankers Association

Charleston, West Virginia

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It is a pleasure to be speaking to the West Virginia Bankers Association on "Bank Profits, Regulation, and Monetary Policy." Your program leads me to believe that you would want me to cover a wide range of topics. This is a crucial period for bankers, regulators, and monetary policy makers. We need to stay in close touch with each other, and with events, if we are to negotiate this transition safely.

West Virginia is a very special State where banking is concerned. After spending much of my time in Washington working on bank branching matters and bank holding company applications, it is instructive to observe banking in a State where bank branching and multi-bank holding companies are not permitted. That banking can be profitable without such features is attested to by your return on capital of 12.3 per cent in 1977, and by the recent rate of growth of your assets, which was 11.9 per cent. These are achievements upon which West Virginia bankers can look with pride.

Bank Profits During Inflation

Nevertheless, during a severe inflation such as we are experiencing, banking profits can be seriously distorted. Properly adjusted for the effects of inflation, they may be quite different from what "generally accepted accounting principles" make them appear. Let me give you some data.

For 1977, profits of all insured banks in the United States amounted to $8.9 billion or 11.8 per cent of equity capital. In historical perspective, this is a good rate of return, although somewhat lower than the early 1970's. It reflects a rate of growth of bank profits of 13.2 per cent over 1976, which is an above-average achievement. For 1978, preliminary data show indications of strong further growth, with profits possibly of $10.7 billion, a return of 12.8 per cent and a growth of profits of 20 per cent. Unfortunately, these seemingly satisfactory numbers do not take into account the high rate of inflation that has prevailed and what it has done to the capital of the banking system.

Banks are unique among business enterprises in that almost all of their assets consist of paper values that are vulnerable to inflation. Industrial firms and utilities typically have a good part of their assets, sometimes the great majority, in the form of brick, mortar, and machinery. During an inflation, these "hard assets" protect the firm's equity to some degree. The bank has only its building and some equipment and capital leases that can perform a similar function. For the banking system as a whole, real estate shown on statements averages about one-quarter of equity capital. In other words, the protection of bank equity by "hard," i.e., nonmonetary, assets seems to fall short by 75 per cent of full coverage.

The market value of this real estate, to be sure, could be quite different, and perhaps higher. However, even today not all commercial real estate has appreciated. That depends largely on location and local experience. The replacement cost of the buildings, of course, has much increased. But so has the depreciation that would have had to be charged to the appreciated replacement cost. Some very tentative calculations seem to show that, net of depreciation, the present replacement cost may not be substantially higher than book value. In addition to real estate owned outright, we should probably take capital leases into account. These are the economic equivalent of ownership of the underlying property and are regarded by accountants as "nonmonetary" assets, but aggregate data on these are not available.

This is of great importance in assessing the impact of inflation on banks and their earnings. It is sometimes said that inflation is neutral with respect to bank earnings, because it affects equally their assets and their liabilities. That statement applies to the great bulk of bank assets and liabilities. It overlooks, however, two crucial factors -- the bank's equity capital on the liability side, and the bank's building and real estate and equipment on the asset side. Bank equity is not a liability. The erosion, by inflation, of the value of deposits and of the assets covering them causes no loss to the bank. The loss falls on the depositor or holder of subordinated debt. But any erosion of assets that reflects bank equity, i.e., of the amount by which assets exceed liabilities, falls upon shareholders.

This erosion of capital is a crucial part of the bank's over-all profit situation, even though it is not reflected in any outflow of cash like other costs. In assessing the addition that his retained earnings make to the true net worth of the bank, the banker must take this erosion into account, except as it is offset by hard assets. If hard assets constitute 25 per cent of equity, and 75 per cent, therefore, are unprotected, and if inflation moves at about 7 per cent, as it did in 1977, the erosion of capital would amount to about 5 per cent per year. To get a realistic picture, i.e., one adjusted for inflation, of the true economic profits of this hypothetical bank, the 5 per cent erosion needs to be deducted from the bank's rate of return on capital. If that rate of return is equal to that of the entire banking system, it was 11.8 per cent in 1977. Deducting an inflation-caused erosion of about 5 per cent from this return would give an inflation-corrected return of a little less than 7 per cent.

I would be the last to claim that the adjustment for inflation that I have applied here to bank profits -- and that seems to reduce a handsome return on capital of 11.8 per cent to only about 7 per cent -- has any pretense to accuracy. It is a highly simplified shortcut, a rule of thumb, that happens to approximate very roughly a sophisticated technique developed by the Financial Accounting Standards Board (FASB) known as General Price Level Accounting (GPLA). I might add, however, that an analysis of bank earnings done in a manner similar to FASB's GPLA technique for the years 1974-76 does indeed produce inflation-adjusted bank earnings quite consistent with the picture conveyed here by the shorthand rule-of-thumb method.

There are other techniques of adjusting business accounts for inflation, such as the current cost method. FASB presently has under way a task force whose purpose is to propose methods of making supplementary statements to the ordinary bank balance sheets and income statements. You will, therefore, probably be hearing a good deal about this subject. We may take for granted that there is no way of making precise adjustments. All that one can hope for is that the valuations arrived at on the basis of these adjustments are in reasonable accord with the judgment of the market in which bank stocks are priced and traded. Conformity to market judgment should be the test of any method of adjustment for inflation. There is good reason to believe that the market is aware of the distortions caused by inflation and is not seriously deceived by accounting conventions that ignore economic realities. Conformity with the valuation of the market can, therefore, be taken as a test of the appropriateness of an accounting convention.

I would not have ventured to put before you the rough estimate that I gave if its results were not reasonably well supported by the verdict of the market. The stock market's judgment is that bank profits are greatly overstated. The stock market places an astonishingly low value on reported earnings of bank and bank holding company stocks. The price/earnings ratio for nine of the largest money market banks runs from not quite five to a little better than seven times. This contrasts with ratios during the early 1970's of 10-20 times. Ordinarily the stock market accords so low a multiple only to high-risk situations. But the condition of our large banks is sound, and I can see no justification for these low multiples on grounds of banking risks. Nor would one ordinarily expect stocks with the rapid growth of earnings and dividends that bank stocks have enjoyed to sell at such low multiples. It is difficult to reject the conclusion that the stock market has analyzed the situation correctly and is capitalizing bank earnings at a low value because, after adjustment for inflation, bank earnings indeed are low and growing only slowly.

The conclusion that bank profits are grossly overstated is supported also by a look at the ratio of market value to book value. That ratio tells the same story. With some notable exceptions, the large money market banks are selling in the market far below their book value. Book value for banks is more meaningful than it is for industrial companies, because bank assets, being monetary, should by and large all be collectible, and should yield enough to pay off liabilities and leave for the owners the amount referred to as book value. For an industrial company, with its typically large holdings of nonmonetary assets, the liquidation value of which is highly uncertain, book value is, of course, not very meaningful.

Thus, when banks sell substantially below their book value, the market is conveying a message. That message, in my view, is not that bank assets are of poor quality. There is no basis for such an interpretation. The message, rather, is that bank earnings are of poor quality, i.e., that they need to be adjusted downward for inflation. The divergence between book value and market value becomes possible, of course, because banks are not expected to be liquidated, so that higher liquidating value has only very limited effect on market value. Thus, it comes about that our large banks seem to be worth more dead than alive.

Evolution of the Banking System

From the subject of bank profits I would now like to turn to matters of bank legislation. Banking matters have been prominent in this and last year's session of Congress. An effort, carried over from last year, to resolve the membership problem and simultaneously enhance equity among financial institutions and prevent further erosion of the Federal Reserve's ability to conduct monetary policy has been slowed in the House. This development reflects the fact that member banks, especially small banks, have found the financial cost of membership increasingly burdensome. That is, of course, a by-product of inflation which has raised interest rates to levels that make the holding of sterile balances very costly. I believe that, in a broad sense, membership is nevertheless worthwhile. A country without a strong central bank is not a good country for banks to operate in. But it is difficult for the Federal Reserve to be a strong central bank without broadly based reserve requirements.

Meanwhile, Congress will probably turn to other aspects of bank legislation. One important area is the effort to help the small saver. The small saver is being victimized by inflation in a particularly severe form. In addition to the damage to his principal, he is subject to interest-rate ceilings that do not affect large investors. Proposals have gone forward for comment that would give the small saver somewhat improved options without excessively burdening the depository institutions whose solvency must be a prime concern of the respective regulators.

Related to the same range of problems, a study is going forward by the Administration on future policy concerning Regulation Q in general. Based on this study, the President will make recommendations to Congress.

Some of the problems posed by Regulation Q in the past during periods of rising interest rates have been dealt with, as far as the impact of disintermediation on housing is concerned, by the introduction of money market certificates. But there is no denying that this whole set of problems is made very much more difficult by the ongoing inflation and by the high interest rates that inflation brings about. Progress in dealing with the problems created by Regulation Q is urgently needed.

Another study mandated by Congress that is also going forward is a review of the McFadden Act. This was mandated by Congress as part of the International Banking Act (IBA). The IBA perpetuates, in limited degree, the interstate branching privileges enjoyed previously by foreign banks operating in the United States while also providing more nearly equal competitive footing in the future. In Washington, the Federal Home Loan Bank Board is proposing to experiment with branching across State lines for savings and loan associations in the Washington Standard Metropolitan Statistical Area (SMSA). New ways of handling family accounts, of doing business, and of applying new technology may call for changes in this area. But I feel confident that the ability of well-managed small banks to compete effectively with larger branch systems has been well established.

Turning to the area of bank regulation, the banking agencies have been busy with the implementation of the Financial Institutions Regulatory Act (FIRA). Last year, Congress passed this omnibus Act, which is a mammoth piece of regulation running to about 100 pages in length and containing 21 separate titles. At the risk of understatement, this Act does not appear to have been very well received by the banking community, particularly the smaller banks. I would now like to talk about several provisions of this Act that seem particularly relevant to banks and bankers in West Virginia.

The first provision involves bank loans to directors and companies they control. In several ways, the new legislation tightens up on these types of loans. First, loans to directors must be made on substantially the same terms as those prevailing at the time for comparable transactions with other persons not associated with banks. Second, all loans to a director that would result in aggregate outstanding loans exceeding $25,000 must be approved in advance by a majority of the bank's board of directors, with the interested director abstaining. Finally, the statute prohibits a bank from honoring an overdraft for the acount of a director, subject to certain exceptions.

The purpose of these provisions, of course, is to prevent a director from inappropriately using the bank's resources for personal purposes. Such abuses have occurred to a limited degree in recent years. Unfortunately, however, the new legislation is also likely to have an adverse side effect -- it will reduce the ability of banks to attract directors. Traditionally, leading businessmen in their communities have been bank directors. This has assured banks of the services of men and women who are well informed and capable. It has been an advantage to the bank and has enabled the bank better to serve its community. But leading businessmen in the nature of things often are associated with firms that borrow. It would be unfortunate if the new Act should make this natural and well-established relationship difficult to sustain.

Under the new Act, a director applying for a loan in excess of $25,000 would have to wait until the loan is approved at the next meeting of the bank's board, unless the directors had already approved a line of credit from him and companies that he controls. In contrast, all other creditworthy borrowers can get speedy approval from the bank. These borrowers also can have their overdrafts honored by the bank, whereas a director cannot, subject to the exceptions provided in the statute and regulation.

These disadvantages associated with being a director may not be weighty in many cases. However, they do add to a growing list of disadvantages -- including increasing director liability -- that are making it more difficult for banks, especially small banks, to retain existing directors and attract new ones. Beyond a certain point, this result could threaten the viability of small banks.

In writing the regulations for this title of FIRA, the regulatory agencies have sought to make it possible for directors and their affiliated institutions to obtain credit from their banks. Specifically, the agencies have provided for advance authorization of lines of credit for directors and their affiliated institutions and by further liberalizing the automatic transfer and automatic loan provisions of the statute by providing for inadvertent overdrafts of up to $1,000 for not more than five business days.

In addition to the foregoing restrictions, most of which apply also to executive officers and principal shareholders, as well as directors, FIRA imposes an aggregate lending limit of 10 per cent of a bank's capital and surplus on loans by a bank to each of its executive officers and principal shareholders and their related interests. This lending limit, I am happy to say, does not apply to directors. The Board has amended its Regulation O to implement the new statutory provisions and has addressed the problems raised by the new restrictions to the extent of its statutory authority to do so.

The Financial Institutions Regulatory Act also puts restrictions on loans by a correspondent bank to executive officers, directors, and 10 per cent stockholders of its respondent banks. Specifically, the correspondent bank cannot make loans to these parties unless the loan is made on substantially the same terms as those prevailing for comparable transactions with other persons, and also does not involve more than normal risks of collectibility. The purpose of this provision is to prevent an insider of a respondent bank from obtaining a preferential loan by placing a correspondent balance with the lending bank.

The Financial Institutions Regulatory Act also contains new restrictions on interlocking relationships of management officials -- including officers and directors -- among non-affiliated depository institutions, including banks, savings and loan associations, credit unions, bank holding companies and savings and loan holding companies. These restrictions relate, in different ways, to depository institutions in the same SMSA, in identical or contiguous or adjacent localities, and in certain size categories.

These provisions greatly expand the type of prohibited relationships that were formerly covered by Section 8 of the Clayton Act. The principal saving grace is that a 10-year grandfather clause was included for management interlocks that were in effect on November 10, 1978, and were not in violation of Section 8 of the Clayton Act on that date. The Federal banking agencies, the National Credit Union Administration, and the Federal Home Loan Bank Board are in the process of adopting final regulations to implement the new statutory prohibitions.

Finally, the Financial Institutions Regulatory Act requires any person wanting to acquire an insured bank to file an application with the appropriate bank regulatory authority. The applicant must furnish the agency with a personal history, information on his or her business background, a recent financial statement, information on the terms and conditions of the proposed acquisition and the source of funds, and certain other relevant information. The regulatory authority has sixty days within which to deny the application. If no denial is forthcoming, the proposed acquisition may be consummated.

The Federal Reserve recognizes that this new application requirement may present problems for certain individuals, particularly those not used to the regulatory process. Accordingly, the twelve Federal Reserve Banks and the other bank regulatory agencies stand ready to aid those individuals in need of help in making out an application. Moreover, the three Federal banking agencies recently agreed to design their information requests to meet the statutory requirements but at the same time reduce the reporting burden whenever possible.

While several applications recently have been filed with the Federal Reserve, we have thus far acted on only one application under the new legislation. In making its decisions, the Federal Reserve will be guided by the statutory criteria contained in the Act. These criteria permit us to deny any acquisition that would be anticompetitive, or would threaten the financial condition of the bank. While the Federal Reserve, of course, will be faithful to these statutory criteria, I can assure you that it will also attempt to carry on its long-standing policy of trying to facilitate the transfer of ownership of smaller banks.

Problems of Monetary Policy

Monetary policy is never simple but at the present time it presents some quite unusual difficulties. We are now going into the fifth year of continuous expansion which makes the present business cycle uptrend the longest in peacetime history since World War II.

From the record of the past, a recession could have been expected some time ago. On the present occasion, however, we have been fortunate in avoiding some of the major economic imbalances that historically have tended to develop during upswings and that typically have brought these upswings to an end after no more than two or three years. In particular, overexpansion of inventories seems to have been largely avoided on this occasion. Business investment in plant and equipment has not been excessive. Housing, which on past occasions used to drop sharply as soon as interest rates went up, has resisted much better this time, thanks to the money market certificate and other institutional developments designed to supply funds for housing. Consumer buying has remained quite strong through the expansion and there is some doubt that it can continue.

Meanwhile, however, pressures on capacity are mounting and our past cost-push inflation is being aggravated by the addition of demand-pull forces. Thus, there are indications that the economy must be, and indeed is, slowing down. But there is no evidence that a recession is unavoidable. It is worth noting that the difference between the very rapid expansion during the fourth quarter, at a nearly 7 per cent rate, and the moderate expansion during the first quarter at less than one per cent would constitute a more significant slowdown than would a subsequent drop from the first-quarter rate to a moderate negative rate of expansion. To call two quarters of negative expansion a recession and treat it as a major calamity to be avoided at all costs, while a slowdown from nearly 7 per cent to less than one per cent is taken as acceptable and indeed beneficial, does not make much sense. Whether or not we are moving into something that statisticians would call a recession matters much less than whether or not such a recession, if it occurs, is short and shallow or deep and protracted.

We can reasonably believe that the economy is now moving in the right direction, toward more restraint, to which monetary policy is contributing. But the setting of monetary policy close to what could turn out to be a cyclical peak is not easy.

The problems of monetary policy at the present critical juncture have been compounded by the peculiar behavior of the monetary aggregates. The Federal Reserve uses M_1, M_2, and M_3 as guides to monetary policy and communicates its one-year target ranges to the Congress. Until about a month ago, for a period of half a year, the various monetary aggregates showed little or no growth. This could have meant that a recession was on its way. It also could have meant that the demand for money balances was diminishing, perhaps owing to rapid inflation. Now the monetary aggregates have accelerated once more, signaling either that recession fears were premature, or that shifts in the demand for money balances have come to an end for the time being. The episode has, of course, shaken confidence in the reliability of M_1, M_2, and M_3 as guides to monetary policy. As a result, some observers have proposed that the Federal Reserve pay more attention to still another variable -- the monetary base. The monetary base, so called because it is the basis for the nation's money supply, consists chiefly of certain liabilities of the Federal Reserve -- primarily currency and member bank reserves. It would like to say a few words on this subject, because it seems to have attracted a certain amount of attention.

The monetary base -- which supports the monetary liabilities of the banking system -- as of mid-April consisted of about $100 billion currency in the hands of the public, $13 billion vault cash of banks, and $32 billion reserve deposits of member banks. It is sometimes alleged that by controlling the base the Federal Reserve can do as good or better a job of influencing the economy as by controlling the money supply M_1 or M_2.

To evaluate this claim, it is necessary to keep in mind the relationship between the base and the money supply. Both contain currency in the hands of the public. But while the money supply contains bank deposits (excluding Treasury deposits), the base contains only, broadly speaking, the deposits with the Federal Reserve that member banks carry against their reservable liabilities. Viewing the base as a proxy for the money supply, currency receives a weight of one while deposits receive a weight of only 1/8, which is the ratio of reserves to M_1 deposits.

Treating the base as the proper embodiment of the concept of "money" comes close to saying that only currency is money. Deposits hardly count. It means going back to the days of the 19th century, when currency and gold were the principal media and the monetary role of deposits had not yet been recognized. Today, deposits, including time and savings, are equal to about nine times the public's holdings of currency. There seems to be no good reason for ignoring them in measuring the money supply except that during the last six months the base and the GNP have moved more or less in step, whereas the money supply and the GNP have not.

A closer analysis of currency in circulation raises further questions about the use of the base. Of the $100 billion in circulation, probably very little is held by business. The behavior of business and its demand for money, therefore, is not at all well reflected by the base. But who holds the rest? If it were all held by American households, each man, woman and child would, on average, be carrying over $450 in currency on him. I must confess that I carry my fair share of currency on me only very rarely and the other members of my family probably even less often. This leaves a great puzzle as to where all the money went.

Where could these greenbacks have gone, if not into the wallets or under the mattresses of the average citizen? Have they been lost or destroyed? Have they gone abroad, through unreported shipments by tourists or reported bank shipments, to be hoarded as a last reserve by people in countries with unsympathetic governments or unfriendly economic systems? Are they perhaps being used in the "underground" or "off-book" economy that some observers believe to be expanding rapidly in the United States? Perhaps all of these extracurricular destinations have contributed to maintaining a high volume of currency in circulation in an age of checks and credit cards. In any event, a monetary variable the magnitude of which is so hard to explain and that is exposed to such peculiar possibilities invites only very limited confidence as a guide to monetary policy.

Under present circumstances, monetary policy must be guided principally by the direct observation of the economy. It can, for the time being, receive only very limited assistance from observation of instrumental variables such as interest rates and the money supply. In time, I would expect, more stable relations between the real economy of output, employment, and prices on one side and financial variables such as money supply and interest rates on the other will probably be re-established. The conduct of monetary policy will then be fraught by less uncertainty than it is today.

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