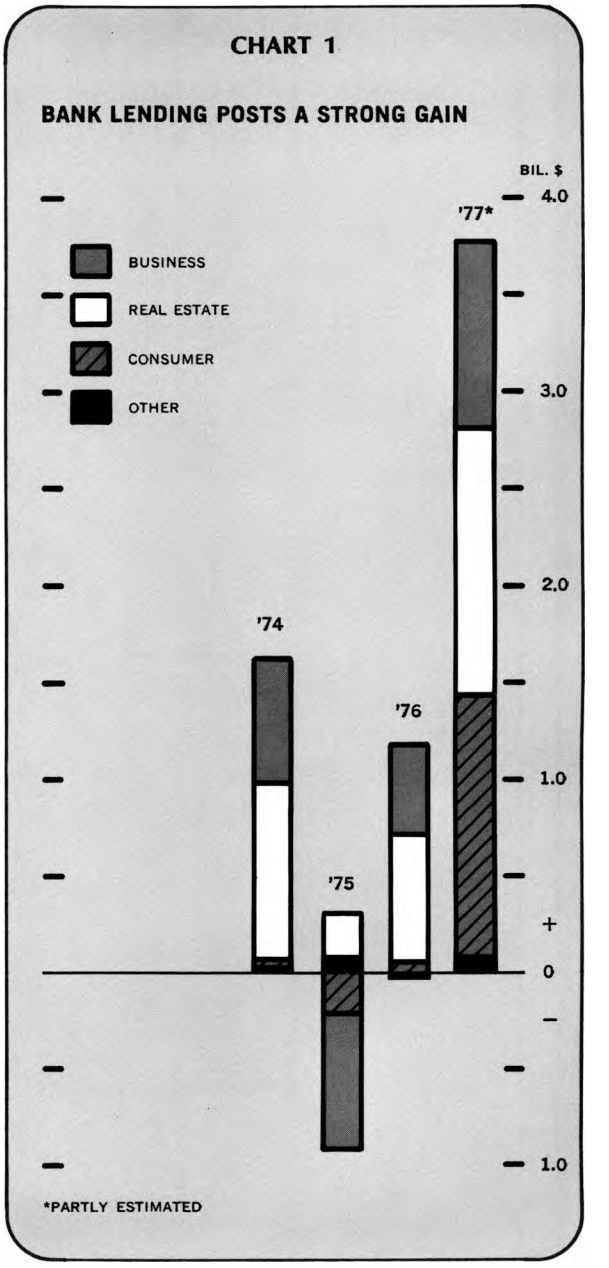
SOUTHEASTERN LOAN DEMAND REVIVES— AT LAST!

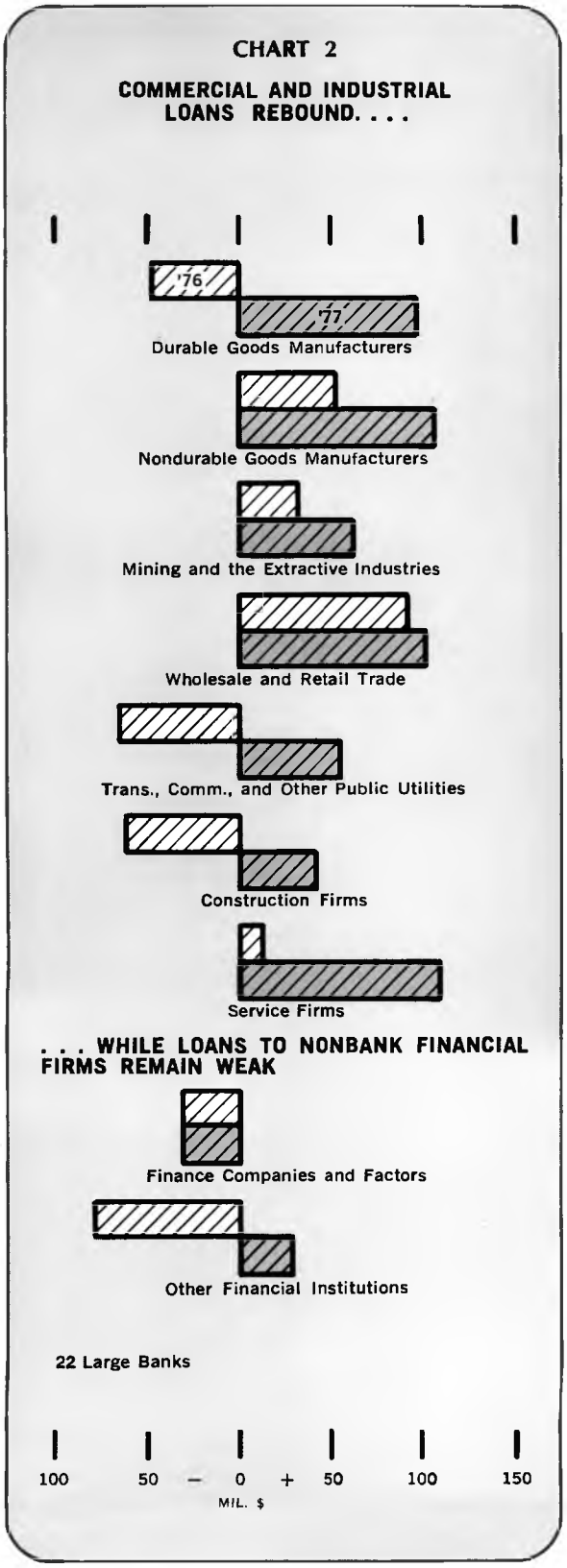
by John M. Godfrey

As the southeastern economy moved into its third year of expansion, the region's banks picked up strong momentum. With liquidity positions rebuilt, Sixth District banks were in the advantageous position of experiencing strong deposit inflows concurrently with robust credit demands from many types of borrowers during 1977. As a result of this favorable balance of conditions, southeastern banks reported strong gains in interest income that generally flowed through to the bottom line as higher earnings.

Loan Demand Recovers. The most significant—and welcome—development to occur last year was the strong and broadly based pickup in loan demand. Not since 1973 had banks been in a position to really sell their major product—the direct extension of credit to households and business firms. In 1975 and 1976, the only significant growth in bank credit had been acquisitions of U. S. Treasury securities. Overall loan demand had been weak, with borrowing primarily limited to households. With expenses exceeding taxable income, many banks had been unable to take full advantage of the tax exemption on income from their large holdings of state and local government securities. Higher yielding government obligations thus had become more attractive in bank portfolios.

Bank loans in the District rose 14 percent last year and were advancing at an even faster pace in the latter half of the year. The strongest loan growth occurred in Alabama, Florida, and the southern half of Mississippi. While bank lending had advanced satisfactorily at the medium-sized and smaller banks in 1976, it had remained weak at the larger banks until late in that year. Since then, the lending increase at the larger banks has been below that of the other banks. While the credit expansion has been less rapid than the nearly 25-percent rate of the mid-1970s, most bankers would rather not repeat that experience.



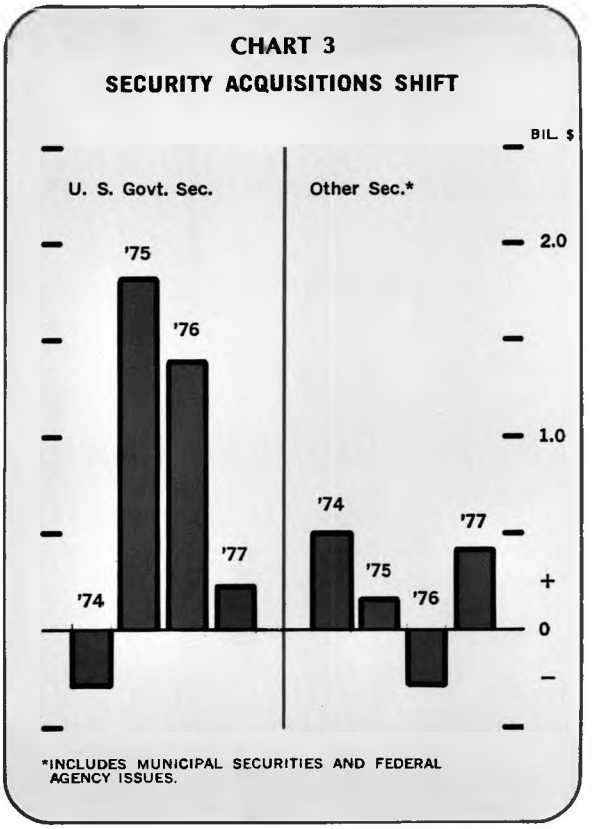


Loan demand in 1977 was strongest from households. Consumers' use of bank credit for purchases advanced nearly 20 percent, as they financed new and used automobiles, home improvements, and other retail purchases. Only in the area of mobile home credit did consumer instalment credit decline. Even though bank consumer lending rose throughout the District, Tennessee banks cut back on their extensions of consumer credit in late summer, responding to uncertainties generated by a court decision that more strictly enforced the state's usury ceiling.

Household borrowing was not limited to financing retail purchases. Home mortgage credit rose, too, as purchases of new and used single-family homes posted large gains. The sharp rise in real estate credit was not attributable only to home mortgage loans, however. Loans to finance commercial properties increased strongly at the larger banks in Tennessee, Georgia, and Florida. Loans to finance land development and construction loans were up at the larger banks in Alabama and Louisiana.

The major turnaround in bank credit demand last year reflected an upsurge in business borrowing. Increased use of business credit lines while other credit demands were heavy was partly responsible for the advance in bank prime lending rates during the year. They rose from a low of 6 1/4 percent in early 1977 to 7 3/4 percent by the end of the year. The higher interest charges and expanding business loan volume added significantly to banks' interest income.

The resurgence in business loans was most apparent at the larger banks. Commercial and industrial loans had risen slightly over $100 million in 1976, but strength had been evident only in lending to textile and apparel goods producers, wholesale and retail trade firms, and the mining and extractive industries. Last year, however, business loans jumped nearly $600 million (about 13 percent), expanding in all major industrial and commercial loan categories. In contrast, at large banks nationally, growth was about one-half the District rate. Those categories showing strong net loan increases in 1977, as compared with reductions or only weak gains in 1976, included durable goods manufacturers, transportation, communication



and other public utilities, construction firms, and the services industry. Lending also continued to the business customers who had been heavy borrowers in the previous year. This broad base for business credit expansion gave regional banks a much better balance in their loan growth.

While commercial banks enjoyed increased business from their commercial and industrial firms, even the larger banks found that financial institutions such as finance companies were weak, if not inactive, customers during the last three years. (Lending to these borrowers includes both direct loans and purchases of commercial paper issued by these companies.) Loans to sales and personal finance companies and business factors dropped about $31 million during 1977, the same as in the previous year. Since most banks price their direct loans to finance companies at the prime rate or above, they have in many cases priced themselves out of this loan market. The prime rate has recently been set at 125 basis points above the commercial paper rate. As a result, finance companies have been borrowing in the commercial paper market at the lower rates and repaying their bank loans. Other financial institutions—primarily mortgage and insurance companies, bank holding companies, savings and loan associations, and REITs—increased their bank borrowing by only $28 million in the past year following a $78-million reduction in 1976.

With the revival of overall loan demand in 1977, District banks had less need to increase their holdings of securities to obtain earning assets. District banks added to their holdings of U. S. Government securities by only 4 percent during the year, in sharp contrast to their more than doubling these holdings in the previous two years. Despite this small advance in government holdings, banks did make some portfolio adjustments that reflected changing credit conditions. They sharply pared their holdings of Treasury bills in favor of higher yielding intermediate-maturity notes. Positions in long-term Treasury bonds were unchanged.

With taxable income up, District banks once again made modest additions to their municipal bond portfolios. Since banks can most effectively utilize tax-exempt income only when they have taxable income, the strong advance in interest income and a reduction of loan loss expenses paved the way for many District banks to return to the municipal bond market as active purchasers.

Deposit Inflows Advanced. The continued overall strengthening in deposit inflows was a major factor in enabling District banks to meet last year's revival in credit demands. Total member bank deposits rose $4.1 billion, a brisk 10.4-percent gain. Furthermore, last year's dollar growth in deposits exceeded the net increase of the two previous years combined.

The change in the distribution of the deposit gains was as important as the magnitude. Demand deposit inflows accelerated sharply in the District, just as in other parts of the country. Larger checking account balances provided banks with a more ample supply of interest-free funds (although these funds are not without some cost to the banks) and are but one further indication that the region's households, business firms, and governmental units required more funds to transact a

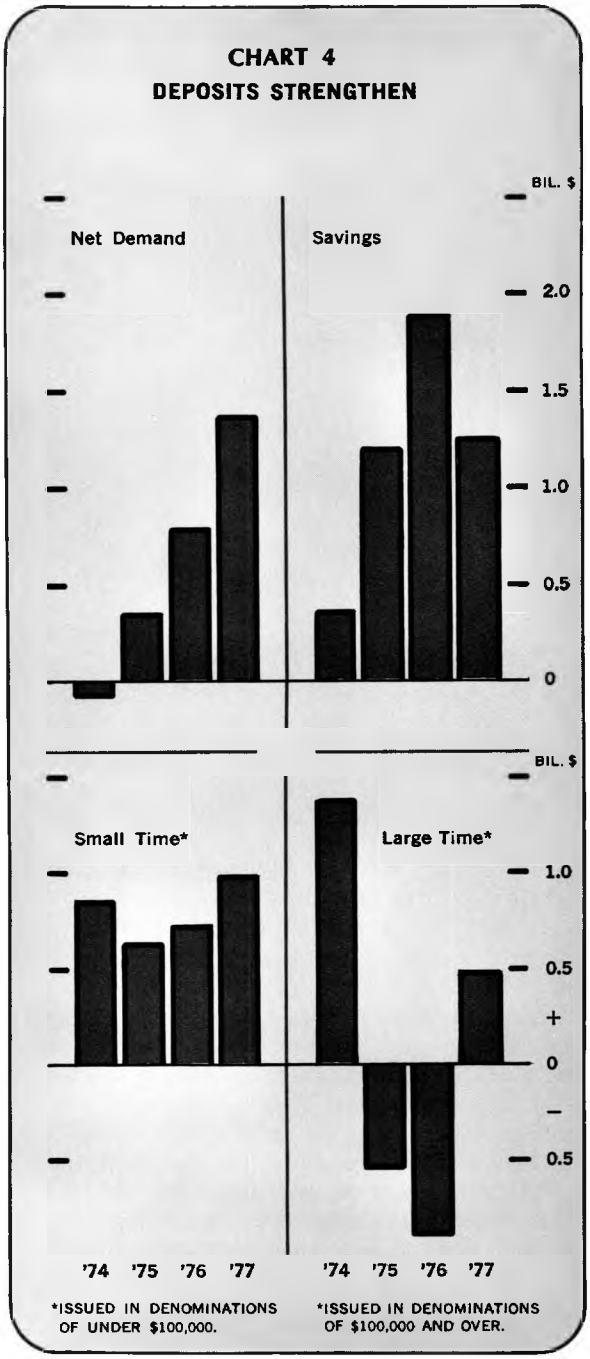
higher level of spending and financial transactions.

Although gains in passbook savings were considerably lower than those of the two previous years, they were certainly adequate. Growth in savings accounts is important because it helps ensure a relatively stable and low-cost deposit base. But since this single source of deposits had been supplying about three-quarters of the banks' net deposit gains in recent years, the more diversified deposit inflows in 1977 were beneficial.

For the first time since 1974, District banks posted net gains in time deposits, as both the smaller denomination time deposits and larger "money market" type deposits rose. The smaller denomination time deposits gave many consumers, businesses, and governmental units the opportunity to obtain higher interest yields by leaving their money on deposit for longer periods. While time deposits add to banks' interest expenses, they do help to ensure that these funds will not be suddenly withdrawn, should the return on competing financial instruments rise. The strongest inflow of time deposits came from those deposits maturing in four years or more. They were up nearly $700 million, a 20-percent gain. The District's smaller banks, where the competition from nonbank thrift institutions is less, accounted for most of the advance.

The expansion of long maturity time deposits must have been a particular relief to many banks, since they collectively faced the prospects of about $700 million in "wild-card" deposits maturing during the July-October period. These "wild-card" deposits were originally issued with four-year maturities in the summer and early fall of 1973, when they carried no mandated interest ceiling rates. By 1977, the interest on a number of these "wild-card" deposits exceeded the Federal Reserve Regulation Q interest ceiling rates and/or the current rate that many banks were willing to pay. Aside from a special situation in Louisiana, District banks were able not only to maintain their longer maturity time deposit levels but also to add to them throughout the rollover period.

As is typical when loan demand is rising, the larger District banks began increasingly



to acquire funds through managed deposit liabilities. By selling negotiable CDs and other large denomination time deposits, they raised about $500 million in "money market" funds. The majority of these funds were obtained in the last quarter of the year when lending was quite strong. While banks expanded their managed liabilities

(after letting them decline by nearly $1.5 billion over the two previous years) to the year-end level of $4.5 billion, the volume was nearly $1 billion below the peak reached in early 1975. And, in recognition of the more interest-sensitive nature of negotiable CDs, banks significantly increased their average maturity. Over the last year, all of the $270-million net increase in outstanding CDs was in maturities of over 90 days.

The Outlook for the Coming Year. Many of the conditions that had made for an improving and favorable banking climate had begun to change by late 1977. And while these developments do not necessarily mean that 1978 will be an adverse year for banking, it may not be as easy a year as 1977. Banks have already begun to experience a deceleration of inflows to household and business savings and short maturity time deposits because of rising yields on competing financial instruments. Slower growth in these types of deposits may force banks to rely more heavily on expensive longer maturity consumer time deposits and on money market deposits. Banks may also trim their most liquid holdings of government securities and depend more upon such managed liabilities as Fed funds.

Not only might banks find deposit growth becoming harder to achieve, but overall loan demand might well be strong during the year. Heavy use of bank credit by business customers, along with continued strong credit demands from households, might result in new loan volume exceeding last year's. Banks may also find that the spread between their net interest return and their net cost of funds will narrow during 1978, but the higher volume of loans should allow them to report earnings gains for the year. This year will most likely be a year of good, solid growth for banks, but bankers will have to work harder to achieve that growth than they did in the calmer environment of 1977. ■