Research Department
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Commercial Paper, Commercial Banks

Business-loan demand at large money-center banks has been unusually weak in the current economic expansion— at least until the last several months. Why such sluggishness in loan growth? The answer may lie with the large national and multinational firms which do business with the money-center banks. To some extent, they have not had to borrow because of the strong liquidity positions they built up during the earlier stages of the recovery. In addition, they have relied increasingly on alternative sources of short-term credit—including the commercial-paper market.

This market has become a primary source of short-term credit to large corporate borrowers in recent years, so that it has taken over part of the role traditionally played by large commercial banks. Of course, it remains a somewhat limited market. Only highly rated and widely known corporations can issue commercial paper, because of the unsecured nature of these short-term promissory notes. Still, the market for nonfinancial paper has only recently begun to reach its potential, because most eligible firms have begun to use the market as an important source of funds just within the past decade.

For these firms, commercial paper became a viable alternative to short-term bank borrowing during the two credit "crunches" of the late-1960's, when disintermediation limited banks' ability to obtain loanable funds. During these episodes, banks actually encouraged their strongest customers to borrow in the commercial-paper market. This type of borrowing historically had been less costly than short-term bank borrowing, yet many corporations had hesitated to use the paper market for fear of straining bank relationships. Thus, they quickly overcame their hesitation after their own bankers encouraged them to turn to this alternative form of borrowing.

Borrowers had also been pushed in this direction by the upward trend in credit-market yields over the postwar period. This trend had led major corporations to pursue more sophisticated strategies in managing their portfolios of financial assets, but it also made them more conscious of interest-cost differentials in managing their liabilities. Thus, many eligible firms came to place emphasis on changes in relative borrowing costs in deciding between commercial-paper market or bank borrowing in the post-credit "crunch" period—see chart.

Cost advantage

While decreases in the relative cost of paper-market borrowing led to heavier paper utilization in 1973-75, business firms have continued to rely more heavily on the commercial-paper market despite a somewhat more competitive prime-rate stance by bank lenders in 1976-77. A clue to this paradoxical behavior is the fact that the spread between the prime bank-lending rate and the commercial-paper rate, while narrowing, is still well above historical levels. For the highest-rated paper issuers, the spread is currently around 1¼ percentage

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points—below the 1¾-percentage-point spread of the 1975-76 period, but far above the ⅓-percentage-point average of the 1966-74 period.

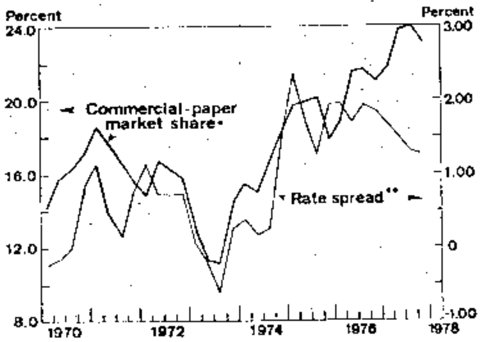
Spreads in recent years may well have been well above the threshold which had attracted heavy reliance on paper by most companies already in the market. Once spreads rise significantly above those levels where the short-term bank balances of these firms have been reduced to zero or very low levels, further changes in the spread will have only a small impact on short-term financing decisions. Thus, a decline of, say, ¼ percentage point when the spread is above the threshold level will have little impact on the relative growth in paper and loans, compared to a ¼ percentage point decline when spreads are below the threshold.

Entry into the market

Nonetheless, the size of the spread in recent years has stimulated some growth in commercial paper, as more and more firms that were eligible to issue paper responded to the strong financial incentive to do so. In 1976, the number of firms rated by Moody's, the largest commercial-paper rating service, increased more than 17 percent, compared to very small or negative growth throughout the 1972-75 period. Actually, the faster entry lagged about a year behind the widening of the bank-paper rate spread, reflecting the time required to be rated, as well as uncertainty over whether spreads would remain high enough to make the paper market a worthwhile long-run proposition.

However, further growth of the commercial-paper market through entry may be somewhat limited because of the relatively small number of companies qualified to obtain access to the market. Indeed, 1976 may represent the peak year for new entrants into the market. In 1977, the number of firms rated by Moody's increased only about 4 percent, despite the continued cost incentives created by the wide rate spread.

An important new factor in recent years has been the emergence of borrowing by certain foreign firms (especially French utilities) in the commercial-paper market. Foreign issuers, who apparently borrow very little from large U.S. commercial banks, have ac-



*Ratio of nonfinancial paper to paper plus (large bank) short-term loans.
**Bank prime rate minus 30-59 day dealer placed commercial-paper rate.

counted for roughly one-third of nonfinancial paper growth since the early-1974 removal of U.S. controls on capital outflows and foreign controls on capital inflows. Starting from a base of almost zero, their outstandings represented roughly 10 percent of nonfinancial paper at the end of 1977. These foreign borrowers have apparently acted in response to the sizable spread between European bank-loan rates and U.S. commercial-paper rates. Thus, their business mainly represents a subtraction from European rather than U.S. bank loan totals.

Secular shift?

It is difficult to see how the large money-center banks could reduce their prime rates enough to regain their traditionally dominant role in the short-term financing of prime-rated nonfinancial corporations. These firms are now paying primary attention to cost considerations instead of bank relationships in their short-term borrowing decisions, as a result of the upward trend in interest rates in the post-war period, the bank encouragement of commercial-paper borrowing in the earlier credit "crunches," and the large rate spread of the past several years.

Banks of course offer intangible services which are not available in the more impersonal commercial-paper market. Banks will usually support a good customer when general credit availability is limited, and they can develop knowledge of customers' creditworthiness which would be difficult for smaller or regional firms to generate in the open market. But since commercial-paper issuers are usually among the financially strongest and best-known firms, they generally need such bank services less than other firms. And in any case, bank relationships can often be maintained through longer-term loans, deposit balances and infrequent use of credit lines.

Today, the bank cost of funds for an additional loan is roughly equal to the prime commercial-paper yield. To make profitable loans, banks must add mark-ups for variable operating costs and reserve requirements – perhaps more than ½ percentage point for the latter factor alone. In view of these and other considerations, the mid-1970's may have witnessed a secular (rather than cyclical) shift in the short-term financing patterns of prime-rated nonfinancial corporations.

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