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Banking's Capital Shortage:
The Malaise and the Myth

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On our cover: The Campbell Museum, located in Camden, New Jersey, is the only museum of its kind in existence. The museum's collection consists of objects pertaining to the service of soup and its equipage. It is international in scope with examples from 24 countries and not limited to any one period. Although the first purchase was a rare American silver soup tureen made circa 1795 (upper left), other objects of high quality as examples of popular and individual choice are a Vincennes tureen of soft-paste porcelain (upper right), a Chelsea tureen (soft-paste) made in 1762-63 (lower left), and a Russian silver tureen bearing the monogram of Catherine the Great (lower right). (Photographs courtesy of The Campbell Museum, Camden, N. J.)

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Banking's Capital Shortage: The Malaise and The Myth

By Ronald D. Watson

Is it possible that bank capital—like oil—is a scarce resource whose supply is in danger of being exhausted? To read the financial industry's trade journals a person might conclude that capital is a rare substance whose supply can grow only at a strictly limited rate. However, the current presumption that banks can't raise the funds they want for strengthening their capital positions and expanding deposits needs a lot of rethinking. Banks must have capital to inspire public confidence and absorb losses.¹ If they can't get the capital required to support their operations, maybe banks aren't serving the economy as effectively as is generally assumed.

Clearly, the banking industry must raise additional capital if it is to grow. Growth without

new capital is possible, but only if bank regulators are willing to allow risks to increase, and that isn't likely. The "shortage" is occurring because banks are expanding their assets more rapidly than reinvested profits can boost capital. The obvious supplement to retained earnings is new capital from public issues of long-term debt and equity securities. But bankers claim that declining stock prices and higher interest rates have made the cost of this new money (especially the equity) too high. The problem is compounded by generally weak markets for bank securities, especially in the wake of several failures of large banks in 1974. Most banks resort to outside financing only when other sources of funds are no longer readily available.

Restricting the industry's growth to the rate at which it can generate capital internally has been suggested, but most banks are reluctant to accept a policy that might mean losing ground to other financial intermediaries or

¹Ronald D. Watson, "Insuring Some Progress in the Bank Capital Hassle," *Business Review of the Federal Reserve Bank of Philadelphia*, July-August 1974, pp. 3-18

even slowing the whole economy's growth. Yet, further growth for banking appears to be stymied. Internal generation of new capital is too slow, outside capital seems too costly, and the regulators are closing off the alternative of expanding without additional capital.

This should not—and need not—be an impasse. If the problem looks insurmountable, it may be that we are zeroing in on the wrong target. The issue should not be one of “how to get capital for future expansion,” but “are the profit opportunities of this expansion great enough to justify raising new capital at today's prices?” If the profits are there, banks can afford to pay the going rate for capital. If they aren't, then the capital should go to industries that have better opportunities to use it. Bank capital markets may be in poor shape, but that alone shouldn't change the way the decision to expand is made.

THE CAPITAL CHASM

The bank capital “shortage” has been brewing for several years, but recent projections of enormous capital shortfalls over the next decade have significantly pepped up discussions of the problem. There have been prophecies of a capital “gap” (differences between probable capital accumulations and capital demands of the industry) of \$16.7 billion² by 1978 or \$32.0 billion³ by 1979. These projections have intensified the industry's awareness that the methods used for financing growth in the '60s may not be equal to the task in the '70s.

Bankers have normally considered it impractical to try to close this gap with outside sources of funds. Data on bank financing is very sketchy, but the industry has a long history of depending heavily on earnings retention for additional long-term funds (as

have most corporations). Of the new securities issued by banks the bulk has been debt (subordinated notes and debentures) rather than common or preferred stock.⁴ In general, internal funds are more appealing as a source of capital than external funds because their cost seems very low. Retained earnings almost always look cheaper than new common stock. A new stock issue may dilute the earnings of current shareholders, but retaining earnings never will. Furthermore, there are substantial transaction costs associated with floating new debt or equity issues publicly. Retained earnings may also seem less costly than long-term debt which carries an explicit obligation to pay interest.

Raising money through new issues of common stock has become even more expensive in the last few years because bank stock prices have declined dramatically even though earnings have been growing. Bankers accustomed to seeing their shares sell for 15 to 20 times earnings in the early 1960s were dismayed to see those prices drift into the 10 to 15 times earnings range in the late 1960s and early 1970s and then plummet to the 5 to 10 times earnings range in 1974.⁵ As stock prices decline, the number of shares that must be sold to raise a fixed amount of new capital increases. When this occurs, the current stockholder's control of the bank is diluted and his future dividends diminish relative to what he would have received if the stock had been sold at a higher price. And each jump in equity cost has strengthened management's resolve to avoid paying the cost of raising

⁴“Report of Securities Issued by Commercial Banks and Holding Companies,” Report #67, Corporate Financial Counseling Department of Irving Trust Company, New York, February 28, 1975.

⁵Keefe *Bank Stock Manual* (New York: Keefe, Bruyette, and Woods Inc., 1974). Inflation and riskier bank portfolios have been important reasons for the rising cost of new debt and equity capital. However, many bankers claim that public statements by regulators warning of capital inadequacy problems have increased the cost of funds even to very conservative banks by making investors wary of all bank securities—not just banks that had been aggressive in using leverage.

²*The Capital Adequacy Problem in Commercial Banks, 1974-1978* (Princeton, N.J.: The Institute for Financial Education, 1974), p. 8.

³Warren R. Marcus, *The Challenge to Banking: Capital Formation in the Seventies* (New York: Salomon Brothers, 1974), p. 6.

funds with new stock issues.

Even debt capital has become more expensive in the last few years. Not long ago sound banks were able to sell their long-term obligations at an interest rate of 5 to 6 percent. However, an upward drift in rates and recent concern about bank soundness have made the going rate 8½ to 10 percent these days.

CURRENT REMEDIES FOR SPANNING THE GAP: A WEAK BRIDGE

Even though there is no universally accepted response to this problem, there have been any number of suggestions. Some have been directed toward loosening the regulatory constraint on expansion while other plans have been designed to reduce the industry's cost of capital. All of these proposals have some merit, but none constitutes a lasting solution to the problem.

Lower Capital Standards. Some effort has gone into convincing the regulatory agencies that banks don't really need all the capital that supervisors currently consider prudent. If capital standards were lowered, still more expansion could take place. Bankers point to the willingness of investors in the capital markets (until very recently) to advance debt funds to banks at interest rates nearly on a par with other high-quality corporate borrowers. This is interpreted as evidence that investors (who are the first to lose their money if banks fail) have considered banks to be good risks. If regulatory standards on capital are too conservative, reducing them would alleviate the current bind on growth. Reducing capital requirements might also enable banks to maintain the lower standard through retention of earnings. However, such a hope might be overly optimistic. A key reason that banks haven't maintained capital at the current standard through internal generation of profits is that they have been willing to sacrifice profits to achieve asset growth. If the regulator's capital constraint is relaxed without a simultaneous reexamination of the impor-

tance of maintaining profitability, the problem will just reappear in a couple of years. Asset growth will again be halted by the capital adequacy barrier, but this time it will be at an even lower standard.

More Debt. The second type of suggestion for closing the capital gap consists of plans for lowering the price that banks must pay for their capital funds. The most common proposal is that banks use more long-term debt as a substitute for equity capital. As long as debt hasn't been overused, it has a cost below that of equity and appears to be the cheapest way to raise outside capital. Debt is a particularly attractive form of capital in that it is the one form of long-term funds whose cost is a tax-deductible expense.⁶

Yet, substituting long-term debt for new equity is also only a partial solution. Long-term debt is an inadequate substitute for equity because it has legal characteristics which are different from those of common stock. Its claim to interest is secondary to that of depositors, so it backstops their claims. But interest and principal must be repaid on time if the bank is to avoid default, and operating losses cannot be charged against debt "capital" (except in liquidation) as they can against equity capital.

Accordingly, if bank's asset growth is financed with debt capital rather than equity, the chance of incurring a large loss that would wipe out the remaining cushion of equity capital grows. The greater the amount by which the growth of risky assets exceeds expansion of the equity cushion, the greater the risk of failure. Bondholders are also wary of this heightened risk of failure. As the investors' risks grow, the yield they demand on their investment also climbs. As a result, heavy use of "cheap" debt capital will eventually

⁶There have recently been legislative proposals that all dividend payments be treated as tax-deductible expenses in the same way that interest payments are now deductible. If this change in the tax codes were enacted, it would make stock a relatively more attractive way to finance corporations.

raise the cost of new equity and debt (both new and refinanced) by causing the market price of these securities to decline. This risk "spillover" reduces the cost advantage of new debt. It also hurts the financial position of the current shareholders whose investment has now dropped in value. If a bank's debt position becomes excessive by market standards, management will find that by cutting back on the use of debt the shareholders' risk will be reduced, the stock's price will tend to rise, and the overall cost of funds will be lower (even new equity issues become relatively less costly than additional debt).

New Securities. One of the problems preventing banks from using more debt capital is the poor marketability of these securities. Major banks that have market recognition are able to sell large amounts of debt at relatively low interest rates. However, smaller banks that lack this reputation aren't so fortunate. The market for their securities is normally restricted to their operating region, and borrowing costs may be higher than those of a large bank of the same risk. To overcome these disadvantages some smaller banks have borrowed debt capital from their big-city correspondents.⁷ There have also been suggestions that smaller institutions use investment trusts (like mutual funds) to pool their securities. This device is intended to simplify the investor's diversification problems while providing a wider market for the securities of these banks.

Weakness in the stock and bond markets has prompted some authors to suggest that banks turn to convertible bonds for new capital. These are securities that can be converted into common stock if stock prices rise. Convertible bonds usually have an interest rate below that of nonconvertible debt. What's more, the price at which holders are allowed to convert their bonds into common

stock can be set above the current market price of the stock. This type of security is supposed to give the issuer a cheap source of debt which will eventually be turned into equity at a better price than new stock issued right now—in a sense, the best of both worlds for the bank.

Investment trusts and convertible debt securities might be useful to a bank, but they won't make the cost of new capital *substantially* lower. Such a trust may improve the overall marketability of a bank's securities, making it easier for the institution to tap new sources of capital. However, an investor should be able to diversify his or her investments without the trust and has little reason other than convenience to accept a significantly lower return on pooled securities than for the individual issues.

Convertible bonds (and convertible preferred stocks) are also useful, but again they don't solve the problem. On the surface they look like a very cheap way to raise money. But this is not the case. If a bank offers a convertible bond, it may sell the securities at a low interest rate and attractive conversion price. However, it has still sold a debt issue, and debt is riskier for the bank than new equity. Holders of these bonds will only convert them to stock if the price of the bank's stock rises to a level above its conversion price in the future. If a bank really wants debt capital now and equity capital sometime in the future, it might be better off to float a bond issue initially, and then refinance it with a common stock issue later at the stock's higher price. In principle, there's no reason to expect a bank to be able to raise capital substantially more cheaply in the long run with convertible securities than with ordinary debt and stock.

Cut Dividend Payout. The high cost of new external capital has also prompted the suggestion that banks boost earnings retention by gradually cutting the proportion of earnings paid out as dividends. Retained earnings are an appealing way to build equity capital because the process doesn't create

⁷This may make the smaller bank's capital position look more sound, but it hardly enhances the stability of the banking system.

new shares which dilute earnings. The internal funds also increase the likelihood that there will be higher earnings in subsequent years.

But the suggestion that higher earnings retention be used when equity capital costs are high skips over some basic economics. If the cost of new equity is prohibitive, the cost of retained earnings should be treated as only “a bit less” than prohibitive. The cost of retained earnings is closely linked to the cost of new equity in the long run. In a world without taxes these costs would be identical except for the cost of underwriting new stock issues. Taxes make retained earnings slightly cheaper because investors whose profits are retained for reinvestment by the bank will avoid income taxes—at least until the reinvested profits produce higher dividends or until stockholders realize a capital gain on their investment. Realizing a capital gain would reduce the effective tax rate on the profits from reinvestment.

The connection between the cost of retained earnings and that of new common stock becomes clearer if we think of retained earnings as bank profits that are being reinvested within the organization for the *benefit of the shareholders* rather than being paid out to them in the form of dividends. Those same investors who want a very high return for investing in a new stock issue aren’t likely to be happy to have their profits reinvested for them at significantly lower expected returns. If investors currently expect 15 percent as a return for investing in a bank’s stock, they must feel that 15 percent is a competitive return given the risks of bank investment and the alternative uses they have for their money. If the bank can’t earn enough profit on these retained earnings to give the shareholders that 15 percent return, it would make the investors better off by giving them the money as a dividend to invest as they see fit. In the long run, reinvestment of retained earnings at substandard rates will lower the bank’s overall rate of return, and investors will bid down the price of the bank’s stock. Therefore, reinvesting retained earnings

when profit prospects don’t warrant doing so is no solution to the capital problem.

Boost Earnings. The final proposal for closing the capital gap is one of speeding internal equity creation by increasing earnings margins. Greater profits would allow earnings to grow faster, equity to expand faster, and asset growth to be less impeded by capital. The proposal that banks raise their profit margins is the soundest and the most important of this crop of “solutions.” It comes the closest to confronting the fundamental reason that the industry finds itself “unable” to raise adequate capital. It is also the basic component of a real solution.

THE FUNDAMENTAL PROBLEM

The problem that banks face isn’t a *shortage* of capital but an *unwillingness or inability* to pay the “going rate.” There is no question that capital costs are high right now. By the historical standard of the last three decades, the only time they were higher was in the latter part of 1974 when long-term interest rates were above their present levels and stock prices were extremely depressed. Adjusting to these rising capital costs is difficult for all businessmen—and the reaction is likely to be slow. Many bankers have delayed raising capital hoping that a future drop in market rates will reduce these capital costs.

Beyond the argument that rates may soon drop, many bank managers are simply unwilling to tolerate the dilution of earnings per share that could accompany a new stock issue (spreading the existing earnings pool over a larger number of shares). Retained earnings may have a high implicit cost, but it’s a difficult cost to pinpoint. Diluted earnings, however, suggest that management may have made some errors somewhere along the line. That makes dilution a difficult path to accept (see Box).

Bankers may also be unwilling to pay the high cost of new capital for the sound economic reason that they cannot reinvest it at a sufficiently high return. They may know

WHEN WILL DILUTION OCCUR?

A common argument advanced against sell new stock issues is the concern that the stock's earnings per share (E.P.S.) will be diluted by an increase in the number of shares outstanding. This is true, and to the extent that a bank's ability to pay dividends is tied to its E.P.S., it is undesirable to dilute earnings. However, this isn't the whole story.

New equity capital does more than simply dilute the current earnings of the existing shares. The new money can be invested profitably and used as a base for expanding other liabilities. It also reduces the risk of the bank's capital structure. It is quite possible that shareholders of a bank that sells new common stock can experience a mild dilution of their earnings but be better off. They have a sounder investment because their risk is lower and the bank now has a better equity base on which to expand in the future. As a practical matter, new stock issues *almost require* dilution in the short run. Stock must be sold in large enough blocks that the flotation and underwriting cost aren't too large a proportion of the total funds raised. But the new equity will then be sufficient for further expansion of fixed-cost liabilities and the bank can re-leverage the earnings to their former level.

Stock Price Dip. It's almost an article of faith that new stock can't be issued after a fall in the bank's stock price without diluting earnings. Dilution may well occur, but it isn't a foregone conclusion. Suppose the Ninth National Bank's balance sheet is the following.

Cash	(0%)*	\$ 100	Deposits	(6%)	\$ 600
Bonds	(7%)	500	Borrowing	(7%)	500
Loans	(11%)	600	Capital	(20 shares @ \$5 per)	100
Total		\$1200	Total		\$1200

Assuming the bank's tax rate is 50 percent, its earnings per share would then be

$$\begin{array}{rclclcl}
 \text{revenues} & - & \text{expenses} & = & \text{income} & - & \text{taxes} & = & \text{profit} \\
 (0 + 35 + 66) & - & (36 + 35) & = & 30 & - & 15 & = & 15/20 = \$.75 \text{ E.P.S.}
 \end{array}$$

Assuming that the stock's market price is equal to its par value, this is a 15-percent return on the stockholders' investment.

*The numbers in parentheses denote the effective *yield* on assets or the net cost of funds raised. Economic theory suggests that a firm should utilize a source of funds until the marginal cost of the next dollar raised from that source is exactly equal to the marginal cost of a dollar from any alternative source. If the bank described above really found that its cost of obtaining new deposits was below the cost of new short-term borrowings, it should tap that source until the marginal cost of deposits rises to the level of the cost of new borrowings.

Suppose this bank had some attractive investment and lending opportunities but needed additional money to expand its assets. A total of \$200 could be invested as follows:

$$\begin{array}{r}
 20\% \text{ in bonds at } 7\% = .014 \\
 80\% \text{ in loans at } 11\% = \underline{.088} \\
 \hline
 .102 = 10.2\% \text{ before-tax yield} \\
 \qquad 5.1\% \text{ after-tax yield}
 \end{array}$$

Suppose, also, that the bank would have to rely heavily on purchased funds and new stock to raise this money but could get it in the following way:

- 20% from new deposits
- 70% from borrowings
- 10% from new common stock (4 new shares).

The average cost of these marginal sources of funds (adjusted for the tax deductibility of interest) would be

Proportion	Tax-Adjusted Cost		
.2	x (.06 x .5 = .03)	=	.0060
.7	x (.07 x .5 = .035)	=	.0245
.1	x (.15)	=	<u>.0150</u>
			.0455 = 4.55% tax-adjusted cost of funds.

As long as funds can be raised at 4.55 percent and invested at 5.1 percent, the bank should expand.** In fact, if the bank makes this expansion its new balance sheet would be

Cash (0%)	\$ 100		Deposits (6%)	\$ 640
Bonds (7%)	540		Borrowings (7%)	640
Loans (11%)	760		Capital (24 shares @ \$5 par)	120
Total	\$1400		Total	\$1400

and the E.P.S. of the bank's stock (including the new shares) would jump to

$$\begin{array}{r}
 \text{revenues} \quad - \quad \text{expenses} \quad = \quad \text{income} \quad - \quad \text{taxes} \quad = \quad \text{profit} \\
 (0 + 37.80 + 83.60) \quad - \quad (38.40 + 44.80) \quad = \quad 38.20 \quad - \quad 19.10 \quad = \quad 19.10/24 = \$.796 \text{ E.P.S.}
 \end{array}$$

**Bankers continually confront choices between greater return with higher risk or lesser returns with lesser risks. This analysis assumes that the bank's overall risk has not been altered by the expansion. The proportion of risk assets is up, but so is the bank's capital position. Therefore, the return expected by investors will not change.

Now suppose that inflation picks up or investors become worried about the long-run profitability of banks. The price of Ninth National's stock might drop from \$5 to \$4 a share. That represents a significant increase in the cost of new equity capital to the bank (15 percent to 18¾ percent), and it will now take five new shares rather than four to raise the \$20 of new equity. However, the fact that these costs have risen is not sufficient reason to abandon the expansion. If profits from the new investments are high enough to cover the jump in equity costs, the bank should go ahead with its plans. If overall profits are unchanged the new E.P.S. will be ...

$$\$19.10/25 \text{ shares} = \$.764 \text{ E.P.S.}$$

This is far less attractive than the 79.6¢ E.P.S. that the bank's shareholders would have received had the stock price remained \$5 a share. But both new and old shareholders are still better off with the expansion than they would have been without it (76.4¢ versus 75¢).

In summary, an expansion that earns enough to benefit the new shareholders will automatically make the old ones better off. It's only when the new capital investment isn't profitable by the market's current standard of returns that expansion shouldn't be undertaken. Dilution will occur only when the wrong financial decision has been made or when the bank has exceeded the bounds of prudent leverage and has to sell more equity to get back to a safe capital structure.

that they need greater earnings to justify raising additional funds yet may be unable to increase their margins because competitive pressures are too strong. Any move to raise earnings will be hard to sustain if other financial institutions don't consider themselves to be under the same pressures. If only one bank in an area raises its loan rate, its competitors will have an advantage in selling their services. In all probability the first bank will lose some of its share of the market. It's only when all banks feel the pressure to build their capital (and no one has a clear cost advantage) that profit margins can be raised successfully. Even then, banks may lose some business to other nonbank financial organizations unless those firms are under equivalent pressure to boost earnings.⁸

⁸This should not be interpreted as an approval of collusion to raise prices. Even though the entire industry has profits that are insufficient to attract new capital, each bank must respond to the problem individually. However, the more widespread the profits squeeze, the more likely that individual banks will follow a move to raise prices rather than try to increase their market share by maintaining current prices for loans and services. In the long run, competitive markets will generate equal prices from all suppliers, but at a level which covers the cost of all factors of production including equity capital.

In the long run, the banking industry can only pay a higher price for capital if it can pass these costs along to customers in the form of higher effective interest rates or higher fees for other services provided. The ability to pass costs along depends in great part on whether the industry can preserve its cost advantage over (or, at least, parity with) competing suppliers of financial services. If bank loan prices can't be competitive, profit opportunities will shrink and maintaining the industry's recent growth rate will be impossible.

THE FUNDAMENTAL SOLUTION

The industry can pay the going rate for capital if it is careful to use sound methods in analyzing its costs of funds and return available on new investments. In the long run, solid financial analysis will be more effective in loosening the industry's growth constraints than plans to make bank securities more marketable. Management will also find that its own long-run interests are served by making sound financial decisions. Asset growth may be one measure of accomplishment, but consistent profitability over the long haul makes a banker's position more secure.

The Cost of Funds. One of the most basic problems that industry must confront is estimating the costs of its own sources of funds. Bank management must determine where new money is coming from, what its full cost is, and what effect decisions to change the bank's capital structure (and, thereby, its risk) will have on the cost of these funds. The cost of funds to a bank depends in part on the riskiness of its capital structure—the proportions in which it raises long-term versus short-term funds and debt capital versus equity. A bank may raise its *next* dollar of funds from any of several specific sources, but it must carefully maintain a balance of debt and equity as it grows over time. If this week's funds come from debt sources, they will soon have to be balanced with new equity. Since increasing risk makes it impractical to expand indefinitely using only short-term borrowings, bankers must include the cost of funds from all of the sources that will eventually be tapped when they estimate the real cost of additional funds.⁹ To be profitable, any investment made by the bank should earn enough profit to pay for all the funds used to finance it.

Lending money at rates which cover only the cost of funds borrowed to make the loan will quickly lead to profit problems. The cost of the new equity that must be raised to keep risk exposure constant must also be covered in the rate charged on the loan. Otherwise, the cost of the bank's funds will rise even further. If the cost of new capital is increasing, the signal to management should be clear:

⁹A common technique for estimating a corporation's cost of new funds is the weighted average method. A business evaluates the net cost of raising additional funds from debt and equity sources by estimating the cost of each source and weighting the cost according to the proportion that those funds will represent of any new money raised. If a bank expects to finance 80 percent of its growth with short-term debt costing 4 percent after taxes and the other 20 percent of the expansion with new stock costing 12 percent, its weighted average cost of funds is $.8 \times .04 + .2 \times .12 = .032 + .024 = .056$ (5.6 percent). See Box for a more thorough explanation of this process.

either reduce the bank's overall risk or be prepared to earn a high enough return on assets to pay for this capital. Successful operation over a long period requires that investors be given an expected return on their funds that is as high as returns available from other comparable securities. The fact that markets for the capital of smaller banks are especially imperfect doesn't alter the fact that those banks must have equity to expand and must pay whatever the "going market rate" is for that equity.

A Minimum Return. Once a bank has estimated the price it must pay for new funds it has a benchmark for judging alternative investments. A bank should only invest in loans or securities (or combinations of them) whose expected return is above the cost of the new funds required to finance them. That seems obvious. But the decision must be made on the basis of the current cost of *all funds* that will be raised during the next planning period rather than just the cost of a block of short-term debt which might be raised next week. It should also consider the full effect that any change in the bank's asset or liability risks will have on the cost of any funds raised. Furthermore, if the bank expects to have more funds than it needs to meet loan demand and liquidity requirements for an extended period, simply investing them in the highest yielding asset available may not be the best strategy. The investment must still yield enough to pay the full cost of these funds, or they should be returned to those who have loaned to or invested in the bank. This might be done by not replacing maturing debt issues or by paying extra dividends. In the long run, capital markets should eventually force a bank in the direction of managing its funds efficiently. (Limitations on entry into banking and imperfections in the market for bank securities may make market discipline less effective than it is in unregulated industries.)

Shrink, If Necessary. If investment prospects don't justify raising new funds, the institution shouldn't try to expand. Doing so

isn't in the best interests of either shareholders or management. When the cost of funds exceeds the returns available to a bank, capital markets are giving management a signal that alternative uses for its shareholders' fund are relatively attractive. If the bank can't earn a competitive return on its equity, its stockholders can use the money for other investments. A bank that reinvests shareholder earnings when its return isn't on a par with other securities of similar risk is preventing shareholders from making better use of their own money. Eventually, the shareholders will sense this and try to sell their stock. The falling stock price will put pressure on management to correct the problem or answer to the stockholders.

The market is also signaling the bank that consumers and borrowers aren't sufficiently interested in its banking services to pay the prices that make the bank able to give investors a competitive return. Either another financial organization can provide that service at a lower cost or tastes have changed and people don't really want the service at all. Banks that can't afford to pay the going rate for funds (because they can't pass their higher costs on to their customers) should not expect to get additional money.

The Regulatory Constraint. If banks were unregulated and absolutely free to buy money and sell services in a competitive business environment, these market forces could resolve the "capital shortage" automatically. But the fact is, they're not free and, therefore, they do not work perfectly. The industry, in fact, is tightly regulated, and the regulations influence bank profits. Exclusive rights to issue demand deposits and limitations on entry into the industry are examples of implicit subsidies from Government to commercial banks. Conversely, capital adequacy constraints, reserve requirements, and portfolio limitations tend to lower bank profits. The point is not that these constraints are "wrong" or "unjust," but that they influence the profitability and com-

petitiveness of banks *vis-à-vis* other financial service organizations.

Firms operating in an unregulated world have the right to raise their prices enough to compete for the higher cost equity funds—as long as their customers are willing to pay those higher prices. Banks are free to make some price adjustments, but they may not be able to pass on higher money costs as effectively as unregulated financial corporations. If banking agency regulations or state usury statutes inadvertently hold earnings below the level needed to raise new capital, the industry's growth would be unnecessarily curtailed.¹⁰

There is no way to know, right now, whether this will be an important problem or not. Bank regulators must be vigilant in assuring that only the constraints that are necessary to promoting the financial system's stability are enforced. This problem becomes especially important as regulators weigh the pros and cons of changes in capital requirements and of expanded powers for both banks and thrift institutions.

CONCLUSION

Any projection of historical trends in bank growth, profits, and dividend payout practices suggests that the banking system's demand for external capital will expand rapidly in the years immediately ahead. Yet the capital "gap" will probably sow the seeds of its own resolution. If banks curtail their growth because of an inability to find profitable new investments (or to circumvent the regulator's capital constraints), the least attractive investments can gradually be culled

¹⁰It is also possible that their regulated environment gives banks an advantage as money costs rise. In that instance, regulations are giving banks an unearned competitive edge and allowing them to increase their market shares at the expense of nonbank businesses. This results in just as great a misallocation of society's resources as occurs when bank profits and growth are unnecessarily restricted.

from their portfolios. By concentrating available resources on the more profitable business that remains, banks will be taking steps to build capital internally. Better profits and stronger capital positions will cut risks, and banks will then be more able to compete for new external capital. Competition from the nonbank financial sector will remain, but these organizations must also pay high prices for additional capital. The key, however, is astute use by banks of the money available to them and prudence in raising only those funds that can be reinvested profitably. As long as the profit opportunities exist, banks will have the opportunity and the justification for raising whatever funds they need. When expected profitability is insufficient, the

desire to expand must be held in check.

Regulators also face a challenge in the years ahead. They must not only protect the public's interest in its financial system but also try to keep the game "fair." The regulatory agencies can alter the competitive viability of the industries they regulate. If these industries are to serve society and their shareholders efficiently, they must be free to respond to their changing economic environment. The desire to expand banking's capital base rapidly is one development which can only be accomplished successfully if regulation doesn't prevent the industry from competing for funds, investing rationally, and passing rising costs along to customers who are willing to bear them. 

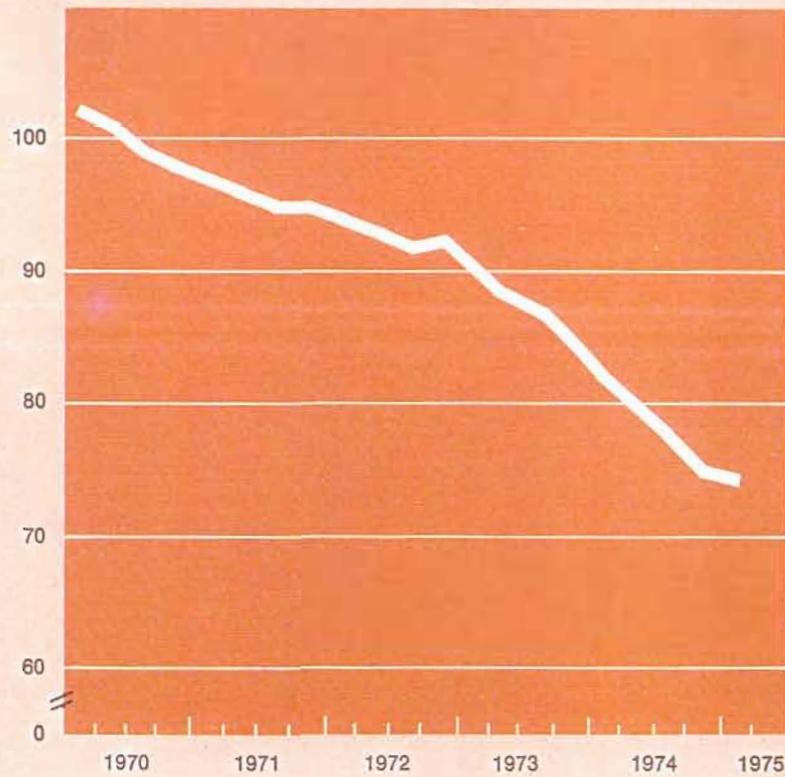
The Dollar at Home and Abroad

By John G. Bell

CHART 1

BECAUSE OF STEADY INFLATION IN THE U. S. OVER THE LAST FIVE YEARS, THE DOLLAR TODAY BUYS FEWER GOODS IN THIS COUNTRY THAN IT DID IN 1970.

Index of Purchasing Power of the Dollar* (1970 = 100)



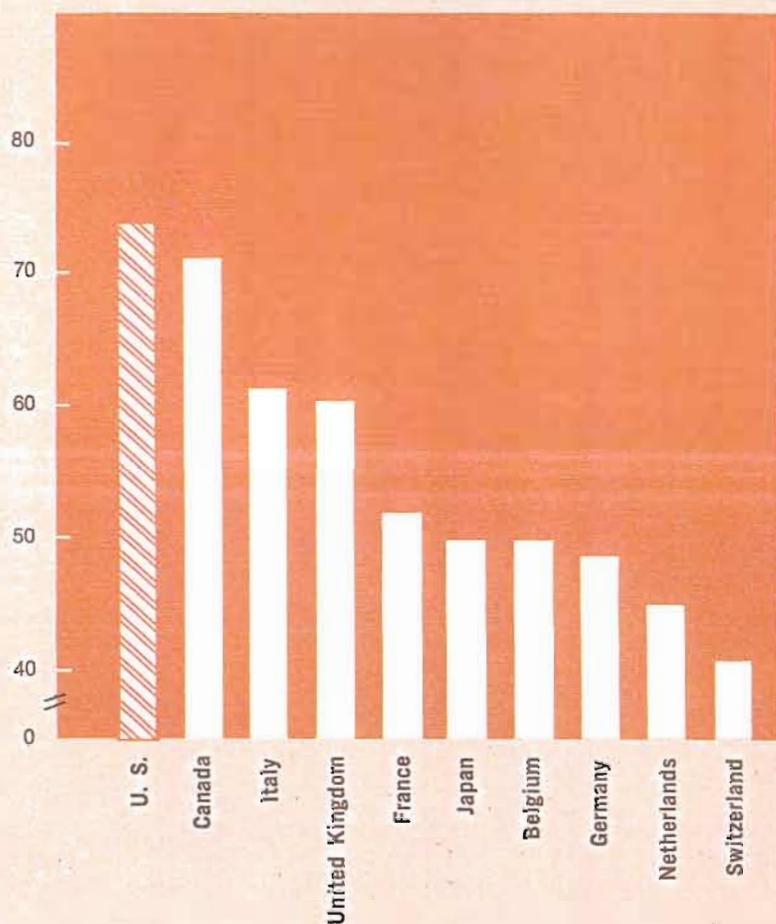
* $\frac{100}{\text{CPI}}$

SOURCE: U. S. Department of Labor, Bureau of Labor Statistics.

CHART 2

YET THE DEPRECIATED DOLLAR HAS STILL HELD ITS PURCHASING POWER FAR BETTER AT HOME THAN IT HAS OVERSEAS . . .

Index of Purchasing Power of U. S. Dollar*
 In Selected Countries—1st Quarter, 1975
 (1970 = 100)



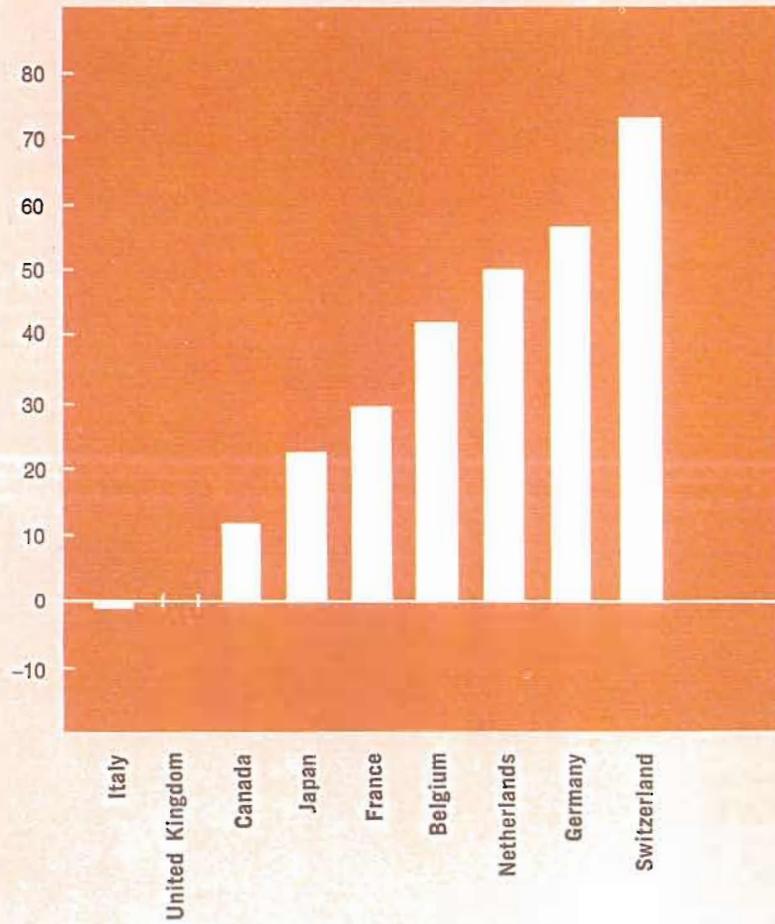
* This index is computed by multiplying the exchange rate in terms of dollars per unit of foreign currency by the CPI for the country and converting to an index with 1970 = 100

SOURCE OF COMPONENT FIGURES: International Monetary Fund

CHART 3

... BECAUSE IT TAKES MORE DOLLARS TO BUY FOREIGN MONEY ...

Percentage Change in Dollars Needed to Buy One Unit
Of Foreign Currency—1970 to 1st Quarter, 1975

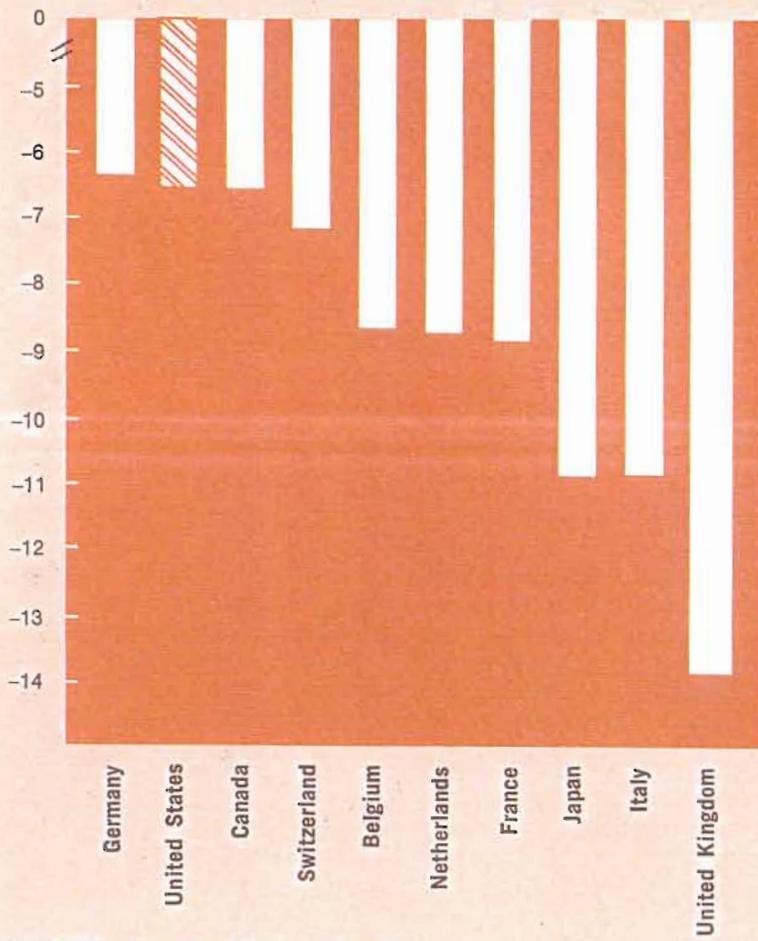


SOURCE: International Monetary Fund

CHART 4

... AND FOREIGN MONEY BUYS FEWER FOREIGN GOODS.

Average Decline in Purchasing Power of Selected Currencies in Their Home Countries
Percentage Change from 1970 to 1975



SOURCE: International Monetary Fund