

Research Department
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Profitable Banking

The nation's banks pursued a profitable course during the first half of 1979. They had to contend with worries about a predicted economic downturn as well as uncertainties about pending legislative and regulatory changes affecting financial institutions. But profits were excellent during this period, as banks expanded their loans and investments at a 14-percent annual rate and maintained a favorable spread between their returns on these earning assets and their rising cost of funds. Loan growth was well-balanced, with stronger credit demand from the business sector offsetting some moderation in consumer demand for mortgages and instalment credit. Banks also prudently added to their holdings of securities — both U.S. Treasuries and tax-exempt issues.

With short-term interest rates near record levels during most of the January-June period, banks encountered a shift in the sources of funds needed to finance asset growth. They experienced some disintermediation — net outflows or greatly reduced gains in savings deposits and small time certificates subject to fixed Regulation Q interest-rate ceilings. To make up for these shortfalls, banks relied heavily on six-month money-market certificates (MMC's) with floating rates tied to the Treasury-bill auction rate. As MMC's approached \$60 billion — nearly 10 percent of total interest-bearing bank deposits — the average cost of deposit liabilities rose significantly. Starting in March, however, large banks began to let some of their maturing large-denomination CD's run off, offsetting some of this \$12-billion reduction with relatively less costly Eurodollars and other borrowed funds which are not subject to reserve requirements.

Divergent rate movements

Most key money-market rates rose to near-record levels in early January, declined very gradually until early June, and then dropped sharply until mid-year. Treasury-

bill rates, however, did not peak until May, partly as a reflection of the Treasury's relatively low first-quarter net borrowings. Bank loan rates meanwhile remained relatively flat during the first half of the year.

The Federal-funds rate, governing banks' overnight lending of unused reserves, averaged just over 10 percent through April, and then fluctuated around 10½ percent following an April surge in money-supply growth. This limited movement in the funds rate reflected the lack of any major shift in Federal Reserve policy after November 1978, when the Fed adopted a firmer stance as part of a major dollar-support program. The discount rate, the cost to member banks of borrowing funds from the Federal Reserve Banks, remained at the record 9½ percent established in November 1978. And the prime business-loan rate remained at 11¾ percent until mid-June, when banks reduced it to 11½ percent following the decline in market rates.

With loan rates stable, banks were able to take quick advantage of differentials arising among alternative money-market sources of funds, including foreign sources. Also, banks used the Federal Reserve borrowing privilege more extensively, particularly after April when the spread widened between the Fed-funds rate and the discount rate (daily-average borrowings in recent months have exceeded \$1 billion). Again, as the prime rate remained well above the commercial-paper rate, corporations continued to divert a large volume of their short-term borrowing from banks to the commercial-paper market.

Pressure on the capital markets moderated somewhat from the record pace maintained during 1978, but long-term interest rates still edged upward, reaching record highs in May as inflation expectations worsened. The municipal market, however, was an exception, as rates on tax-exempt issues

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continued to drift downward, to levels substantially below the record levels reached back in 1975. In early June, all long-term rates (except mortgage rates) declined sharply, as market participants detected some softening of business activity and therefore of inflation expectations. Mortgage rates continued to rise, to a point well above the previous (late 1974) peak — but rates may soon decline even in that sector, judging from a drop posted by California institutions in early July.

Key business demand

Total loans rose \$54 billion in the January-June period, accounting for 78 percent of the overall increase in bank credit. Business loans, which expanded at a 21-percent annual rate, were the dominant factor, making up nearly one-half of the total loan increase compared with less than a one-third share in 1978. Corporate borrowing strengthened at money-center banks and accelerated further at regional banks. All major categories of borrowers, except for nondurable-goods manufacturers, significantly increased their bank loans during this period. Large corporations, while waiting for a downturn in the record level of corporate bond rates, turned to banks for longer-term credit to “bridge” the period before their return to the capital markets. Thus, at large banks, loans with maturities of over one year accounted for roughly 70 percent of all new business loans. Regional banks continued to finance

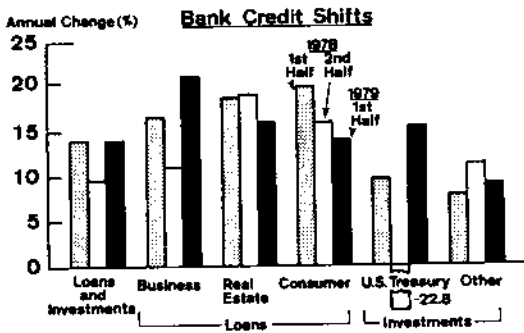
both the long- and short-term needs of their small and medium-sized customers, who lack easy access to the commercial-paper and capital markets.

As business loans accelerated, the pace of mortgage lending decelerated from 1978's 20-percent gain to a 16-percent annual rate of increase in the first half of 1979. But that still represented a \$17-billion boost to bank mortgage portfolios, as gains in multifamily and nonresidential mortgages offset the somewhat slower growth in single-family mortgages. Record mortgage rates, which climbed to 11¾ percent on the West Coast, dampened credit demand only modestly, as prospective home owners sought to buy property before housing prices escalated further. However, in many states the low interest rates enforced by usury laws effectively restricted mortgage lending. Many home owners also continued to obtain bank credit for various purposes by using the rising equity value of their homes as collateral.

The growth in consumer loans also slowed, from 1978's 19-percent pace to an estimated 14-percent annual growth rate in the first half of 1979. Consumers became more cautious spenders as recession fears became more prevalent and as inflation cut deeply into family paychecks. This cautious attitude, reinforced by the gasoline shortage, showed up especially in slower sales of autos and other consumer durables and, in turn, in slower growth of consumer credit.

Record bank income

Most money-center banks, as well as regional banks, experienced record income gains in the first quarter, with many institutions reporting year-to-year gains of 20 percent or more. Preliminary reports indicate a continued strong trend in the second quarter, although not at the first-quarter pace. A relatively large expansion in



earning assets contributed to the earnings trend, along with an increase in spreads (net interest margins) between the return on assets and banks' cost of funds. Loan portfolios were heavily weighted by relatively high-income mortgages and consumer instalment loans, and also by business loans carrying the higher rates prevailing in 1978 and early 1979. In contrast, a large portion of bank deposit liabilities remained under Reg Q ceilings, although new funds and replacements of maturing deposits had to be obtained at the higher market rates prevailing on MMC's and negotiable CD's. Banks also benefitted from lower loan losses and from further reductions in the number of loans with postponed repayment schedules.

Adjustments ahead

Despite their strong first-half performance, the nation's banks face major adjustments in the second half of 1979. A Reg Q modification, effective July 1, wrote in a major cost increase in the form of a quarter-percent rise in the passbook-saving rate to 5¼ percent. This increase could apply to over \$200 billion in banks' savings deposits. Another change, authorizing a new 4-year time certificate tied to the yield on 4-year Treasury securities, could increase the cost of funds obtained from longer-term consumer certificates. In addition, the elimination of minimum-denomination requirements on all consumer time certificates (other than the 6-month MMC's) will mean higher costs for those banks adopting lower minimum requirements. Uncertainties also continue regarding the future of the ATS (automatic transfer from savings) innovation, which by court order must cease by year-end if Congressional action is not taken in the meantime. Many of these accounts, which amount to over \$6.5 billion, have meanwhile become more costly because of the new 5¼-percent ceiling on savings accounts.

As a result of all these developments, banks currently are reexamining the costs of administering their interest-bearing deposits, particularly low-balance and/or high-transfer activity savings accounts. Also, they remain uncertain about Congressional action on several pieces of pending legislation, which could make basic changes in bank reserve requirements and in the lending authority of financial institutions.

Remembering their dismal 1973-1974 experience, most bankers are probably more cautious lenders now than they were then. Moreover, bank loan-loss reserves appear relatively high, and delinquency rates on consumer and mortgage loans remain at relatively low levels. Also, from an income standpoint, banks normally fare better than nonfinancial sectors in the early stages of a cyclical downturn. A large portion of their earning assets carry fixed rates of return made at high interest-rate levels, while their cost of funds decline with a recession drop in market rates. Traditionally, loan rates also remain somewhat sticky on the downside, so that overall interest-rate spreads remain favorable. Nevertheless, given the present state of the economy, banks henceforth may be hard-pressed to match their impressive performance of early 1979.

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