FLOATING THE PRIME RATE

In the fall of 1971, a few large commercial banks adopted a floating prime rate in an effort to make their loan rates more responsive to the cost of attracting additional funds and also to remove bank loan rates from the political spotlight. During the second half of the 1960's, when banks were subjected to extended periods of tight credit conditions and high interest rates, the prime rate had formally been in existence for over 30 years. Because such conditions represented a marked change from those of the prior 30 years, many traditional practices in the financial community, the prime rate among them, came under close examination. Later, after credit conditions eased in the second half of 1970 and 1971, at least three large New York banks decided to test the feasibility of a floating prime rate. This article discusses the historical use of the prime rate, why a floating prime rate has been introduced, and the possible effects of the floating prime on banks and their customers.

History of the Prime Rate The prime rate was formally established by the banking community for the first time in the 1930's as a "floor rate" to prevent competition from driving rates below the level of administrative and servicing costs associated with bank loans. In the midst of the Great Depression, business activity had come to a virtual standstill, and accordingly business loan demand was negligible. Banks were flush with reserves and lending capacity, while interest rates had been forced to unusually low levels. Fearing that some banks might even be willing to make loans at, or below, cost as a short-run measure, many banks felt that a unform minimum lending rate throughout the banking community would be appropriate. Thus emerged the prime rate at 1½%, where it remained until 1947. The term "prime rate" has been used because only the most credit-worthy, or prime, borrower has been allowed to borrow at that rate. Other borrowers are charged rates scaled upward from the prime rate.

After 1947 the prime rate was changed much more frequently, especially during the early and late 1950's. Although it remained unchanged during the first half of the 1960's, the prime rate was changed as often as several times a year in the second half of the decade. Historically, however, movements of the prime rate have not provided an accurate index of changes in credit market conditions.

Behavior of the Prime Rate Because the decisions of individual banks to change the prime rate have been influenced to a large degree by nonmarket forces, such as institutional and political factors, prime rate changes have usually lagged movements in economic and credit market conditions. The prime rate has not moved in the same fashion as, for example, the Treasury bill rate, which fluctuates on a day-to-day basis in direct response to changes in supply and demand conditions. Instead, bank loans are very different from a typical, negotiable, open market, credit instrument. Bank loan rates are part of the unique arrangement a bank has with each of its customers, an arrangement that involves a number of noninterest rate factors such as compensating balances, additional lines of credit, or advice and counsel of bank officials. Furthermore, even though the length of a particular loan may be rather short, the relationship between a bank and a borrower usually extends over a number of loan arrangements. Thus, a bank must consider the long-term implications of changes in various aspects of the loan arrangement. Before a bank adjusts the interest rate on such a complex financing arrangement, it must make certain that a definite change in credit conditions has occurred. Daily or even weekly fluctuations in various short-term interest rates cannot be used by a bank as a reliable indicator of overall credit conditions. Such variables as movements in Federal Reserve policy, changes in deposit flows, as well as the general level of economic activity must be assessed. Moreover, a considerable time lag can occur while these variables are adjusting and banks are evaluating them.

Other factors also contribute to the laggardness of changes in the prime rate. Even after bank officials become aware that changes in credit conditions are something more than temporary, the decision making process within the bank further delays the actual rate change. An element of gamesmanship also may be involved either within the bank or with

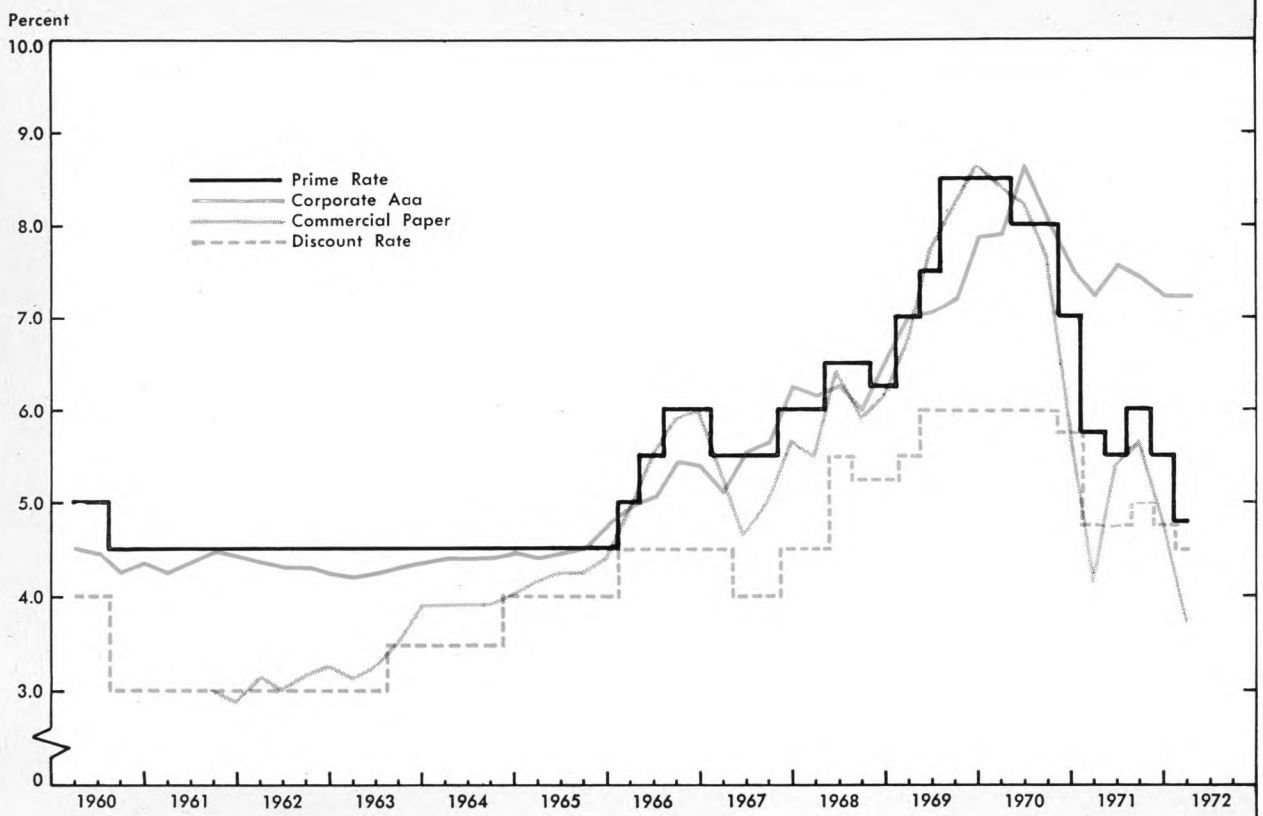
respect to attempts to anticipate the behavior of customers and other banks. When a given bank chooses to lead a change in the prime rate, it must be relatively certain that other banks will follow. If one bank raises its prime rate but other banks do not raise theirs, then the loans of the lead bank may be priced out of the market. On the other hand, if a bank lowers its rate but others do not follow, it may experience a substantial increase in loan requests. Because of the risk associated with leading changes in the prime rate, most moves have traditionally been initiated by very large banks or by small banks that are trying to establish a dynamic image.

Overall, the prime rate serves as the base or anchor rate of the banking system. Although the rate was originally designed to eliminate cutthroat competition among banks, today it plays an important role in the highly competitive national loan market. As described above, a bank must operate at the competitively determined rate or it will experience either too much or too little loan demand. A uniform prime rate is also useful in the instance of the very large corporate borrower who obtains funds from several banks under a single loan arrangement.

Over the credit cycle, differing proportions of total loans are made at the prime rate. Analysis of the Federal Reserve Quarterly Interest Rate Survey reveals that a larger proportion of total loans is made at the prime rate during periods of limited credit availability and high interest rates than during periods of limited credit availability and high interest rates than during periods of easier credit conditions. One explanation of this phenomenon is that during periods of rising interest rates prime borrowers who were previously issuing commercial paper often turn to commercial banks because adjustments of the prime rate tend to lag behind changes in market determined rates. A second explanation is that banks tend to accommodate the loan requests of their prime borrowers ahead of loan requests by nonprime bor-

Chart 1

INTEREST RATE MOVEMENTS



Sources: Federal Reserve Bulletin; **Money and Capital Movements**; Salomon Brothers.

rowers during periods of limited credit availability.[1]

In the latter 1960's, when credit conditions were tight and interest rates were higher and fluctuating more than in the past, the traditional prime rate presented problems to many banks. Finding it difficult to maintain lending rates in line with their costs, a few banks eventually sought an alternative method of adjusting their loan rates.

Forces for Change The forces for a change in loan pricing practices at commercial banks were of a political as well as an economic nature. The practice of moving the prime rate in one-quarter or one-half percentage point steps and then publicly announcing the move had made banks the frequent target of political attack. These attacks were especially strong in the last five or six years, because most of the prime rate changes were upward. When the prime rate was raised to its peak level of 8½% in mid-1969, some politicians accused banks of contributing to inflation and of taking advantage of the small, defenseless borrower. The presence of historically high interest rates in nearly all sectors of the credit markets, which were pushing up bank costs, had little impact on the political bric-a-brac directed at the banking community.

With Phase II of the President's economic program imminent in November 1971, a few banks attempted to remove their actions from the political arena by tying their lending rates to market determined rates. Under a floating rate format, changes in the prime rate would be much more frequent and much less the subject of major announcements. Apparently, those banks that have opted to let their prime rate be directly determined by market forces have been successful in reducing the volume of political criticism. Since its initiation in late October, the floating prime rate has moved down to 4⅜% from 5¾% and then back up to 5¼% with considerably less comment from its former critics.

The more important factor in the banks' decisions to move to a floating rate, however, was the substantial change in the relationship between bank costs and revenues during the second half of the 1960's. The groundwork for this change was laid in the early 1960's when banks began issuing negotiable certificates of deposit and in general managing their liability positions much more closely than they had in the past. As part of this approach to bank management, short-term money market funds became a relatively more important source of funds. Thus, when credit conditions tightened in the face of strong loan demand at various times between 1966 and 1970, and interest rates rose to historically high levels and became much more volatile than in the past, bank profit margins on loans became quite unstable. Of course, the relative inflexibility and lag in the prime rate, in the face of volatile bank costs, contributed heavily to the instability of profits on loans.

In addition to the problem of unstable profit margins on loans, the traditional prime rate structure was a direct cause of certain fluctuations in bank loan demand. Rate-sensitive treasurers of large corporations shifted their borrowing between banks and open market sources in response to rate differentials between these sectors. As credit conditions tightened and open market rates rose relative to the prime rate, corporations shifted their borrowing to banks. On the other hand, when credit conditions eased and market rates fell, prime corporate borrowers shifted their loan demand back into the open market, again because of the lagged adjustment in the prime rate. Chart I indirectly shows the relationship between the prime rate and the commercial paper rate over the credit cycle. A hypothetical floating prime rate has been constructed for the period 1965-1971, based on the technique currently used to compute the floating prime rate. During periods of credit stringency the prime rate would have been higher than it actually was, but during periods of credit ease the prime rate would have been lower.

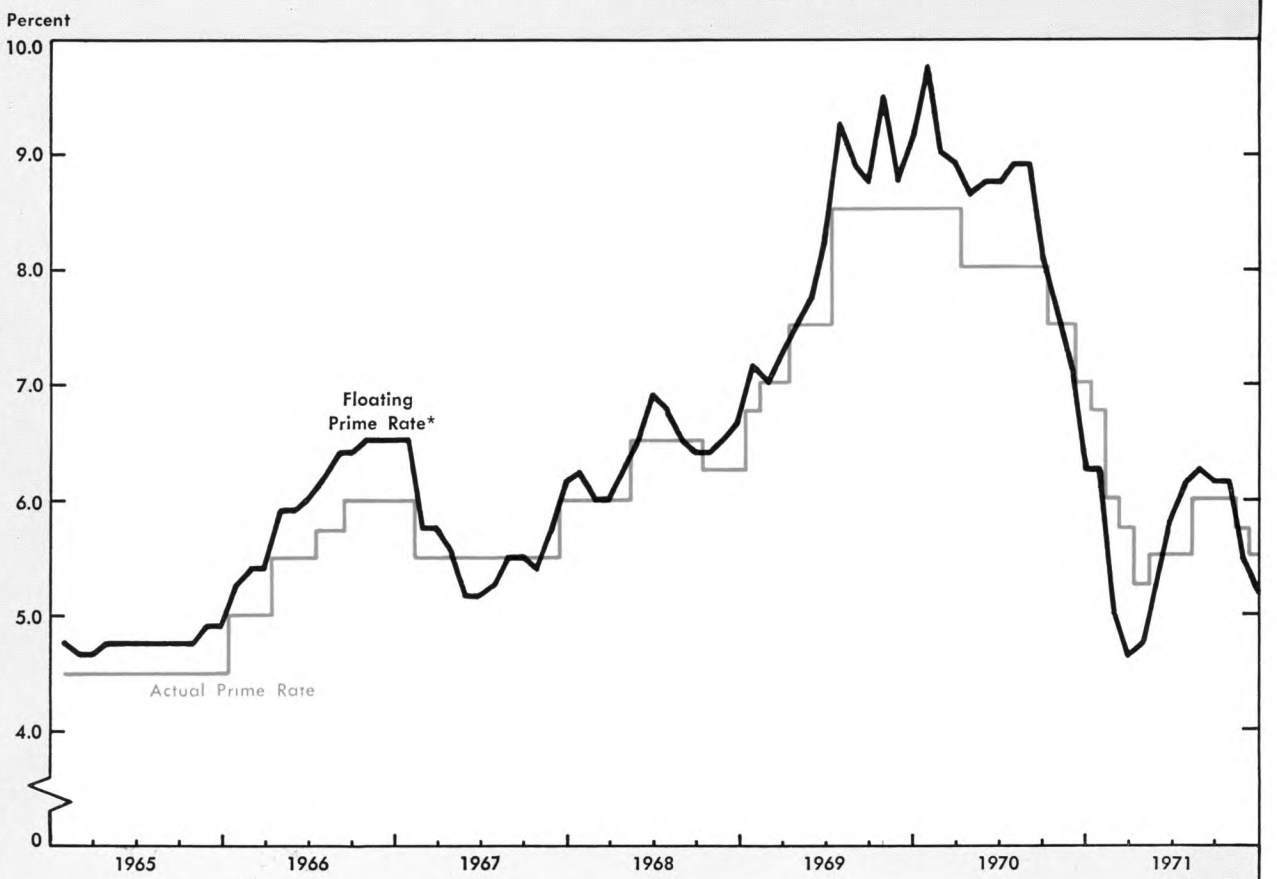
After the economy slowed down in 1970 and credit conditions eased, a few banks saw an opportunity to alter the degree of flexibility in their loan rate structure. Thus, in October 1971, First National City Bank of New York, the nation's second largest, adopted a floating prime rate.

How the Floating Prime Rate Works The three major New York banks using a floating prime rate have tied it to a commercial paper rate. Although one of the three also has been using the rate it pays on 89-day CD's as a prime rate determinant, the new floating prime rate will essentially be set at 50 basis points above the rate on 90-day commercial paper sold through dealers. Banks have chosen this rate as a base rate (1) because it is largely determined by impersonal competitive forces, (2) because commercial paper is a reasonably close substitute among many investors for large denomination CD's, (3) because commercial paper sales are an alternative source of funds to bank borrowing for prime corporate borrowers, and (4) because it has a

[1] Empirical investigation completed in recent years suggests that banks have been forced to ration credit among their various classes of customers during periods of tight money. Dwight M. Jaffee and Franco Modigliani, "A Theory and Test of Credit Rationing," *The American Economic Review* (December 1969), pp. 850-72.

Chart 2

HYPOTHETICAL BEHAVIOR OF A FLOATING PRIME RATE



*Floating Prime computed from 3-month Commercial Paper rate.

Sources: Federal Reserve Bulletin; Salomon Brothers.

maturity comparable to that on the typical short-term business loan.

Although the commercial paper market does not possess the size and competitive nature of the Treasury bill market, it is much more characterized by arm's length bargaining than is the business loan market at commercial banks. The commercial paper rate is essentially determined by freely fluctuating demand and supply conditions. Thus, changes in the prime rate, especially increases, determined by changes in a commercial paper rate could not be mistaken for attempts by the banking community to take advantage of the public. Certainly this reason for adopting a floating prime rate was an important consideration in the minds of many bankers at a time when interest rate controls were being advocated.

The high degree of substitutability between commercial paper and large denomination CD's in the portfolios of short-term investors suggests that interest rates on these two instruments are quite similar under most conditions. Since CD rates are a major component of the cost of funds to banks, a floating prime rate that is tied to a commercial paper rate tends to reflect changes in bank costs. The plan of one large bank to relate its floating prime rate to its CD rates as well as to a commercial paper rate indicates the importance bankers place on having loan rates move directly in line with costs.

There are some drawbacks, however, to using the 90-day commercial paper rate as the base rate. The commercial paper market does not generally operate with a large volume, and at times activity can be rather thin. Thus, there is the possibility that at

times commercial paper rates may be influenced by the policies of large banks or large borrowers. Further, no one rate can adequately reflect the costs incurred by an individual bank. At times the commercial paper rate might be out of line with other short-term interest rates. Such was the case on two occasions in late 1971. In both instances, however, paper rates became realigned with other short-term rates before those banks using a floating prime rate were forced to post a prime rate that was markedly different from other banks' loan rates. On balance, the 90-day commercial paper rate appears to be as useful a guide for determining the prime rate as any other short-term rate. Perhaps, as experience with a floating prime rate is gained, an improved method for determining the base rate can be devised.

Possible Effects of a Floating Prime Rate The most important effect of the introduction of the floating prime rate should be on the marginal relationship between bank costs and loan revenues during tight money periods. Whereas, in the past, costs of marginal, i.e., additional or extra, sources of funds rose more rapidly than loan revenues during such periods, the use of a floating prime rate should help to keep revenues in line with costs. It is generally assumed that movements of commercial paper rates will be similar to movements of other short-term rates in size and timing, thus causing the prime rate to move in step with the costs of short-term funds.

It might be argued that even though only a very few banks are utilizing a floating prime rate, other banks will also benefit. Those banks with floating prime rates will most likely take the first step in adjusting lending rates. If other banks choose to follow, they will be able to justify their adjustments on the basis of the actions of the floating rate banks. Although not every move in the floating prime rate will be followed by the other banks, the old prime rate should be more flexible than it has been in the past. For example, the traditional nonfloating prime rate has changed six times in the last six months, as shown in Table I. During periods of similarly moderate credit conditions over the past 20 years, rate changes have only occurred two or three times a year. In contrast, the floating prime rate has changed 15 times during this period.

Greater flexibility in bank loan rates should also enhance the relative importance of the interest rate factor in bank lending arrangements. Compensating balances and other noninterest rate factors may be used to a lesser extent as a means of adjusting the effective interest rate. During past periods of tight money, banks often raised the minimum percentage of the loan to be left on deposit by the borrower instead of raising the interest rate. This action had the effect of increasing the finance charge to the borrower. With a more flexible loan rate, the need to adjust compensating balance will be reduced.

Table I

COMPARISON OF CHANGES IN THE NEW FLOATING PRIME RATE AND THE FIXED PRIME RATE

1971	Actual Floating Prime Rate	Fixed Prime Rate
Nov. 3	5.63	5.75
10	5.63	5.50
17	5.50	5.50
24	5.38-5.50	5.50
Dec. 1	5.25-5.38	5.50
8	5.25-5.38	5.50
15	5.25-5.38	5.25
22	5.25	5.25
29	5.25	5.25
1972		
Jan. 5	5.00	5.00-5.25
12	4.75	5.00
19	4.63	5.00
26	4.63	4.75
Feb. 2	4.50	4.75
9	4.50	4.75
16	4.50	4.75
23	4.38-4.50	4.75
Mar. 1	4.38	4.75
8	4.50	4.75
15	4.75	4.75
22	4.88-5.00	4.75-5.00
29	5.00	5.00
Apr. 5	5.00	5.00
12	5.25	5.00
19	5.25	5.00-5.25
26	5.13-5.25	5.00-5.25

Source: Wall Street Journal.

Conclusions In general, a floating prime rate should be beneficial to the commercial banking system, especially during periods of tight money. If the adoption of a floating prime rate by a few leading banks encourages the traditional prime rate to become more flexible, then most of the incentive for adopting a floating prime rate will be reduced for many banks.

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