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BUSINESS CONDITIONS

A REVIEW BY THE FEDERAL RESERVE BANK OF CHICAGO

New Bad Debt Reserves Lower Bank Profits

1948 Gross Earnings at New Peak As Loan Income Rises

As a result of extraordinary additions to bad debt reserves, 1948 net profits after taxes of Seventh District member banks aggregated only 79.5 million dollars, a decline of 13.3 million from the previous year. With increased income from loans, however, gross earnings reached an all-time high of 396 million, an increase of 35 million over 1947. Operating expenses were likewise larger, but net current earnings aggregating 136 million were still 10 per cent higher than the prior year, continuing an upward trend in operating results that had halted in 1947. Net profits would also have topped those for 1947 by about five million dollars were it not for the special additions to bad debt reserves made during the year in conformity with a special Federal income tax ruling made late in 1947.

LOAN EARNINGS INCREASE

The increased earnings from loans were a result both of higher interest rates and a greater loan volume. Total loans of Seventh District member banks were 4,557 million at December 31, 1948, as compared with 4,281 million a year earlier. Total earnings on loans as a percentage of the average of monthly loan balances during the year were 3.66 per cent for 1948 and 3.38 per cent for 1947. A noticeable increase in commercial loan rates at large city banks occurred during the first nine months of the year, chiefly apparent in a one-quarter per cent increase in the rate for prime loans in Chicago, and there was also a lesser availability of mortgage credit at low rates.

The increase in average total loans was largely outside of Chicago, which had an effect on the gross earnings increase because of the somewhat higher average interest rate characteristic of the aggregate loans in country banks. In 1948 gross earnings on loans of Seventh District banks other than the Chicago central reserve city banks were 4.35 per cent of average monthly loans; in 1947 they were 4.09 per cent.

Earnings on securities declined one million dollars to 171 million, and reflected a slight shift in the pattern of securities investments. Interest on Government securities was 147 million in 1948, as compared to 151 million in 1947, while earnings on other securities were three million higher than in 1947. Investment accounts in 1948 reflected some selling of long-term Governments with par-

tial replacement by short-term Governments and some municipals. Securities investments in the aggregate declined about 600 million during the year, partly caused by the need of banks to secure reserves to support the increased loan volume and partly as a result of increased reserve requirements. The latter were increased three times during the year for central reserve city banks and once for all other member banks.

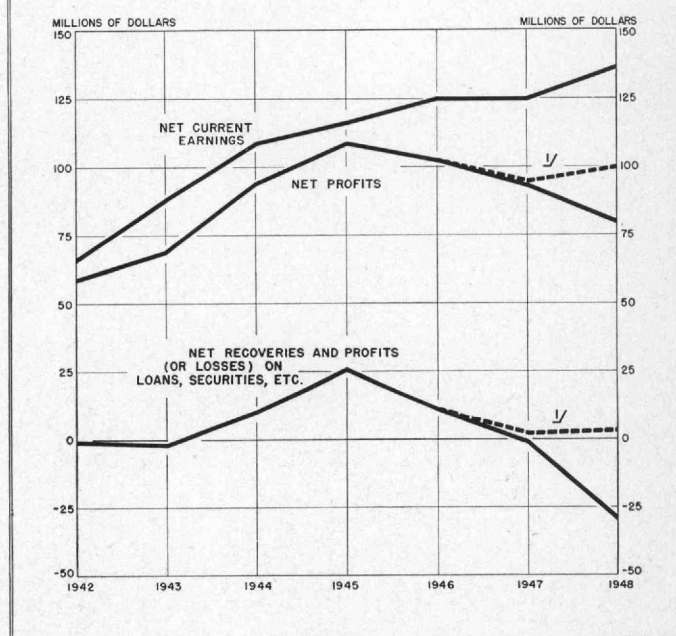
HIGHER SALARIES LEAD EXPENSE INCREASES

All categories of expense were higher during the year. Aggregate salaries of officers and employees were 121 million, an increase of 11 per cent over 1947—a result of higher salaries rather than any increase in personnel. Interest on time deposits was somewhat higher, reflecting some increases in rates. Other current expenses were 10 per cent higher.

The earning power of banks is often measured by the net current earnings, i.e., the excess of gross earnings over operating expenses before consideration of securities profits, other losses and recoveries, and income taxes. In 1947, rising salary and other costs absorbed all of

(Continued on Page Eight)

EFFECT OF LOAN VALUATION RESERVE INCREASES ON NET PROFITS
ALL SEVENTH DISTRICT MEMBER BANKS



¹For explanation of adjustment to eliminate loan valuation reserve increases see footnote to Table 2.

The annual study "Operating Ratios of Seventh District Member Banks—1948" contains tables showing average ratios of earnings and other operating results and of selected balance sheet items by bank size-group and geographical location. Copies may be obtained on request to the Research Department, Federal Reserve Bank of Chicago, Box 834, Chicago 90, Illinois.

Residential Mortgage Trends

New Home Construction and Financing Volumes Decline

There are strong indications that the postwar peak demand for new mortgage funds has been passed. Since last fall new housing starts have experienced a gradual but persistent slide-off, while real estate transactions have dropped even more sharply. Prices for old and new houses have leveled and begun to move downward. Gross recordings of nonfarm mortgages in this District have declined steadily since August 1948, about 30 per cent, and current reports show that the downward trend is persisting. In spite of this reduction in new mortgages recorded, however, total residential debt outstanding continues to grow because recordings are still in excess of repayments. Except as to precise timing, these trends were generally anticipated, and hence have not come as a surprise, but recent declines have been greater than commonly foreseen a few months ago.

New residential building in 1949 is almost certain to be substantial in terms of prewar levels, but nevertheless is widely estimated to fall as much as 10 per cent or more below 1948's record, both in terms of total dollar expenditures and mortgage requirements. Lagging housing starts to date this year tend to confirm this general expectation of a drop in residential construction.

What do these recently observed trends mean for the mortgage and real estate market? Do they indicate that a repetition of the experiences of the late 1920's and early 1930's is in the offing? Or, is a gradual adjustment to more normal market conditions under way, meaning that a somewhat smaller, although not sharply lower, volume of mortgage activity can be expected?

Since the future course of real estate prices is always dependent upon general business developments, precise answers to these questions are not readily discernible. However, there are several important differences between today's mortgage market and that of 20 years ago serving to cushion any contraction in the residential mortgage field. While these changes promise to ease mortgage problems arising from any general downturn in business or in residential building, obviously they cannot be expected to eliminate some losses.

Throughout the postwar period, the Seventh Federal Reserve District has not had its expected "share" of home construction or of new residential mortgages. Several reasons are apparent: (1) higher material and labor costs; (2) somewhat greater restrictions on residential building, and especially apartments, which comprise a relatively larger part of normal house accommodations here; and (3) more emphasis on non-residential construction. Although a significant volume of residential building has taken place in the Midwest since the end of the war, it appears small in contrast to the building booms in the Pacific Coast, Southwest, and South regions. During 1948 more urban houses were built in the single state of

California—about 90 thousand—than in the entire Seventh District—about 65 thousand.

As a consequence of the lesser significance of home building here, total mortgage recordings in the District now comprise a smaller percentage, 17 per cent of the national total than in 1929 when it was over 20 per cent. This implies that the general level of business in the Midwest has been, and is, less dependent upon the construction industry than the regions mentioned. Moreover, construction occupies a less important position in the District economy than during the 1920's building boom. Hence, a decline, even if quite sharp, should have a less far-reaching adverse reaction on business in this District than in some other sections of the nation.

RESIDENTIAL MORTGAGE VOLUME

In each of the three postwar years aggregate residential mortgages recorded in the nation have averaged about 10 billion dollars. This record volume—nearly double the estimated recordings in 1926, 1927, or 1928, the three peak years in the 1920's—has resulted from the large amount of new construction and the high turnover of existing residential property at higher prices. Total mortgages recorded are, of course, offset by repayments on existing mortgages, so that the increase in outstanding debt is always less—during the postwar period about 50 per cent—than the total new recordings.

The years since 1945 represent the first period of any significant duration since the late 1920's in which nonfarm mortgages have increased materially. During the years 1931 to 1938 total home debt dropped quite markedly, principally because of the fall in the general price level, the heavy volume of foreclosures, and the decreased number of new houses built. Mortgages outstanding remained relatively stationary during the war years, ranging between 25.6 and 26.6 billions of dollars. The advancing income level during this period permitted reduction in existing mortgages in an amount about equal to the volume of new home debt resulting from higher prices, new construction, and refinancing transactions.

Since approximately half of the dollar amount of new recordings of mortgages during the postwar years has been offset by repayments, the outstanding debt on all dwellings has increased nationally at the rate of about five billion dollars per year. The total amount of nonfarm residential debt currently outstanding is estimated to be over 40 billion dollars, compared with 26 billion dollars in 1945, and slightly over 29 billion in 1929.

MORTGAGE VERSUS OTHER DEBT

Outstanding *residential* mortgage debt comprises a

somewhat greater proportion of total private debt now than was the case in either 1929 or 1939—an estimated 23 per cent at present as against 20 per cent a decade ago, and 18 per cent in 1929. However, *total* mortgage debt outstanding, including farm and commercial mortgages as well as residential, represents about the same percentage of all private indebtedness, 26 per cent, as in the two previous decades. Nonfarm residential and commercial and industrial mortgages have increased both absolutely and relatively while farm mortgages have declined to less than half their 1929 volume and are very significantly smaller in relation to total debt.

In contrast, the present relationship of residential mortgage debt to total *personal disposable income*, less than 25 per cent, is significantly smaller than at any time during the prewar decade. In 1929 and also in 1939 outstanding residential mortgage debt was about 35 per cent of disposable income. Since postwar home buying has been fairly general among all but the lowest income groups, this broad relationship of mortgages to income suggests that the ability of mortgagors as a whole, with present incomes, to meet their monthly payments is considerably better than during prewar years.

However, it must be emphasized that mortgage debt is a fixed obligation, not subject to the short-run fluctuations of personal income. A significant drop in income, consequently, could quickly change the ratio to one which appeared much less favorable. Considering amortization requirements, moreover, current monthly mortgage payments tend to be heavier than during the 1920's. Also, consumer debt other than mortgages, including charge accounts, instalment credit, and personal loans stands at an all-time high, and likewise represents a claim upon personal income.

VULNERABILITY OF MORTGAGE DEBT

Approximately one-fourth, or about 10.6 billion dollars, of all nonfarm residential mortgages are guaranteed, insured, or actually held by the Federal Government. When 1-4 family dwellings are considered separately this fraction rises to somewhat more than one-third. The majority of these protected mortgages, both in number and in dollar volume (6.2 billion), are guaranteed by the Veterans' Administration (VA), and consist entirely of young postwar mortgages. The longer-standing program of insuring mortgages through the Federal Housing Administration (FHA) provides mortgagee protection for a somewhat smaller, but nevertheless significant volume (4.4 billion dollars) of the residential mortgages currently outstanding. Since FHA has insured loans over a period of nearly 15 years, some of its mortgages tend to be relatively more seasoned and are generally considered to be preferred risks. However, many new FHA mortgages have been made since the end of the war and hence do not fall in the same category.

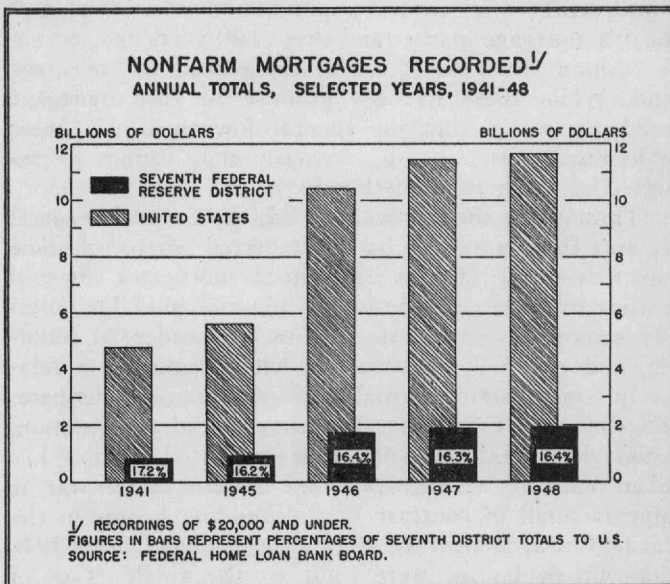
The volume of federally protected mortgages has increased to the point where it must be fully considered in making comparisons between current risk and rate patterns and those which prevailed in real estate markets

during the 1920's and early 1930's. Guaranteed mortgages in some respects serve to exert a price supporting influence in real estate similar to official price supports in other economic fields. This is because: (1) the somewhat more liberal appraisal standards and practices recently used for guaranteed and insured loans have tended to become guides for appraising uninsured loans as well, resulting in generally higher appraisals; (2) the higher loan-value ratios and longer average maturities on insured mortgages likewise have set a pattern for many of the non-insured mortgages, and have the effect of supporting the price structure through liberalization of credit terms; and (3) the private secondary mortgage market is more stabilized, since institutional investors usually are more willing to purchase mortgages which carry Government protection.

This is not to say that Government influence in the real estate market through insured and guaranteed loans can prevent substantial price movements, either up or down. As pointed out in *Business Conditions*, May 1948, there are several distinct reasons why lenders may be hesitant about making further mortgages even though they are insured or guaranteed. Among these are: (a) their concern over the unguaranteed portion of their portfolio, (b) interest rate ceilings on VA and FHA mortgages, (c) possible delays and expenses in foreclosure and guarantee claim procedures, and (d) endangered public relations from widespread foreclosures.

Nevertheless, the above-mentioned supports—not present in like degree during any earlier complete real estate cycle—seem likely to help “cushion” future downward movements in real estate values. Moreover, an added factor is the apparent willingness of Government (e.g., see President's Budget Message recommendations) to adopt further measures deemed appropriate to support a high level of new construction and prevent general deflation.

One other aspect of mortgagee—and indirectly price level—protection is the secondary market created through reactivation last year of the Federal National Mortgage



Association (FNMA) after virtual drying up of the private secondary market for VA mortgages. This agency is empowered to purchase one-half of all eligible (i.e., meeting FHA standards) mortgages of 10,000 dollars or less insured or guaranteed after April 30, 1948. The President in his Budget Message recommended an upward revision in this limitation on mortgage purchases, and recently it has been proposed by private homebuilding interests that FNMA be empowered to purchase *all* such mortgages. Such a proposal, if accompanied by relaxations in eligibility rules, might cause some increased availability of mortgage funds, and as indicated previously, provide an indirect support to current price levels.

The principal elements of weakness in the present mortgage market seem to be:

1. There is an extremely large volume of young mortgages. More than 35 per cent of the dollar total of all nonfarm residential mortgages represents obligations less than four years old.

2. Postwar appraisals for mortgage purposes have tended to follow price increases, and usually have been at higher loan-value ratios than was common practice for first-mortgages during the 1920's.

3. The long-run rise in real estate prices has continued for about 16 or 17 years, and the magnitude of the increase has been greater than in any previous period of history. A large part of the mortgage portfolio, therefore, represents loans based upon what may prove to be peak prices.

However, among the offsetting influences, are the following elements of strength:

1. Virtually all mortgage loans now require planned amortization, eliminating large principal due dates. Payments, moreover, include taxes and insurance as well as interest and principal, thus minimizing other serious causes for mortgage delinquency in earlier periods.

2. A large part of total residential debt is insured or guaranteed. It was previously stated that more than one-third of all nonfarm mortgages on 1-4 family homes were in this class. However, of the *postwar* mortgages—the ones considered to be most vulnerable—more than half are covered by this Government protection.

3. Second and third mortgages in today's market are virtually non-existent. Secondary claims have been an important and unstable element of weakness in earlier real estate booms.

4. Both the number of foreclosures of single family homes, and vacancy ratios in tenant-occupied properties are unusually small. Foreclosures have been increasing very slowly since the extreme low of 1947, but are currently only about 10 per cent of the 1928 rate. In major District centers of population vacancy ratios in rental properties continue to be virtually zero. It seems unlikely that present mortgage portfolios could be seriously endangered except as these two measures increase significantly above their present levels.

5. The lower average interest rates in today's market, compared with the market of the 1920's, mean that monthly payments are being applied to reduction of principal in greater degree than previously.

In summary, the elements of weakness in today's real estate market appear to be outweighed by those of strength when comparison is drawn with the situation of the late 1920's. In other words, lenders today appear less vulnerable to serious loss in the event of a downturn in business.

MORTGAGE SUPPLY AND DEMAND FACTORS

Broadly speaking, there is no inadequacy in the overall supply of capital funds available in this District for mortgage purposes. The extent to which these funds can and will be used for mortgages relative to other investment uses, however, is much less certain. For all groups of lenders except savings and loan associations, nonfarm residential mortgages still represent a relatively small segment of total assets.

Of the entire assets of the District's member banks, less than one dollar in twenty currently is invested in residential mortgages. Among the nation's life insurance companies generally, the proportion is about one dollar out of eight; and for mutual savings banks, which are virtually absent in this District, it is about one in six. Savings and loan associations, however, now have over 80 per cent of their assets in nonfarm home mortgages, a ratio higher than for many years, although well under the figure in 1929.

Limiting supply factors, nevertheless, are present in particular localities within this District. The states of Michigan, Indiana, Iowa, and Wisconsin, for example, place legal limitations on the size of mortgage portfolios of commercial banks operating within their borders. Whether or not such limitations are the principal cause, nevertheless it occurs that in some smaller communities the local lending resources available for a net expansion in mortgages may be already largely committed to use. Ofttimes it is difficult to attract capital from outside. Even in the larger centers local laws relating to land titles, tax delinquency, and tax exemption often cause major differences in investment attractiveness which are tantamount to limitations of supply. The practical effects of such differences are exemplified in the willingness of insurance companies to finance large apartment projects in New York City and their hesitancy to do so in the Chicago area.

In the states of the Seventh Federal Reserve District savings and loan associations and commercial banks are relatively more important in direct mortgage recordings than they are in the nation generally. Insurance companies are less active as direct mortgage investors and, as is true in most of the nation outside New York and New England, mutual savings banks are relatively insignificant here. Thus the burden of mortgage supply in this District seems to rest with savings and loan associations, commercial banks, private mortgage companies and individuals.

Whereas savings and loan associations generally were approaching limits in their readily convertible assets in mid-1948, a noticeable rise in savings receipts subsequently has occurred, lessening the problem of availability of funds for mortgage lending. Legal and institutional

limitations on bank mortgage portfolios, however, may result in continued tightness from this source. Increased Midwest activity by life insurance companies, particularly in the purchase of mortgages made by private mortgage companies, may offset this trend. The problem of supply of mortgage funds in 1949, therefore, promises to be somewhat less in this District than during the past year.

INTEREST RATES

Rates in the Seventh District have moved upward slowly in recent years so that the average rate on non-insured mortgages appears to be nearly one per cent higher than in 1945. Unquestionably the existence of federally guaranteed and insured loans at legal maximum rates has had a dampening effect upon the amount of rate increase on non-insured mortgages.

Among institutional lenders, savings and loan associations have exhibited the strongest tendencies toward higher interest rates. Within the past few months many Seventh District associations have adopted higher dividend policies in order to attract larger share account funds which in turn can be loaned on mortgages at the higher rates. These policies have been marked by considerable success in obtaining new loanable funds; net share accounts of associations in the District in the fourth quarter of 1948 increased nearly 20 per cent more than during the same quarter a year ago, and during January-February 1949, the comparable gain has increased to more than 30 per cent. Since early this year, however, mortgage loan demand has fallen short of savings inflow. There is some scattered evidence, therefore, that the upward trend in mortgage rates has been halted, and even some speculation that the recent rise in dividend rates among savings and loan associations may be reversed.

Furthermore, some life insurance companies now are emphasizing the refinancing of older, prime mortgages on well-located properties at four per cent. Through such refinancing many insured mortgages which have been made at higher effective rates to borrowers are reduced as much as one per cent or more.

There are scattered reports of commercial banks in the District recently increasing their interest rates on mortgages, but the more general practice appears to be to maintain existing rates. Banks in the District frequently report virtually "full" mortgage portfolios. Consequently, their aim is to keep the volume of new mortgages in rough balance with mortgage repayments, rather than make active solicitation of mortgage business to expand their present portfolios.

The significance of legal maximum rates on FHA (4.5 per cent plus .5 per cent for insurance) and VA (4 per cent) on the prevailing mortgage rate level is such that an increase in these maximums no doubt would be reflected in new insured and guaranteed loans made. Last year there was considerable interest in obtaining legislative action to increase the legal limits on these guaranteed loans by one-half per cent. However, with the current easing of demands for mortgage funds, there may be less reason for such a step to be taken.

RESIDENTIAL CONSTRUCTION TRENDS

The relatively tighter mortgage situation which has existed in this District since the end of the war has had some limiting effect upon the number of new houses started. Construction costs, which moved continuously upward from the depression low until October 1948, now appear to have leveled and started down. Throughout the last year of this cost increase, financial institutions became increasingly unwilling to extend their appraisals for mortgage purposes as high as mounting costs would have required. This mortgage tightening was accompanied by the inability of many builders to sell completed houses at peak asking prices. Thus rising costs forced mortgage tightening which in turn retarded home sales and new housing starts.

In spite of the continuing needs for new multi-family rental housing in the larger centers of this District, it is significant that only a small fraction of all new housing units since the war have been of this type. As a result, mortgage portfolios of most banks and other lending agencies now contain a much smaller proportion of loans on multi-unit dwellings than was true in the predepression decade. Except for some possible increase in publicly aided slum clearance construction, no important expansion in apartment house building appears likely in the immediate future in this District. Uncertainty of longer-range rental income, adverse effects of rent control on multi-unit investment, growing public disinterest in cooperative apartments, and the threat of a downturn in residential values are usually cited as the deterring factors.

Prospects for over-all home construction in 1949 will depend in large part on the ability of the construction industry to reduce costs. The U. S. Departments of Commerce and Labor jointly forecast a nine per cent drop in housing starts from the 1948 level. During the height of housing shortages and construction delays in 1946-47, it was widely reported in the Seventh District that as much as 10-15 per cent reduction in building costs could be made through greater efficiencies in job organization, site labor, and properly timed material supply. Presumably most of these improved efficiencies are now possible. A reduction of this general magnitude in 1949 could go far toward bringing houses within the financial means of many new buyers, and also toward satisfying reasonable appraisal limits of mortgage lenders. It must be recognized, however, that prospective home buyers want not only *low cost*, but also some *minimum acceptable quality*—in other words, "something for their money." Unsold houses priced "under 10,000 dollars" confirm this point.

The course of building activity in the next few months in itself will influence developments later in the year. If costs and prices are reduced, it is reasonable to expect a good volume of home construction this year in this District. On the other hand, if homes do not become more attractively priced relative to means of financing them, the prospects must be for a continued slide-off for some time to come. In short, a large housing "market" remains to be tapped, but the question is whether the "key" can be found soon enough.

Consumer Credit Trends Under Regulation W

Effects of New Lending Restraint Receive Increasing Study

Readjustments in numerous business fields, marked by shifts from "sellers" to "buyers" markets, have heightened interest in Regulation W as a contributory cause. While restraint of the inflationary expansion of consumer instalment credit is the basic objective of the regulation, available evidence suggests that Regulation W is only one of several factors contributing to current lagging sales developments in the consumer durable goods field. Continuing study of the effects of consumer credit regulation is being made, with present attention focused upon the relaxed terms, effective March 7, 1949, making the maximum maturity uniformly 21 months, instead of 15-18 months, on all covered extensions of consumer instalment credit. Down payments on furniture and listed appliances have been reduced from 20 per cent to 15 per cent, while the one-third down payment on automobiles has been retained. The new amendment to the regulation has had the effect of eliminating the previous requirement that instalment payments on principal amounts of credit of more than 1,000 dollars be not less than 70 dollars per month.

IMPORTANCE OF CONSUMER CREDIT

Consumer credit—including charge accounts, single payment loans, and service credit as well as instalment credit—now aggregates about 15.4 billion dollars,¹ or about eight per cent of total private debt, but under four per cent of all debt, public and private. Next to mortgages on real estate, it represents the largest single category of private noncorporate debt.

Instalment credit currently is estimated to be slightly

¹Consumer credit statistics necessarily are estimates and subject to minor revision from time to time; see January 1949 *Federal Reserve Bulletin* for latest changes. Moreover, thus far it has not been feasible to measure the amount of consumer credit obtained through informal personal channels. Some questions also may arise as to whether particular loans should be classified as consumer or commercial credit.

over eight billion dollars, over half of total consumer credit outstanding. The present instalment credit volume is approximately four per cent of personal income, compared with six per cent in 1941.

While none of the 7.3 billion *non-instalment* consumer credit is subject to Regulation W, most instalment credit is covered by present controls. About 35 per cent of total instalment credit comprises automobile credit, and 20 per cent, sales credit of department and furniture stores. Cash instalment loans by banks and consumer finance companies account for roughly 25 per cent; insured repair and modernization paper about 10 per cent; and the remaining 10 per cent consists of a small amount of sale credit at other types of retail stores.

Since the end of the war, instalment credit has increased in relation to total sales, eight per cent now as compared with four per cent in 1944, but has not reached the 13 per cent ratio to sales which existed in 1941. However, the strong tendency toward cash buying during the war years when cash payments reached 80 per cent of total sales has subsided. Consumers appear definitely more dependent upon the monthly payment type of purchase, with cash now used in about 70 per cent of total sales, and moving steadily toward the 65 per cent figure which prevailed in 1941.

BACKGROUND OF CREDIT CONTROLS

Similar, although of course not identical, economic considerations caused both the original enactment of Regulation W on September 1, 1941 and its reinstatement on September 20, 1948. At both times aggregate disposable income appeared to be excessive in terms of particular goods to be bought, and therefore any increase in total purchasing power could only result in higher prices, i.e., more inflation. Extension of consumer instalment credit was one factor increasing available purchasing power.

In general, the regulation currently in force is of the same form as the wartime restriction which existed from September 1, 1941 to November 2, 1947. It covers instalment sales of, and loans for, the purchase of consumers durable goods in 12 listed classifications, provided the cost of each article is \$50 or more and the individual extension of credit is \$5,000 or less. Instalment loans for other nonexempt consumer purposes are also subject to the regulation's provisions. Authorization for Regulation W expires on June 30, 1949, unless extended by legislative action.

Regulation W now permits more liberal extension of credit than was allowed at the time of termination of the previous order in November 1947. Down payment minimums are generally smaller, and maximum maturi-

PRINCIPAL CURRENT SALES CREDIT TERMS OF REGULATION W Effective March 7, 1949		
Listed Articles	Down Payment	Maturity
Automobiles.....	33½ per cent	21 months
Cooking stoves.....	15 per cent	21 months
Dishwashers.....	15 per cent	21 months
Ironers.....	15 per cent	21 months
Refrigerators.....	15 per cent	21 months
Washing machines....	15 per cent	21 months
Combination units....	15 per cent	21 months
Air conditioners, room unit.....	15 per cent	21 months
Radio, television, phonographs.....	15 per cent	21 months
Sewing machines.....	15 per cent	21 months
Suction cleaners.....	15 per cent	21 months
Furniture, rugs, carpets.....	15 per cent	21 months

ties somewhat longer (see table). A one-third down payment is now required on automobiles *only*, whereas the original control had required one-third on all listed articles. Maturities of all covered instalment loans are now 21 months, whereas under the initial regulation such maturities were limited to 15 months. From September 20, 1948 to March 7, 1949 loans of over \$1,000 were premitted to run for 18 months. The regulation at present is more inclusive, however, in that it applies to covered instalment credit extensions up to \$5,000, while the earlier limit was \$2,000.

During the war years several very important factors overshadowed Regulation W in restricting consumer credit. Production of all "listed articles" was curtailed, reducing the availability of goods normally bought on time payment plans. Moreover, aggregate personal income moved sharply upward, and total savings increased markedly, further limiting consumer needs for credit. Thus, the observed steep decline in instalment credit during 1942-43 and the approximately static level in 1944-45 can be explained only partly in terms of the credit restrictions.

With the resumption of full production of consumer durable goods in the postwar years, instalment credit rapidly reversed its downward trend. The total volume of instalment credit has increased about two billion dollars in each of the past three years, so that the present aggregate exceeds eight billion dollars, four times the wartime low level, and 40 per cent above 1941, the pre-war peak year (see chart). Termination of the initial Regulation W seems to have made relatively little difference in the *rate* of growth of instalment credit. This is to be explained largely in terms of the limited volume of goods available for instalment credit sale during 1946-47 and early 1948.

Since the reinstatement of Regulation W in September 1948, the rate of increase in both instalment credit and instalment sale credit slackened considerably, and in January 1949 the first absolute declines in three years occurred. Total consumer credit fell 548 million dollars to 15,376 million dollars from the December 1948 level, and instalment sale credit declined 145 million dollars to 8,051 million dollars. Gains in consumer loans, excluding single payment and repair and modernization loans which are not subject to regulation, made by all Seventh District member banks during the last six months of 1948, were only about half as large as during the period January-June 1948, which was unaffected by reinstatement of Regulation W. These and allied developments in recent months underlie the current general interest in evaluating the impact of Regulation W upon instalment sales.

VARIED FORCES RESTRAIN SALES

Under present mixed business conditions, it is particularly difficult to single out the effects of consumer credit regulation upon sales of listed articles, the volume of cash instalment loans, or the general level of business. Beginning in October 1948 increases in instalment credit

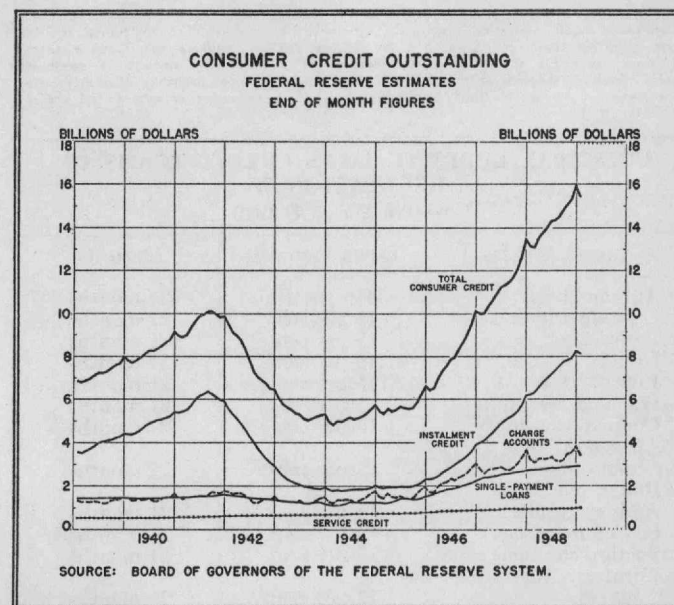
outstanding became more moderate, in large part because of a lessening in credit sales at furniture stores and among automobile dealers.

At least four other broad factors besides Regulation W, however, currently are exerting some generally restraining influences upon further expansion in sales or credit: (1) stepped-up production of previously "scarce" items restoring better supply-demand balance in most markets for listed articles, (2) increasing consumer resistance to higher prices because of personal budget stringencies, (3) return to more normal seasonal changes in sales and credit activities, and (4) some lessened availability of funds for consumer credit financing institutions.

The return to ready availability of many items long on a "waiting list" basis in itself has had a marked psychological effect upon some prospective buyers. Eagerness to obtain certain items is widely reported in the District to have waned when individuals have been confronted with a specific opportunity to purchase rather than merely a chance to order. This development, of course, is not new, having occurred in the radio market well over a year ago, and reflects changes over time in consumer scales of needs, values, and financial resources.

Rising consumer prices, scattered reductions in family income, and increased credit commitments have made it necessary for more and more families to reappraise their expenditure plans in recent months. Furthermore, reports from throughout the Seventh District indicate conclusively that growing family budget problems have contributed to mounting consumer price consciousness. Demand for some listed articles, and certain branded items in particular, has dropped sharply, not alone because of greater availability, but because buyers have concluded that the articles no longer are "good buys."

As indicated in the recent article on "Soft Spots in Midwest Business" (*Business Conditions*, December 1948), a return to seasonal buying habits is being widely observed. This obviously affects the volume of credit



purchases in different months, especially early in the year. Since there is little or no danger of supplies being exhausted at the time of actual need, most consumers are quite reluctant to tie up funds unnecessarily.

The past year made it clear once again, for example, that used automobile sales lag appreciably for several months during the summer and winter, but experience considerable rise during the spring season. The prewar annual pattern of refrigerator sales also seems to have been re-established, i.e., rising sharply during the spring, declining until fall, and then resuming a downward movement except for a minor upturn at Christmas. There is considerable evidence in the Seventh District that managements of firms producing and distributing major household appliances, quite understandably, are devoting a good deal of time to reacquainting themselves in detail with prewar seasonal variations in sales.

Most family budgets, as well as accepted credit practice, preclude the time payment purchase of more than one or two major listed articles at a time. Growth in the number of families assuming instalment credit obligations has been substantial since the close of the war, primarily because of the increased availability of most items usually purchased on an instalment basis. Expansion in consumer instalment credit itself thus has become a factor limiting still further increases in credit sales.

About nine million "spending units"² were estimated in the 1948 *Survey of Consumer Finances* to have made use of instalment credit in 1947, nearly twice as many as in 1946. It seems likely from the volume of credit investigation inquiries and number of new credit accounts reported by many Seventh District retail stores, that a smaller increase, but probably more than 25 per cent, took place in 1948 in the number of families making purchases on instalment terms. The expansion in 1949 likewise can be expected to be more moderate than during earlier postwar years.

During the past year numerous firms in the sales finance and small loan field in the Seventh District as elsewhere have reported increasing problems of obtaining funds to be used in extending instalment credit. A tendency has been evident for banks to tighten lines of credit available to finance companies and other credit granting institutions. Relatively few instances of acute shortages of funds, however, have been reported to date, principally because nonbank sources of needed funds commonly have become available, especially through sales of debentures to insurance companies. Nevertheless, the threat of a partial drying up of new financial resources, not associated with Regulation W, appears to have exerted some limiting effect in recent months upon the rate of expansion in consumer instalment credit handled by finance and small loan companies.

EFFECTS OF REGULATION W

While these numerous non-Regulation W factors continue to exert a restraining influence upon the growth of

²Defined as all persons living in the same dwelling, and related by blood, marriage, or adoption, who pooled their incomes for their major items of expense.

consumer instalment credit, in a few limited instances the impact of the regulation seems fairly clear-cut. It appears likely, for example, that the regulation has exerted a definite influence in reducing prices, or limiting further increases, in the automobile field, and particularly in the case of late model used cars. The requirement that the maximum loan value must be two-thirds of the cash price or of the "appraisal guide value, *whichever is lower*," and that the required down payment must be the difference between the cash price, including any premium, and the maximum loan value clearly stepped-up sharply the amount of down payment needed for credit purchase of price inflated used cars. Shrinking used car premiums, resulting from the seasonal slack period and the greater availability of cars as well as from the effects of Regulation W, have narrowed the difference between cash price and appraisal guide value during the past few months on most makes of automobiles. A diminishing number of families have appeared able to afford the relatively large monthly payments dictated by prevailing high prices and limited maturity schedules. Lengthening of payment periods may stimulate some new sales.

In the case of other listed articles, the direct effect of Regulation W is more obscure, with mixed opinions evident among Seventh District manufacturers, wholesalers, retailers, and bankers. Sellers appealing for customers primarily upon "easy credit" terms often report sluggish sales which they attribute to an important degree to the new minimum credit requirements. Other managements, less interested in competing for sales through relaxed credit terms, commonly report regulation terms to be "no different" from those "which they would require anyway."

REGULATION W AND THE FUTURE

Relatively little attention appears to be given to the basic anti-inflationary purpose of Regulation W. Most public interest in the regulation centers upon (1) its restraint upon sales of a particular product or store, and (2) its credit policing effect which insures against taking unwarranted risks and competition in credit terms.

In the enforcement program, investigations are being made in the field at all times. These investigations, covering a broad cross-section of registrants, are designed not only to determine compliance with the provisions of the regulation, but also to serve as an opportunity to advise on administrative rulings and amendments, and to clarify any misunderstandings which may exist. Experience to date has revealed very effective cooperation on the part of most businesses affected.

Consumer credit control is but a minor part of an anti-inflationary program, but such control has some useful effect. Moreover, Regulation W has been designed as a flexible credit instrument with the expectation that changes in down payments and maturity provisions will be altered from time to time in accord with changing economic and credit conditions. The current modification of Regulation W is in line with this stated policy.

BAD DEBT RESERVES LOWER BANK PROFITS

(Continued from Inside Front Cover)

the increased earnings from the marked expansion in loans during the year, the first time net current earnings had not advanced in a number of years. In 1948, however, the increase in expenses did not keep pace with greater earnings from loans, and net current earnings totaled 136 million, 10 per cent higher than 1947. As previously mentioned, substantial additions to valuation reserves for bad debts cut heavily into these increased net current earnings, and the resulting net profits figure is not comparable with that for 1947 and prior years.

NEW TAX RULE DISTORTS LOAN LOSSES

Since 1921 the Federal income tax law has permitted taxpayers, under certain conditions, to take as a taxable deduction a reasonable allowance to a reserve for bad debts in lieu of charge-offs of specific bad debts. Advantage of this provision of law has been taken as a matter of course by a great many merchandising concerns ever since, but up to the last four or five years banks have rarely availed themselves of the procedure. Increasing bank use of the reserve method for tax purposes in recent years, however, resulted in the promulgation of a special ruling (Mimeograph 6209) by the Bureau of Internal Revenue on December 8, 1947, which defined a permissible reserve procedure for banks.

Briefly, and omitting minor details, a bank is now allowed to take as a tax deduction each year a certain percentage of its total end-of-year loans. This percentage is computed each year by dividing the total loan losses less recoveries for the past 20 years by the sum of the end-of-year loan balances for the same period; an alternative method is to average the percentages of annual loan losses less recoveries to respective end-of-year loan balances for each of the past 20 years. Bad debt losses in the future then are to be charged to the reserve and any recoveries of such losses are to be returned to the reserve. These annual tax-deductible additions to the reserve are allowed only to the extent necessary to bring the reserve up to a "ceiling," which is set at three times the amount of the current year's permissible addition to the reserve as computed by the 20-year moving average percentage.

For the first year, the bank is allowed as a tax deduction *both* the total of the specific bad debts charged off that year and the amount of the computed permissible addition to the reserve. Also in this first year and subsequent years, recoveries on debts charged off prior to the institution of the reserve procedure are to be included in the current year's profits rather than carried to the reserve.

From 64 Seventh District member banks which maintained valuation reserves for loans prior to 1947, the number increased by the end of 1948 to 490 of the 1,008

TABLE 1
EARNINGS AND DIVIDENDS OF ALL SEVENTH DISTRICT MEMBER BANKS, 1947-48
(Dollar amounts in thousands)

Item	All Seventh District Member Banks			Chicago Central Reserve City Banks			Seventh District Excluding Chicago Central Reserve City Banks		
	1948	1947	Per Cent Change	1948	1947	Per Cent Change	1948	1947	Per Cent Change
Earnings.....	396,443	361,538	+ 9.7	120,387	113,038	+ 6.5	276,056	248,500	+11.1
Interest and dividends on securities:									
U. S. Government.....	146,602	151,126	- 3.0	43,819	45,579	- 3.9	102,783	105,547	- 2.6
Other.....	24,636	21,475	+14.7	9,799	8,593	+14.0	14,837	12,882	+15.2
Interest and discount on loans.....	158,968	127,798	+24.4	45,165	37,690	+19.8	113,803	90,108	+26.3
Service charges and fees on loans.....	3,148	2,769	+13.7	929	1,011	- 8.1	2,219	1,758	+26.2
Service charges on deposit accounts.....	19,744	17,414	+13.4	1,663	1,513	+ 9.9	18,081	15,901	+13.7
Other charges, commissions, fees, etc.....	8,064	8,137	- 0.9	947	946	+ 0.1	7,117	7,191	- 1.0
Trust department.....	17,093	16,015	+ 6.7	11,640	11,534	+ 0.9	5,453	4,481	+21.7
Other current earnings.....	18,188	16,804	+ 8.2	6,425	6,172	+ 4.1	11,763	10,632	+10.6
Expenses.....	260,188	237,271	+ 9.7	75,112	69,995	+ 7.3	185,076	167,276	+10.6
Salaries—officers.....	40,588	36,793	+10.3	10,257	9,622	+ 6.6	30,331	27,171	+11.6
Salaries and wages—other.....	80,124	71,788	+11.6	25,515	23,802	+ 7.2	54,609	47,986	+13.8
Interest on time deposits.....	45,872	43,583	+ 5.3	10,194	9,504	+ 7.3	35,678	34,079	+ 4.7
Other current expenses.....	93,604	85,107	+10.0	29,146	27,067	+ 7.7	64,458	58,040	+11.1
Net current earnings before income taxes.....	136,255	124,267	+ 9.6	45,275	43,043	+ 5.2	90,980	81,224	+12.0
Recoveries, profits on securities, etc.....	39,790	32,745	+21.5	25,600	18,331	+39.7	14,190	14,414	- 1.6
Losses and charge-offs.....	68,818	33,710	+104.1	30,183	15,188	+98.7	38,635	18,522	+108.6
Profits before income taxes.....	107,227	123,302	-13.0	40,692	46,186	-11.9	66,535	77,116	-13.7
Taxes on net income.....	27,740	30,494	- 9.0	10,537	9,651	+ 9.2	17,203	20,843	-17.5
Net profits.....	79,487	92,808	-14.4	30,155	36,535	-17.5	49,332	56,273	-12.3
Cash dividends declared on common stock.....	32,501	31,073	+ 4.6	14,117	14,060	+ 0.4	18,384	17,013	+ 8.1
Retained earnings.....	46,986	61,735	-23.9	16,038	22,475	-28.6	30,948	39,260	-21.2

member banks in the District. In 1948 year-end financial statements all but 28 of these 490 banks reported the maintenance of loan reserves set up pursuant to Federal income tax law. Balances in these tax-purpose reserves aggregated 2.3 million dollars at the end of 1947 and 37.3 million at December 31, 1948.

Some of the new tax-purpose bad debt reserves were created by transfers from other loan valuation reserves previously maintained, but in the main provision for the reserves became extra amounts added to the normal loan losses deducted from current profits. While some of these entries were made in 1947, most of the Seventh District member banks charged their 1947 addition to the reserve as a 1948 expense when the tax return was filed in March 1948. Moreover, in many cases 1948 loan losses also included monthly accruals for the 1948 tax-allowable addition to the reserve. It is obvious then that the effect of the new procedure has been to distort completely the 1948 reported losses on loans and the resultant net profits. These two figures cannot be comparable with previous years' corresponding results, and it is probable that the situation will exist for some time—possibly until most banks on the reserve procedure have brought their reserves to the "ceiling."

COMPARABLE DATA CAN BE ESTIMATED

The 1948 member bank earnings reports contain a new section analyzing changes in valuation reserves for loans and securities. From this source it is possible to gain some idea of how much of the additions to these reserves represent loan losses less recoveries—a basis comparable to previous years—and how much represent building up the reserves. It was determined that the tax-purpose loan valuation reserves increased 35.0 million dollars during 1948, of which 2.7 million was offset by reductions in

other loan valuation reserves and 32.3 million arose from net charges against 1948 profits. From supplemental information furnished by banks which had loan valuation reserves on their books at December 31, 1947, it was determined that the net charges against 1947 profits for the net increase in the aggregate of these two types of valuation reserves during that year was 3.0 million dollars.

Manifestly there are faults in a comparison based on measuring losses charged against current profits with those charged against valuation reserves. Actual entries to effect the latter often lag because at that point these entries are not necessary to account for current net profits. For the purpose of this analysis, however, the 1947 and 1948 reported loan losses (net after deduction of recoveries) have been adjusted to eliminate therefrom the amounts of the aggregate net increases in all loan valuation reserves during these years. The remaining net loss amount then constitutes the total of the actual loan charge-offs less recoveries recorded in both the current profit and loss accounts and the valuation reserves—a basis somewhat more comparable with previous years than the reported figures.

To carry out the adjustments to the net profits results, the item of "Taxes on net income" has been increased by an estimate of the income tax liability which would have applied to these amounts had they not been set up in the reserves, using the average Federal rate of 38 per cent. The adjusted figures are shown in Table 2, from which it will be observed that on this basis net profits for 1948 are 99.5 million as compared with 94.7 million for 1947, an increase of 20.0 million for 1948 and 1.8 million for 1947 over the official reported figures.

CAPITAL STRUCTURE STRENGTHENED

Dividends paid during the year aggregated 32.5 million as compared to 31.1 million in 1947, the average dividend rate for both years being the same. With the wartime expansion of deposits and the more recent increase in loans, adequacy of capital structure is still a major problem in many Seventh District banks. Yet in view of this year's addition to capital structure of 47 million of net profits remaining after the payment of cash dividends, plus the net addition to loan valuation reserves of 32 million, the capital and reserve structure of Seventh District member banks strengthened measurably during the year.

An important result of the new tax-purpose bad debt reserve procedure is this strengthening of the financial structure of banks. Not only have the large amounts of these reserves been withheld from capital funds subject to dividend payments, but the tax saving from the deductible aspect of the reserve provision has added substantial cash funds to the banks. The large scale building up of these reserves, and the resultant tax saving, should continue for at least two more years, until most banks on the reserve method will have brought their reserve up to the ceiling. It is doubtful whether the amounts reflected in one year's earnings reports will again be as large as in 1948, however, unless a considerable number of additional banks adopt the reserve procedure.

TABLE 2
**ADJUSTED NET PROFITS OF SEVENTH DISTRICT
MEMBER BANKS, 1947-48**
Giving Effect of Deduction From Loan Losses of Amounts
of Net Increases in Loan Valuation Reserves
(Dollar amounts in thousands)

Item	1948	1947	Per Cent Change
Net current earnings.....	136,255	124,267	+9.6
Net recoveries or losses (-):			
Loans.....	-2,129	-2,286	-6.9
Securities and other losses and profits.....	5,374	4,296	+25.1
Profits before income taxes...	139,500	126,277	+10.5
Taxes on net income.....	40,004	31,625	+26.5
Adjusted net profits.....	99,496	94,652	+5.1

Note: By the deduction of net increases in loan valuation reserves from net loan losses the result is the total losses less recoveries entered in both the earnings statements and the valuation reserves. Preliminary data show net increases in all loan valuation reserves to be 32,273 thousand in 1948 and 2,975 thousand in 1947. The estimated income tax saving from the reserve procedure which was returned to tax expense in the above adjustment was 12,264 thousand in 1948 and 1,131 thousand in 1947.

SEVENTH FEDERAL



RESERVE DISTRICT

