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Condition of the National Banking System

The year 1980 was a period of both high and very volatile interest rates. The average monthly rate on federal funds, an important source of short-term financing for commercial banks, ranged from a low of 9.0 percent to a high of 18.9 percent. That is in contrast to 1979 when that average rate varied less than 400 basis points. Similarly, the prime, a benchmark rate for lending to large corporate customers, rose rapidly from 15.25 percent at the start of the year to a then unprecedented peak of 20 percent shortly after the Federal Reserve Board instituted an emergency credit restraint program on March 14. The prime rate then fell even more rapidly than it had risen, dropping to 11 percent in July, only to rise again to a new record of 21.5 percent by year-end. During 1979, the prime rate was unchanged for more than 5 months before climbing 400 basis points to the year's high of 15.75 percent in November.

Despite the extreme volatility of interest rates and the general economic downturn in the spring, national banks generally operated profitably, and net income for the system increased nearly 6 percent over 1979. That increase in net income, however, was well below the corresponding increase in total assets and sharply below the 17.4 percent increase in net income enjoyed in 1979.

Successful commercial bank operations are more difficult in a period of rapidly rising interest rates because an increasing portion of banks' liabilities are relatively short-term and interest sensitive funds. Although in the past smaller banks, with their greater reliance on demand and savings deposits, have been relatively insulated from changes in the cost of funds, that situation is also changing. Greater consumer awareness of interest rates and particularly the rapid expansion of money market certificates led smaller banks to rely increasingly on purchased funds. To compensate for the increasing variability in their costs of funds, commercial banks continued the trend toward greater reliance on variable-rate or shorter term loans and toward reduced reliance on long-term securities.

Total assets of the national banking system, both foreign and domestic, totaled $1,095 billion at year-end 1980, an increase of $99 billion, or 9.9 percent, over the total for the previous year. That was the slowest rate of change in total assets since 1975 when assets increased only 6.9 percent.

Reacting to rising interest rates followed by the credit constraint program initiated in the spring, loan growth failed to keep pace with total assets, increasing 8.6 percent, or $48 billion, over the 12-month period. That loan growth was still disproportionately concentrated in foreign offices, with domestic office loans increasing only 6.3 percent. However, the long-term trend of more rapid growth in total foreign office assets was virtually stalled in 1980. Total assets at domestic offices, including the substantial net amount of $19 billion due from foreign branches and subsidiaries, increased 9.9 percent. Foreign office (including Edge Act subsidiaries in the United States) assets, excluding amounts due to the head office, increased over 10 percent to $236 billion, nearly 21 percent of the national banking system's assets.

Although total loan growth was modest, residential real estate lending held up well considering the historically high interest rates prevailing during the period. Total holdings of residential real estate mortgages at domestic offices of national banks increased 7.9 percent to $85 billion. In part, that increase resulted from the innovative use of both short-term and variable-rate mortgages by national banks.

For the first time in several years, national banks actually increased the proportion of securities in their asset portfolios. Their total holdings increased nearly $20 billion, a rise of 12.7 percent over the preceding December. However, the trend to shorter maturities continued. At year-end 1980, 28 percent of domestic office holdings of $80 billion in U.S. Treasury and agency securities had maturities of 1 year or less, compared to 25 percent at year-end 1979.

The effects of rising interest rates and changes in the competitive situation of commercial banking were most readily seen on the liability side of the balance sheet. Although the 9.6 percent increase of $57 billion in domestic office deposits exceeded the growth rate in foreign office deposits for the first time in a number of years, a higher proportion of those domestic office deposits were paying a market rate of interest. Money market certificates of deposit, available in denominations of $10,000, increased 67 percent to $93 billion. Similarly, large negotiable certificates of deposits increased $32 billion to $141 billion. However, the rate of growth in foreign office deposits dropped sharply from previous years'. Those deposits increased only 8.2 percent in 1980, to $206 billion, compared to a nearly 22 percent increase of $34 billion during 1979. Other sources of purchased funds (federal funds transactions, liabilities for borrowed money and Treasury demand notes) continued to increase more rapidly than total liabilities, increasing $12 billion or nearly 12 percent in 1980.

For the first time since 1976, equity capital increased at a faster rate than total assets, interrupting the long-term decline in the equity-to-capital ratio for the national banking system. As national banks continued to retain more than 60 percent of their net income, total equity capital increased $5.6 billion to nearly $60 billion. Total equity capital was equal to 5.5 percent of total assets at year-end 1980, up marginally from the preceding year.

Net income of national banks operating at year-end 1980 was $7.7 billion, a modest increase of 5.8 percent over 1979. That increase was less than asset or equity capital growth so that both the return on assets and the return on equity declined slightly. It was also in marked contrast to the preceding 2 years which saw very rapid increases in net income. Indeed, 1978's in-