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The Belden Center for Private Enterprise Education
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How Private Enterprise Gives Meaning To Value: The Case of Banking

ECONOMICS TEAM WINS REGIONAL COMPETITION

The Harding University economics team won First Place and $1500 in the Mid-South Regional Students in Free Enterprise (SIFE) competition at the Camelot Hotel and Convention Center in Little Rock, April 18-19. The team's entry, "We Heard There Was A Recession, But Decided Not To Participate," included 65 projects and programs which have been presented to civic, professional and educational groups in the Mid-South. The project was judged by chief executive officers of American business and industry.

STUDENTS WIN IN BUSINESS COMPETITION

Harding University's Chapter of Phi Beta Lambda, a national collegiate business organization, won awards in eight events in the 28th Annual Phi Beta Lambda Intercollegiate Competition in Little Rock April 11-12. The First Place and Second Place winners will go on to the National Phi Beta Lambda competition July 6-10 in Anaheim, California.

DIRECTOR RECEIVES FREEDOMS FOUNDATION AWARD

Dr. Don Diffine, Director of the Belden Center for Private Enterprise Education and Professor of Economics at Harding University, was recently presented the George Washington Honor Medal by the Freedoms Foundation of Valley Forge, Pennsylvania. The award was presented in recognition of Dr. Diffine's authoring, publishing, and distributing the booklet "TO THE FLAG — Our Banner of Liberty."

Editor's Note: This excellent article on a timely subject was presented at the 1991 annual convention of the Association of Private Enterprise Educators in Nashville, Tennessee. Dr. Bond is the Executive Director of the Mid South School of Banking in Memphis and Professor of Economics and Finance at Memphis State University.

INTRODUCTION

The banking industry is in an unsettled state. The reasons are due in part to the altered financial marketplace and the shifting of financial products and consumers within that marketplace. The tension on banking has heightened. The 1980s caused much stress in the industry; also new hope was generated that by the 1990s the shifting of products and consumers would have slowed allowing the industry to resume operating in a more settled state. Thus far into the 1990s the results are distant achievements from the hopes.

So critical are the conditions in the industry that most realize that more drastic action lies ahead — a longer period of unsettled conditions. These continue to be unpleasant days for bankers. Earnings are poor; shareholders are alarmed; industry failures remain high; confusion abounds regarding legislation.

The public is aware of the industry's problems. The public is also aware that policymakers are looking at reform and/or re-regulation as alternatives to ease the problems and return the industry to a more settled state.

This paper is less concerned about the policymaker's actions and whether these will be appropriate for tomorrow. Rather the paper is more concerned with an overlooked aspect of the current environment. That is that many of the problems in banking today are traced to mishandling or misunderstanding of value! One should argue that part of the solution to the industry problems should commence with altered handling of value!

VALUE

Value is an often discussed topic in the field of finance. It is not a concept that is well understood. It is the misunderstood or overlooked aspects of value that explain the current difficulties in banking.

Important to understanding value are the following three aspects. First, there are numerous measures of value. Second, value is only a point in time concept. Third, value is a private sector or market concept. A closer look at each of these will help to tie each to the banking difficulties.

Accounting and finance texts point out that an asset (firm) is subject to multiple ways of calculating value. For a business, book value, adjusted book value, earnings valuation, and so on are different methods used to "value the firm." We also know there are other measures such as market (sales) value, value for tax purposes, and liquidity value. All are numerically different.

Next, while the above measures all conceptually arrive at a different numerical value of the business, it is also known that the value is only indicative of that point in time. Not the day before not the week later. Because conditions surrounding businesses change slowly, value, too, changes slowly. But values do change.

The reason any value changes is because regardless of the measure used, the numerical coefficient is a private sector or market determined product. So as market conditions change, asset value or business value changes.

THE CASE OF BANKING

A careful understanding of value is a paramount importance to banking. This is true because banks, unlike other businesses, operate with high financial leverage or dependence on others funds to finance asset acquisition. Bankers, too, are required to repay depositors full value for the usage of their funds. It is this fiduciary responsibility to depositors that sets banks apart from other businesses.

The repayment of depositor funds is dependent on the asset base of the bank. In particular it is dependent on the earning power of the assets and/or the value of the assets themselves. But as established above, the asset values are subject to change. The market conditions will cause asset values to change.

Generally bankers have ignored this. Generally bankers have treated the assets on the books like the deposit liabilities on the books. No change. Partial explanation for this inconsistency of treatment lies in three areas. First, regulators and accountants frown on bankers changing asset values. To do so has normally been viewed as a practice of "cooking the books." Next, banking in the past has really had no good way (methodology) to use to change asset value. In the absence of a management system or methodology, the normal record keeping rule would be "leave the asset as booked." Finally, part of the problem is with bankers themselves. For years they operated in a world of little change, so when the market began to change (70s and 80s) the banker reaction was to continue past practices.

In essence the argument to this point is that bankers failed to observe the market. They failed to perceive how the market was altering asset values. And, few asset values on the books were changed. Bankers were not cognizant of how the private sector (market) altered the value of certain bank assets.

Basically with the problems unattended it became worse, not better. The bank failures from the 1980s forward are evidence of this very problem.

In objective fairness bankers have not always ignored value, nor are they completely unaware that value is a private sector phenomenon. Instead, what has happened has been that bankers have treated different items of asset value differently. And through time as the banker's mix of assets shifted, assets where value was ostensibly ignored worked to harm the bankers.

Three hypothetical lending cases will illustrate the point. Case A is the lending opportunity for a working capital loan to an egg producer with an inventory (eggs) as collateral. Case B is the lending opportunity for a working capital loan to a jewelry store with accounts receivable as collateral. Case C is the lending opportunity of a term loan to a manufacturer with the plant (real estate) as collateral.

The cases illustrate two things about value. First, the perceived longer the life of the asset, the more acceptable, generally, will be the item as collateral. Second, the longer the life of the asset, the less the banker is truly aware of the asset's value and therefore the more the banker is dependent on another's assessment of that value. Correspondingly, the banker becomes more hesitant to change the collateral value.

Of the three cases, the Case A loan would probably not be made. Given the perishable nature of eggs and the short shelf life, the value of the collateral is known to deteriorate quickly.

The Case B loan possibly would be made. Before lending with accounts receivable as collateral some pasteurizing of the account receivables would occur. Maybe an accounts receivable aging or another adjustment to value would occur before accepting the collateral.

Case C loan would probably be booked. The plant serving as collateral would be accepted based on an outside or independent appraisal of value.

The three cases help verify the previous two points on collateral value. Buildings have a longer life than acocunts receivable, which have a longer life than eggs. The acceptability of the collateral runs toward the longer life asset. And, the collateral least likely to be changed during the life of the loan is the building, followed by accounts receivable, then followed by eggs.

The point remains, bankers understand value, but the general treatment of value is not handled uniformly.

The case of banking has one additional dimension. That is for the past 40 years or more, and certainly in the last 10 years, bankers have expanded their array of lending. Corresponding with this expansion has been an acceptance of "longer term" lending. Term loans to businesses, participation loans, equity-kicker loans, and real estate loans to mention four are more predominant on banks' balance sheets than during former years. Where the loan has collateral backing it, the collateral is often the "longer life" type asset, which is not subject to change either quickly or often.

Clearly it is not the collateral that causes bank problems (failures). Rather it is the lending. But bad loans can be overcome with good collateral. When loans go bad and the collateral fails to cover the loan, then banks have problems.

Many banks today are beset with non performing loans and loan collateral at less than loan value. Why? Because the markets changed; value changes. Agricultural lending in the early 1980s provide one example. Energy lending in the 70s and 80s provide another example. Real estate lending of the 90s adds another example.

THE CASE GOING FORWARD

The seeds of the problem remain with us until bankers are forced to better equate loan value with collateral value. The seeds remain with us until bankers become more cognizant that value is ever changing.

The solutions are unlikely to be found in new powers for bankers or a new and tighter set of regulatory reform instructions. New asset powers may be desirable for other reasons, but do little to attack this issue. New regulatory instructions probably do little other than cause closer supervision over the banks.

Going forward, self management by the bankers may be the best alternative. Yes, a private initiative, market derived alternative may work best. The development and use of an informational system or a management system designed to grade loans and assess collateral value would help. Both require a system that incorporates a market test. Both would be dependent on some judgment of value from the private sector. Well implemented, both the loan review and the collateral review system would go a long way toward insuring that "asset value" on the bank's books is sufficient to cover all liabilities (deposits), and judge the sufficiency of the capital residual as a cushion.

Recognizing a truer value of assets would institute an internal management system to guard against insolvency. It will work if the bankers begin to pay closer attention to the private sector effects on value, how value is subject to change, and how altered asset value must generate an action plan by the banker.

Small Business: Hidden Gold Mine Of Our Economy

by Dr. James R. Ferguson
Associate Professor of Marketing and Management

Corporations and other large organizations dominate our economic and business news. Financial planners watch for the latest developments from such giants as I.B.M., Sears, and McDonald's. Students nationwide are enamored of finding that perfect career position in a large company where opportunity, security, and varied benefits all glitter and shine. Certainly big business is vital to our economy and offers career positions which are attractive.

However, small business quietly make very significant contributions to our economy and standard of living which are deserving of more recognition and appreciation. Students and the public need to be more informed of the unique financial and personal opportunities offered through small business.

Pause and realize just how many of our giant corporations began as humble, very small entrepreneurs. Wal-Mart grew from one man and one store in rural Arkansas. Federal Express originated in the mind of Frederick Smith while a student at Yale. Smith's economics teacher gave his paper a C and scoffed. Today, annual revenue is in excess of $5 billion and the firm has helped put Memphis, Tennessee, on the map.

Barbara Proctor pioneered for many as a young black executive in advertising. Yet, she was fired for standing against tasteless, unethical, and offensive advertising.

As a true entrepreneur she was not defeated. She found opportunity. Barbara Proctor started her own agency specializing in advertising targeted to blacks and counts Kraft Foods, Sears, and Jewel Food Stores among key clients. Billings are now over $15 million annually!

The frequent citation of small business failure rates has tended to create an overstatement of the likelihood of failure and discouraged many from trying. Problems are real, but failure is most often due to reckless entry and poor management. Entrepreneurs can dramatically increase their odds of success by researching proposed markets, identifying real needs and demands, gaining experience, analyzing competitors, insuring adequate cash flow in the early years, writing quality business plans, control of costs and especially limiting heavy investments in fixed assets during start-up), and by a heavy commitment to quality and service (since new companies lack the identity and trust often generated by big name corporations). David defeated Goliath; smaller companies can win if they have a sound, superior strategic plan.

Research by David L. Birch found that three-quarters of the firms in his study survived over four years. Younger firms were only slightly less likely than older ones to make it through the four-year period. Research by the Small Business Administration has shown that the survival rate is much higher than believed. Moreover, most firms that do not survive are closed voluntarily, without loss to creditors. Also, survival rates more than double for firms that grow. Two out of three growing firms were found to survive six or more years.

With hard work and careful planning many people can succeed in small business, even though they initially think otherwise. Chris Nguygen came to America from South Vietnam at age 18 with limited English and no capital. He founded an Oriental eggroll business and soon had sales of $4 million!! For over two centuries countless inventors and entrepreneurs have flocked to America, drawn by our unique environment of opportunity and dreams.

Small business makes many unique contributions which are often overlooked. Individuals often find greater personal satisfaction and a heightened sense of achievement when they build as independent entrepreneurs. The very essence of the spirit which built America into an economic power is the individual with a dream and initiative.

For example, today's space travel, high tech military, and giant airlines trace their roots to one lone man, Charles Lindberg, crossing the dangerous Atlantic in a small, simple craft, and to two unknown brothers named Orville and Wilbur who had a vision and followed it. Longenecker and Moore give the following list of special contributions of small business:

1. **Providing New Jobs:** Small and medium-size firms (500 or less employees) accounted for almost two-thirds of all jobs added between 1980 and 1986. In retail we think of J. C. Penney, Safeway, and other heavyweights. However, almost eight of ten retailers are small independents.

2. **Introducing Innovation:** Big business tends to focus on improving present products. The small business can move faster and is not impeded by a highly bureaucratic structure. Edwards and Gordon, among others, show small firms are superior innovators. New products created by small firms include photocopiers, penicillin, jet engines, color film, helicopter, and others. Big businesses have often turned down new winners due to fear of change or satisfaction with the status quo.

3. **Stimulating Economic Competition:** When producers consist of a few big businesses, the customer is often at the mercy of these giants. Small businesses encourage quality, customer service, more reasonable prices, and choices. Big business has to stay on its toes. I.B.M. was surprised by small Apple computers and was jolted into action. The real winners were all consumers.

4. **Aiding Big Business:** Distribution and supply are often more efficiently performed by small business; this contributes to the success of the more visible corporate firms. General Motors purchases goods and services from over 25,000 small businesses. About three-fourths of these employ 100 persons or less! By focusing on one or a few markets and products a small business can often provide the quality and dependability of supply so coveted by big business.

5. **Efficiency:** Efficient size varies with the industry. For instance, big business is superior in manufacturing automobiles, but smalll business is better in repairing them. Small firms, however, are less burdened by multi-level, complex decision making structures that inhibit flexibility, productivity, and speed. Some workers in larger firms see little harm in waste, theft, and general inefficiency. They reason that their employer is so large and wealthy that they will succeed, no

matter what. In terms of organization theory, many large corporations have a built-in tendency for inefficiency. One has only to look at the American auto industry for a ready example of a big leader shocked by more efficient competitors armed with superior production and marketing skills.

Increased foreign and global competition will magnify the value of the contributions made by American small business in all five of these areas. Small business will play a key role in determining America's success as a global competitor in the new century.

Small business contributes substantially and significantly to our American way of life and economic welfare. Give a big thank you and handshake to the next entrepreneur you meet! The accomplishments of entrepreneurs and small business benefit all of us.

The ENTREPRENEUR is a quarterly journal and newsletter addressing contemporary economic issues from a moral perspective. One may not agree with every word printed in the ENTREPRENEUR series, nor should one feel he needs to do so. It is hoped that the reader will think about the points laid out in the publication, and then decide for himself.