1969 Letter by Kenneth V. Chace

Banking Operations

The most significant event of 1969 for Berkshire Hathaway was the acquisition of 97.7% of the stock of The Illinois National Bank and Trust Co. of Rockford, Illinois. This bank had been built by Eugene Abegg, without addition of outside capital, from $250,000 of net worth and $400,000 of deposits in 1931 to $17 million of net worth and $100 million of deposits in 1969. Mr. Abegg has continued as Chairman and produced record operating earnings (before security losses) of approximately $2 million in 1969. Such earnings, as a percentage of either deposits or total assets, are close to the top among larger commercial banks in the country which are not primarily trust department operations. It will not be easy to achieve greater earnings in 1970 because (1) our bank is already a highly efficient business, and (2) the unit banking law of Illinois makes more than modest deposit growth difficult for a major downtown bank.

After almost a year of ownership, we are delighted with our investment in Illinois National Bank, and our association with Mr. Abegg.

1971 Letter

Banking Operations

Our banking subsidiary, The Illinois National Bank & Trust Company, continued to lead its industry as measured by earnings as a percentage of deposits. In 1971, Illinois National earned well over 2% after tax on average deposits while (1) not using borrowed funds except for very occasional reserve balancing transactions; (2) maintaining a liquidity position far above average; (3) recording loan losses far below average; and (4) utilizing a mix of over 50% time deposits with all consumer savings accounts receiving maximum permitted interest rates throughout the year. This reflects a superb management job by Gene Abegg and Bob Kline.

Interest rates received on loans and investments were down substantially throughout the banking industry during 1971. In the last few years, Illinois National's mix of deposits has moved considerably more than the industry average away from demand money to much more expensive time money. For example, interest paid on deposits has gone from under \$1.7 million in 1969 to over \$2.7 million in 1971. Nevertheless, the unusual profitability of the Bank has been maintained. Marketing efforts were intensified during the year, with excellent results.

With interest rates even lower now than in 1971, the banking industry is going to have trouble achieving gains in earnings during 1972. Our deposit gains at Illinois National continue to come in the time money area, which produces only very marginal incremental income at present. It will take very close cost control to enable Illinois National to maintain its 1971 level of earnings during 1972.

1972 Letter

Banking Operations

Our banking subsidiary, The Illinois Bank and Trust Co. of Rockford, maintained its position of industry leadership in profitability. After-tax earnings of 2.2% on average deposits in 1972 are the more remarkable when evaluated against such moderating factors as: (1) a mix of 50% time deposits heavily weighted toward consumer savings instruments, all paying the maximum rates permitted by law; (2) an unvaryingly strong liquid position and avoidance of money-market borrowings; (3) a loan policy which has produced a net charge-off ratio in the last two years of about 5% of that of the average commercial bank. This record is a direct tribute to the leadership of Gene Abegg and Bob Kline who run a bank where the owners and the depositors can both eat well and sleep well.

During 1972, interest paid to depositors was double the amount paid in 1969. We have aggressively sought consumer time deposits, but have not pushed for large "money market" certificates of deposit although, during the past several years, they have generally been a less costly source of time funds.

During the past year, loans to our customers expanded approximately 38%. This is considerably more than indicated by the enclosed balance sheet which includes $10.9 million in short-term commercial paper in the 1971 loan total, but which has no such paper included at the end of 1972.

Our position as "Rockford's Leading Bank" was enhanced during 1972. Present rate structures, a decrease in investable funds due to new Federal Reserve collection procedures, and a probable increase in already substantial non-federal taxes make it unlikely that Illinois National will be able to increase its earnings during 1973.

1973 Letter

Banking Operations

The Illinois National Bank & Trust Co. of Rockford again had a record year in 1973. Average deposits were approximately $130 million, of which approximately 60% were time deposits. Interest rates were increased substantially in the important consumer savings area when regulatory maximums were raised at mid-year.

Despite this mix heavily weighted toward interest bearing deposits, our operating earnings after taxes (including a new Illinois state income tax) were again over 2.1% of average deposits.

We continue to be the largest bank in Rockford. We continue to maintain unusual liquidity. We continue to meet the increasing loan demands of our customers. And we continue to maintain our unusual profitability. This is a direct tribute to the abilities of Gene Abegg, Chairman, who has been running the Bank since it opened its doors in 1931, and Bob Kline, our President.

1975 Letter

Banking

It is difficult to find adjectives to describe the performance of Eugene Abegg, Chief Executive of Illinois National Bank and Trust of Rockford, Illinois, our banking subsidiary.

In a year when many banking operations experienced major troubles, Illinois National continued its outstanding record. Against average loans of about $65 million, net loan losses were $24,000, or .04%. Unusually high liquidity is maintained with obligations of the U. S. Government and its agencies, all due within one year, at yearend amounting to about 75% of demand deposits. Maximum rates of interest are paid on all consumer savings instruments which make up more than $2 million, it consistently has generated favorable earnings. Positioned as we now are with respect to income taxes, the addition of a solid source of taxable income is particularly welcome.

1976

Banking

Eugene Abegg, Chief Executive of Illinois National Bank and Trust Company of Rockford, Illinois, our banking subsidiary, continues to lead the parade among bankers—just as he has even since he opened the bank in 1931.

Recently, National City Corp. of Cleveland, truly an outstandingly well-managed bank, ran an ad stating “the ratio of earnings to average assets was 1.34% in 1976 which we believe to be the best percentage for any major banking company.” Among the really large banks this was the best earnings achievement but, at the Illinois National Bank, earnings were close to 50%

better than those of National City, or approximately 2% of average assets.

This outstanding earnings record again was achieved while:

(1) paying maximum rates of interest on all consumer savings instruments (time deposits now make up well over two-thirds of the deposit base at the Illinois National Bank),

(2) maintaining an outstanding liquidity position (Federal Funds sold plus U. S. Government and Agency issues of under six months' duration presently are approximately equal to demand deposits), and

(3) avoiding high-yield but second-class loans (net loan losses in 1976 came to about $12,000, or .02% of outstanding loans, a very tiny fraction of the ratio prevailing in 1976 in the banking industry).

Cost control is an important factor in the bank's success. Employment is still at about the level existing at the time of purchase in 1969 despite growth in consumer time deposits from $30 million to $90 million and considerable expansion in other activities such as trust, travel and data processing.

1977 Letter

Banking

In 1977 the Illinois National Bank continued to achieve a rate of earnings on assets about three times that of most large banks. As usual, this record was achieved while the bank paid maximum rates to savers and maintained an asset position combining low risk and exceptional liquidity. Gene Abegg formed the bank in 1931 with $250,000. In its first full year of operation, earnings amounted to $8,782. Since that time, no new capital has been contributed to the bank; on the contrary, since our purchase in 1969, dividends of $20 million have been paid. Earnings in 1977 amounted to $3.6 million, more than achieved by many banks two or three times its size.

Late last year Gene, now 80 and still running a banking operation without peer, asked that a successor be brought in. Accordingly, Peter Jeffrey, formerly President and Chief Executive Officer of American National Bank of Omaha, has joined the Illinois National Bank effective March 1st as President and Chief Executive Officer.

Gene continues in good health as Chairman. We expect a continued successful operation at Rockford's leading bank.

1978 Letter

Banking

Under Gene Abegg and Pete Jeffrey, the Illinois National Bank and Trust Company in Rockford continues to establish new records. Last year's earnings amounted to approximately 2.1% of average assets, about three times the level averaged by major banks. In our opinion, this extraordinary level of earnings is being achieved while maintaining significantly less asset risk than prevails at most of the larger banks.

We purchased the Illinois National Bank in March 1969. It was a first-class operation then, just as it had been ever since Gene Abegg opened the doors in 1931. Since 1968, consumer time deposits have quadrupled, net income has tripled and trust department income has more than doubled, while costs have been closely controlled.

Our experience has been that the manager of an already high-cost peration frequently is uncommonly resourceful in finding new ways to add to overhead, while the manager of a tightly-run operation usually continues to find additional methods to curtail costs, even when his costs are already well below those of his competitors. No one has demonstrated this latter ability better than Gene Abegg.

We are required to divest our bank by December 31, 1980. The most likely approach is to spin it off to Berkshire shareholders some time in the second half of 1980.

1979 Letter

Banking

This will be the last year that we can report on the Illinois National Bank and Trust Company as a subsidiary of Berkshire Hathaway. Therefore, it is particularly pleasant to report that, under Gene Abegg's and Pete Jeffrey's management, the bank broke all previous records and earned approximately 2.3% on average assets last year, a level again over three times that achieved by the average major bank, and more than double that of banks regarded as outstanding. The record is simply extraordinary, and the shareholders of Berkshire Hathaway owe a standing ovation to Gene Abegg for the performance this year and every year since our purchase in 1969.

As you know, the Bank Holding Company Act of 1969 requires that we divest the bank by December 31, 1980. For some years we have expected to comply by effecting a spin-off during 1980. However, the Federal Reserve Board has taken the firm position that if the bank is spun off, no officer or director of Berkshire Hathaway can be an officer or director of the spun-off bank or bank holding company, even in a case such as ours in which one individual would own over 40% of both companies.

Under these conditions, we are investigating the possible sale of between 80% and 100% of the stock of the bank. We will be most choosy about any purchaser, and our selection will not be based solely on price. The bank and its management have treated us exceptionally well and, if we have to sell, we want to be sure that they are treated equally as well. A spin-off still is a possibility if a fair price along with a proper purchaser cannot be obtained by early fall.

However, you should be aware that we do not expect to be able to fully, or even in very large part, replace the earning power represented by the bank from the proceeds of the sale of the bank. You simply can't buy high quality businesses at the sort of price/earnings multiple likely to prevail on our bank sale.

1990 Letter

Lethargy bordering on sloth remains the cornerstone of our investment style: This year we neither bought nor sold a share of five of our six major holdings. The exception was Wells Fargo, a superbly-managed, high-return banking operation in which we increased our ownership to just under 10%, the most we can own without the approval of the Federal Reserve Board. About one-sixth of our position was bought in 1989, the rest in 1990.

The banking business is no favorite of ours. When assets are twenty times equity - a common ratio in this industry - mistakes that involve only a small portion of assets can destroy a major portion of equity. And mistakes have been the rule rather than the exception at many major banks. Most have resulted from a managerial failing that we described last year when discussing the "institutional imperative:" the tendency of executives to mindlessly imitate the behavior of their peers, no matter how foolish it may be to do so. In their lending, many bankers played follow-the-leader with lemming-like zeal; now they are experiencing a lemming-like fate.

Because leverage of 20:1 magnifies the effects of managerial strengths and weaknesses, we have no interest in purchasing shares of a poorly-managed bank at a "cheap" price. Instead, our only interest is in buying into well-managed banks at fair prices.

With Wells Fargo, we think we have obtained the best managers in the business, Carl Reichardt and Paul Hazen. In many ways the combination of Carl and Paul reminds me of another - Tom Murphy and Dan Burke at Capital Cities/ ABC. First, each pair is stronger than the sum of its parts because each partner understands, trusts and admires the other. Second, both managerial teams pay able people well, but abhor having a bigger head count than is needed. Third, both attack costs as vigorously when profits are at record levels as when they are under pressure. Finally, both stick with what they understand and let their abilities, not their egos, determine what they attempt. (Thomas J. Watson Sr. of IBM followed the same rule: "I'm no genius," he said. "I'm smart in spots - but I stay around those spots.")

Our purchases of Wells Fargo in 1990 were helped by a chaotic market in bank stocks. The disarray was appropriate: Month by month the foolish loan decisions of once well-regarded banks were put on public display. As one huge loss after another was unveiled - often on the heels of managerial assurances that all was well - investors understandably concluded that no bank's numbers were to be trusted. Aided by their flight from bank stocks, we purchased our 10% interest in Wells Fargo for $290 million, less than five times after-tax earnings, and less than three times pre-tax earnings.

Wells Fargo is big - it has $56 billion in assets - and has been earning more than 20% on equity and 1.25% on assets. Our purchase of one-tenth of the bank may be thought of as roughly equivalent to our buying 100% of a $5 billion bank with identical financial characteristics. But were we to make such a purchase, we would have to pay about twice the $290 million we paid for Wells Fargo. Moreover, that $5 billion bank, commanding a premium price, would present us with another problem: We would not be able to find a Carl Reichardt to run it. In recent years, Wells Fargo executives have been more avidly recruited than any others in the banking business; no one, however, has been able to hire the dean.

Of course, ownership of a bank - or about any other business - is far from riskless. California banks face the specific risk of a major earthquake, which might wreak enough havoc on borrowers to in turn destroy the banks lending to them. A second risk is systemic - the possibility of a business contraction or financial panic so severe that it would endanger almost every highly-leveraged institution, no matter how intelligently run. Finally, the market's major fear of the moment is that West Coast real estate values will tumble because of overbuilding and deliver huge losses to banks that have financed the expansion. Because it is a leading real estate lender, Wells Fargo is thought to be particularly vulnerable.

None of these eventualities can be ruled out. The probability of the first two occurring, however, is low and even a meaningful drop in real estate values is unlikely to cause major problems for well-managed institutions. Consider some mathematics: Wells Fargo currently earns well over $1 billion pre-tax annually after expensing more than $300 million for loan losses. If 10% of all $48 billion of the bank's loans - not just its real estate loans - were hit by problems in 1991, and these produced losses (including foregone interest) averaging 30% of principal, the company would roughly break even.

A year like that - which we consider only a low-level possibility, not a likelihood - would not distress us. In fact, at Berkshire we would love to acquire businesses or invest in capital projects that produced no return for a year, but that could then be expected to earn 20% on growing equity. Nevertheless, fears of a California real estate disaster similar to that experienced in New England caused the price of Wells Fargo stock to fall almost 50% within a few months during 1990. Even though we had bought some shares at the prices prevailing before the fall, we welcomed the decline because it allowed us to pick up many more shares at the new, panic prices.