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FUTURE SOURCES OF LOANABLE FUNDS FOR AGRICULTURAL BANKS

Commentary

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It seems to me that Don Miller's paper contains a serious inconsistency. On the one hand, he offers advice to large and small banks on how to manage their gaps. On the other hand, he seems to agree that rate volatility and high inflation are permanent features of the economic landscape.

When a bank consciously gaps—that is, tries to create a surplus of rate-sensitive assets or liabilities—it is betting a portion of its equity on a certain rate scenario. If the bank guesses wrong, it will impair its capital position.

Interest rates are determined by both systematic and stochastic forces. In recent years, the stochastic or random element of interest-rate movement has become more prominent, in part because of the Fed's decision to stop smoothing interest rate fluctuations within certain parameters. As a result, it appears that interest rates bear many of the characteristics of a random walk. In any given three- or six-month period, they are just as likely to rise as to fall.

Hence banks that gap, however intelligently, are apt to experience sharp fluctuations in net interest margins. If we agree that continued high inflation will tend to erode the ratio of equity to assets, a gapping bank is running a very large risk of impairing a progressively thinner capital cushion. I do not regard this as sound banking practice. In fact, I think it is a recipe for disaster.

Even if a bank is lucky enough to guess right on interest rates most of the time, its fortunes may not improve. Earnings may rise, but the bank's stock price may not reflect this earnings performance. The marketplace, acutely aware of the potential impact of interest-rate volatility on bank earnings, won't pay for superior performance generated by fortuitous success in gapping. It will view such profits

as highly risky and thus capitalize them at much loftier rates than in the past. While bank managers who profess to be endowed with a superior feel for interest rates will end up suffused with a glow of accomplishment, the shareholders for whom these managers work may not feel so comfortable.

Now, Don may argue that if banks don't gap, prudently but consciously, they won't make as much money as they did in the past. I agree that if banks cannot juggle the maturities of assets and liabilities to harmonize with projected changes in interest rates, the rate of growth of bank earnings will be lower than it once was. Yet again we must ask what will be the effect on shareholder welfare. The marketplace currently perceives that bank earnings are threatened (1) by a rising term structure of interest rates and (2) by the increased variance of that term structure. (The two developments are of course interconnected.)

If banks somehow manage to balance themselves in a maturity sense, earnings growth may be lower than in the past, but the quality of earnings will have been enhanced through the reduction of funding risk. Will not the obverse of what I just said then occur? Will not the marketplace respond by discounting earnings streams at lower rates? I think it will. Thus, price-earnings multiples may be higher than they now are, though perhaps lower than they were in the pre-inflationary past.

Now, of course, it may not be possible for banks to balance themselves. Many believe that small banks will have more trouble than large banks. I'm not so sure. I think that small banks may be more successful in shortening the maturity of assets to match the inexorable shortening of liability maturities. In the future, the individual borrower may accept the interest-rate risk more readily than the business borrower. Looking at the Fed terms-of-lending study, I was shocked to learn how few new C&I loans were made at floating rates during the 1977-79 period—something in the neighborhood of 50-60 per cent of total C&I extensions. What's more, at the big 48 banks, the proportion of C&I loans made at floating rates showed absolutely no tendency to rise during 1977-79, a period when liability maturities were being greatly shortened.

Business borrowers want fixed-rate credit, and they apparently have the bargaining power to enforce that demand. Some people argue as follows: Well, if the borrower wants long-term credit and the risks of maturity transformation — converting liquid deposits into

liquid assets — have become greater for the banks, then the banks should be able to raise loan prices sufficiently to cover the increased exposure.

Unfortunately, that argument doesn't wash because the marketplace contains enough intermediaries that are either willing or able to shoulder the maturity-transformation risk on existing terms. These include some domestic banks that are willing to gap fairly dangerously and those foreign banks that apparently regard their U.S. operations as loss leaders and can continue to do so as long as they have such high leverage and modest ROA targets (e.g., French and Japanese banks) or as long as they have a license to steal in their home market (e.g., the British banks, which pay interest on only about half as many of their deposits as do large American institutions).

It also includes the pension funds and insurance companies that can afford to make fixed-rate loans because their liabilities are also long term and fixed in nature. I sometimes think that bankers should devote a great deal of their time to lobbying for the compulsory indexing of pension and death benefits. Were such lobbying successful, both the pension funds and the insurance companies would be forced to revise lending practices, which they are now doing, but very slowly and with no great avidity. Clearly if the pension funds and insurance companies shortened asset maturities, it would be much easier for banks to do likewise and thus be in a better position to achieve rate-sensitivity balance.

So my view, which appears somewhat different from Don Miller's, is that banks should strive for balance, but that this striving cannot always be successful, given what I believe will be greater rigidity on the asset side than on the liability side of the balance sheet.

What can be done about this problem? Bankers could always try to introduce a little more rigidity on the liability side, to slow down the trend toward even shorter liabilities. Bankers have not, I believe, shown much imagination in this area. Why not create a negotiable retail CD? With such an instrument, the saver could transfer ownership by selling the paper through a brokerage house. Since the obligations of banks are safe (provided the FDIC insurance moves with the certificate) and homogeneous, sale in an after market that is certain to emerge will not be difficult.

The saver would get three options: (1) hold the certificate to maturity, (2) sell at a profit if rates fall, or (3) sell at a loss — but perhaps much less of a loss than under the current system of prema-

ture withdrawal penalties—if rates rise and the value of the certificate drops. The S&L industry moved to certificate liabilities some years ago, and had these instruments been negotiable, the industry would not have faced the problem of massive shifts from six-month money in 1979 and 1980.

With a negotiable long-term certificate, nonredeemable except at maturity, the saver's desire for liquidity and reasonably high yield could be satisfied. The bank, in turn, would have bona fide long-term money, insulated from transfer to money market mutual funds. No matter how many times the certificate was traded, it would remain a liability of the bank of issue.

Of course, if interest rates fell, banks would be in trouble. But this eventuality could be protected against by introducing a call feature similar to that incorporated in bonds. If rates dropped dramatically, banks could call in high-rate, long-term certificates, paying the saver a premium that could be tailored to match the prepayment penalties banks would or should be charging borrowers desirous of refinancing loans in the low-rate environment. I understand that Chase Manhattan is currently toying with the idea of a negotiable retail CD. I hope something concrete will emerge. It seems a particularly desirable instrument for small banks.

If banks cannot lengthen liabilities *de jure,* they can still do so *de facto* by the use of futures. In effect a liability hedge is a device that changes the yeild maturity of the liability to more closely match that of the asset it is financing. As Don Miller has mentioned, however, there is the mark-to-market accounting problem. If a bank shorts a strip of 90-day bills to hedge an MMC and rates fall temporarily, the bank has a loss that must be recorded immediately. If interest rates turn around, the bank may record a profit on its hedge sufficient to offset the increased cost of rolling over its MMC. But that benefit occurs subsequent to the highly visible loss.

A way around the mark-to-market problem is to do what agricultural bankers have been doing for years—ask the borrower to execute his own hedge. Agricultural bankers have used this device largely to protect themselves from credit risk. By having a feedlot operator sell a futures contract for live cattle, the bank locks in the value of its collateral. This concept can be extended to protect all banks from interest-rate risk without accounting problems.

Suppose the borrower wants a fixed-rate loan for two years. The bank's funding source is the MMC. The bank makes the loan at 200

basis points over the existing T-bill futures rate. The bank asks the customer to short a strip of 90-day bills for six-month delivery, extending over the two-year period. If rates rise, the borrower has a profit, but, by prior agreement with the bank, this profit is forwarded by the futures commission merchant to the bank. Thus, a rise in the cost of bank liabilities is offset by a payment received from the borrower. If rates fall, the borrower has a loss and must make a payment to the commission merchant. But the bank's cost of funds has fallen and so it credits the loan account of the borrower by an amount equal to the borrower's payment to the merchant.

The borrower gets his fixed-rate loan and the bank locks in its spread (or at least it locks it in if the funding source is highly correlated with the movement of bill futures, which is obviously true in the case of the MMC). Accounting symmetry is established. The borrower has a margin account with the merchant and a loan account with the bank. Then the margin account shows a debit, the loan account shows a credit, and vice versa.

By shifting the hedge from its own books to those of the borrower, the bank has transformed a margin adjustment (a payment it would have to make if interest rates drop) into an accrued interest adjustment (a credit to the borrower's loan account). Since banks are allowed to defer accrued interest, the accountants are satisfied.

A device like this—it is called the synthetic fixed-rate loan—can enable banks to preserve spreads while still accommodating the borrower's demand for reasonably predictable interest costs. If banks can lock in spreads on fixed-rate credit, they are really shortening the yield maturity of that credit. If they can combine this vehicle with a means, like the negotiable retail CD, of lengthening liabilities, they can go a long way toward balancing themselves. And maturity balance, or at least a situation in which the positive or negative gap is much less than 5 per cent of earning assets, is the key to preserving solvency and profitability for both large and small banks in the turbulent years ahead.

My time has about expired, but I'd like to leave you with a thought that may elicit some questions. I think Don Miller ought to have laid much more emphasis on asset sales—and I'm not just talking about the SBA, FmHA variety. Bank profits have historically come from (1) credit intermediation, (2) funding, and (3) regulation. The regulation profit is disappearing, and the funding profit is threatened in the short run and may be nonexistent in the long run, especially if current

trends in saving flows that have a flattening effect on the yield curve persist. Banks should therefore be concentrating on enlarging the profit from credit intermediation. Yet it is my contention that a nostalgic preoccupation with preserving funds profits is tending to impede management's ability to enlarge the profit from credit intermediation, which can be achieved only through a vastly expanded program of loan brokerage.

Now, if that remark isn't sufficiently cryptic, let me conclude with another. Don Miller has identified Merrill Lynch as a strong competitor. In my view, the Merrill Lynches of this world can become the best friends that bankers have, provided bankers understand how to use them.