an economic review by the Federal Reserve Bank of Chicago

Bankers' acceptances

How weak are business loans?

may 1976

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Bankers' acceptances

Perhaps no other financial instrument—apart from money itself—has been as important to the development of international commerce as the bill of exchange and its more refined form, the banker's acceptance. By providing an efficient means of facilitating the shipment of goods through the extension of trade credit, these instruments have made it possible for two traders virtually unknown to each other and located in different parts of the world to enter into commercial transactions.

Economic historians trace the origin of early forms of these instruments to the twelfth century and attribute to their development the onset of the "commercial revolution." Over time, other instruments and means of settling international transactions were developed by banks, and consequently, bankers' acceptances have lost the unique place in international trade and finance they once enjoyed. Nevertheless, they continue to play an important role as modern financial instruments.

What is a banker's acceptance?

A banker's acceptance is a time draft, essentially an "order to pay" a specified sum of money at a specified date, drawn on and "accepted" by a bank. By accepting the draft, a bank assumes the responsibility to make payment at maturity of the draft. Acceptance of a time draft by a bank serves to make the draft, already a negotiable instrument, more readily salable (marketable) because by its acceptance the bank lends its integrity and credit rating to the instrument. The drawing of the draft is frequently preauthorized by a "letter of credit" issued by either the bank on which the order is drawn or by that bank's correspondent bank in the country of the buyer. However, the major dollar volume of acceptances created takes the form of "outright" acceptances—that is, the instrument arises out of a contractual arrangement less formal than a letter of credit and is later supported by the appropriate documentation.

Bankers' acceptances possess several attributes that make them desirable financial instruments from the point of view of traders (exporters and importers), bankers, and investors. To the seller of goods the major advantage in extending credit to the buyer through an acceptance lies in the fact that the instrument provides him with a bank's assurance of repayment. This feature has been particularly important in international trade, where the parties to the transaction may not be well known to each other or where the seller cannot readily ascertain the credit rating of the buyer. By using acceptance credit, the seller of goods in effect shifts the burden of guaranteeing the integrity of credit to the accepting bank.

The acceptance form of financing may be used to cover the shipment stage, which may amount to a substantial period—for example, an ocean shipment. The finance period may, however, extend into the period prior to shipment by the seller as well as into the marketing stage after receipt of the shipment by the buyer. To the trading party bearing the cost of the credit, bankers' acceptances also offer certain advantages over other forms of credit. A banker's acceptance usually compares favorably in cost with a conventional bank loan despite the fact that the rate of interest charged (technically a discount on the face value of the acceptance) on credit extended through bankers' acceptances is

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The life of an acceptance

To illustrate the process by which an acceptance may be created, consider an example where a firm in Brussels contracts for the purchase of office equipment from a firm in Rockford, Illinois. (See flow chart for the sequence of events described below.) Following inquiries and an exchange of correspondence between the two firms, it is agreed that the Brussels firm will arrange for the issuance of a letter of credit in favor of the Rockford supplier. The Brussels firm sends a "purchase order" to the Rockford firm **(1)**, and also makes application to its local bank for a letter of credit **(2)**, under a line of credit extended by the bank to the firm. The Brussels firm foresees a need for financing the office equipment for a period of 90 days from the time of shipment. Therefore, it stipulates in the letter of credit application that the draft is to be drawn at 90 days sight and further that it agrees to bear the charges for discounting of the draft in the United States by the Rockford firm. (The burden of who bears the cost of the discount varies with the relative bargaining power of the exporting and importing firms and may, as a result, rest with the exporter.) The Brussels bank issues a letter of credit available by draft at 90 days sight on its Chicago correspondent and mails it to the correspondent for delivery to the Rockford firm **(3)**. Upon receipt of the letter of credit the Chicago bank verifies the authenticity of the signatures on the credit and mails it to the Rockford firm **(4)**. The Rockford firm inspects the terms of the letter of credit and being satisfied with them, makes the shipment. It then collects the bill of lading and other documents called for under the letter of credit, draws a draft at 90 days sight on the Chicago bank and presents them to the bank along with the letter of credit **(5)**. The Chicago bank satisfies itself that the documents are in compliance with the terms of the credit. It then accepts the 90 days draft, thereby creating a banker's acceptance **(9)**, discounts it—charging discount and other charges to the account of the Brussels bank—and pays the face amount of the draft to the Rockford firm **(6)**. The shipping documents, the advice of debit covering the acceptance fee and other charges, and notification of the due date of the acceptance are mailed to the Brussels bank **(7)**, which makes appropriate entries on its books. The documents are then forwarded to the Brussels firm, which will use them to clear the merchandise when it arrives **(8)**.

The Chicago bank subsequently finds that it needs funds for its banking business. It sells the acceptance to an acceptance dealer **(9)** and receives the face amount of the acceptance less discount at the going bankers' acceptance rate for the number of days remaining to maturity **(10)**. The Chicago bank has thus been able to replenish its reserves, earn some income arising from the difference in the rates at which it discounted the draft and sold it to the dealer, and earn interest for the period during which it held the draft. The dealer in turn sells the acceptance to an investor **(11)** and receives the net proceeds **(12)**, after deduction of a discount, which should be slightly less than what he charged to the bank.

At maturity of the acceptance the investor presents it for payment to the Chicago bank **(13)** and receives the face amount of the draft in payment **(14)**. The Chicago bank in the meantime will have received payment from the Brussels bank **(15)**, which in turn has received payment from the Brussels firm **(16)**.

Bankers' acceptances arise out of the financing of a U.S. import in a similar manner. The major difference is that if the foreign exporter submits the draft for acceptance, it does so to a U.S. bank that is a correspondent to its home bank. The reason the acceptance is not created by its home bank is that the U.S. acceptance market is the only one of consequence among the various national financial markets.

The procedure for a third-country acceptance may follow a similar procedure with the major difference being that the trading participants are outside the United States.

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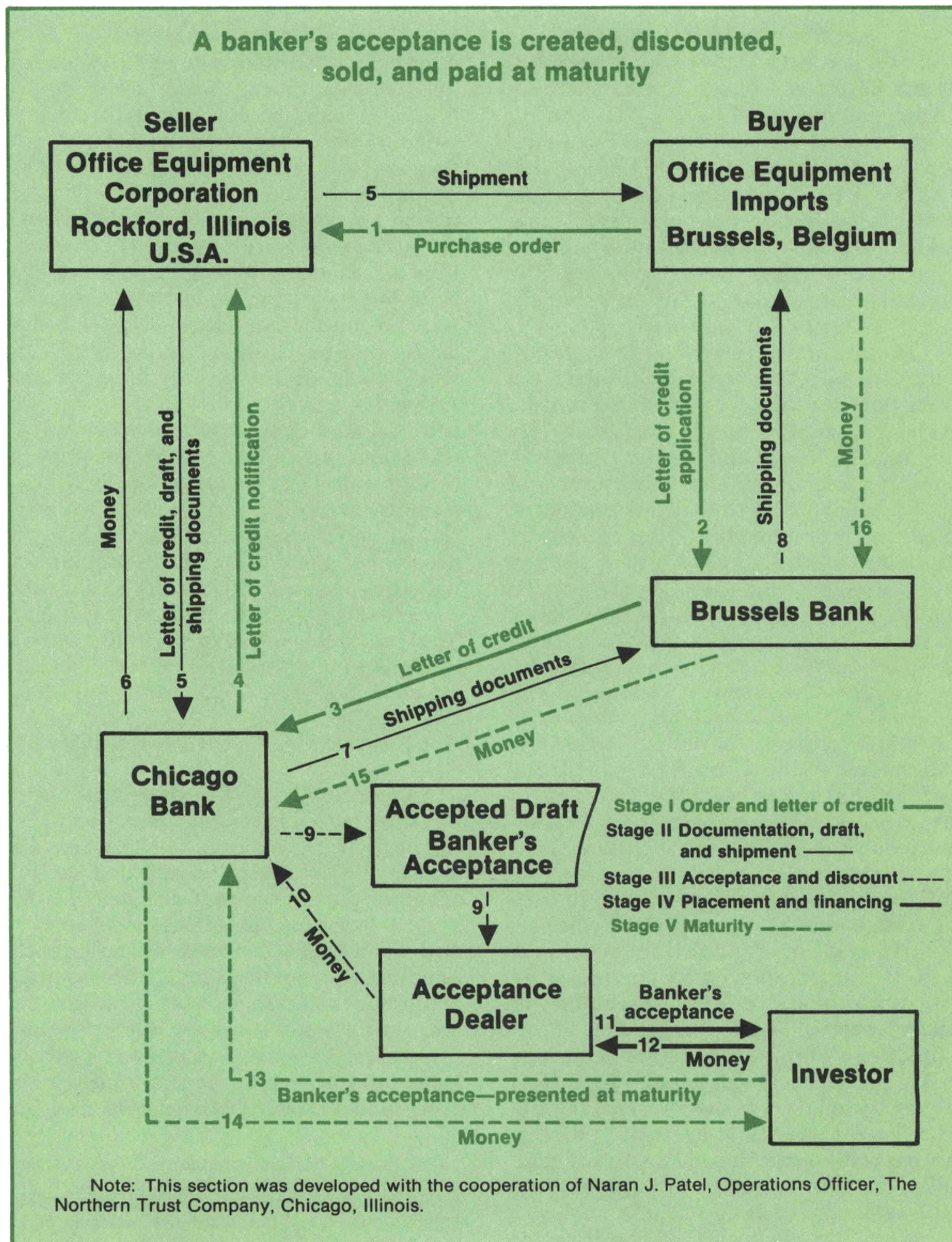

Note: This section was developed with the cooperation of Naran J. Patel, Operations Officer, The Northern Trust Company, Chicago, Illinois.

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often higher than the "prime rate" charged on conventional loans. In part this is because banks usually require conventional borrowers to maintain "compensating balances"—that is, the lending bank requires that a portion of the loan proceeds be maintained as a noninterest-bearing deposit. Because of this requirement, the *effective* cost of conventional credit is typically higher than the *nominal* quoted rate. Also, acceptance credit is typically more attractive for firms that are less than "prime" borrowers.

The attractiveness of an acceptance, as far as a bank is concerned, is that a bank earns a fee (usually 1½ percent per annum of the amount of the acceptance) for merely lending its name and credit rating by accepting a draft, without tying up any of its funds. The actual credit extension is, under these circumstances, undertaken by the seller of the goods. Only when the acceptance-creating bank purchases (discounts) the acceptance, from the seller of goods, for its own account does the bank tie up funds, earning not only the acceptance fee but also the discount charge on the acceptance credit. Even when the acceptance-creating bank purchases the acceptance (and thus, in effect extends the credit), the acceptance form of credit offers the bank certain advantages over a conventional loan. Unlike a conventional loan an acceptance is marketable and may be sold to an acceptance dealer, who in turn sells it to an investor that becomes the party financing the original transaction. As such, the acceptance when purchased by the bank serves as a form of secondary liquidity reserve. Finally, in the case of certain types of domestic shipment or storage drafts, acceptances are secured by title to the goods or a warehouse receipt (at the time the acceptance is created) and offer the accepting bank the advantage of good collateral. (See table for an outline of the applicable conditions.)

From the viewpoint of the investor bankers' acceptances hold two primary advantages. First, an acceptance is a relatively secure investment. By definition, an accepting bank assumes the primary obligation for payment of the face value of the acceptance at maturity. An acceptance is based on specific goods in transit or storage and, as noted above, in the case of domestic acceptances is in some cases secured by title or warehouse receipt. Further, an obligation for payment also rests with the drawer of the acceptance who assumes a liability contingent to that of the primary liability of the accepting bank (such an acceptance is sometimes referred to as "two-name paper"). While it is conceivable that these "lines of security" could break down, an acceptance is viewed by many as one of the safest forms of short-term investment. Second, acceptances are a relatively liquid investment. While the acceptance market is "thin" in comparison with the government securities market and concentrated with the relatively few New York acceptance dealers, quality acceptances are nevertheless readily marketable instruments.[1]

Acceptances by type of transaction

Traditionally, the most typical use of bankers' acceptances has been in financing imports and exports. The rapid expansion in the volume of acceptances in this category during the past decade (1966-75) by and large paralleled the boom in U.S. and world trade. The value of U.S. exports and imports expanded by 3.7 times, while acceptances financing that trade increased 4.2 times. However, during the last five years the rate of expansion in trade substantially outstripped the growth in acceptances. While both exports and im-

[1]The quality of an acceptance depends largely upon the familiarity of the accepting bank in the acceptance market, the financial soundness of the accepting bank, and the "eligibility" category of the acceptance itself. This is discussed in detail later.

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ports increased about 2.5 times, acceptances financing export and import trade were up 1.9 times. This recent lag in growth in acceptance financing of U.S. trade is attributable to a relatively slower growth in acceptances financing imports, which were up only 1.4 times from December 1970 to December 1975. Over the same period export acceptances increased 2.6 times. By the end of 1975 there were $4 billion of export acceptances and $3.7 billion of import acceptances outstanding.

The most dramatic increase in acceptance financing in recent years took place in bills created to finance trade between foreign countries and goods stored abroad—the so-called "third-country" bills. At the end of 1975 over $10.3 billion, or 55 percent, of all bankers' acceptances outstanding were third-country bills. This amount was 3.9 times larger than at the end of 1970. The surge in third-country bills has been primarily due to increased utilization of the U.S. acceptance market by the Japanese. A large proportion of Japan's foreign trade—even with non-U.S. trade—has been denominated and settled in U.S. dollars, thus leading Japanese traders to utilize the U.S. acceptance market rather intensively.[2]

Domestic shipment and storage acceptances have accounted for a minor portion of total acceptances outstanding during most of the post-World War II period. At the end of 1975 just over 3 percent of outstanding acceptances were domestic—about $600 million. The lack of popularity for the domestic acceptance derives, in part, from the requirement that to be *eligible for discount* by the Federal Reserve, the instrument must be secured by attached documents conveying title at the time of acceptance, or a warehouse receipt or other documents securing title to readily marketable staples (see table).

[2]It has been estimated that less than 15 percent of Japan's exports and 3 percent of its imports are settled in the Japanese yen.

Another category of acceptances is the "dollar exchange" bill. The nominal purpose of "dollar exchange" acceptances is the short-term creation of dollar exchange for a foreign country. They may be utilized to alleviate temporary or seasonal shortages of dollar exchange, "as required by usages of trade." As such, dollar exchange acceptances are unique, among bankers' acceptances, in that they are not based on specific merchandise trade or storage transactions.

The creation of dollar-exchange acceptances has been restricted by the Federal Reserve Act. Member banks may accept dollar exchange bills only from certain countries that are eligible for this form of credit. Further, since April 1974 such acceptances cannot be purchased by the Federal Reserve (see table covering eligibility conditions). These restrictions—plus the availability of alternative, more flexible sources of credit—have made these acceptances rather unpopular. At the end of 1975 they accounted for less than 1 percent of total U.S. acceptances outstanding.

Acceptances and the Federal Reserve

The Federal Reserve Act of 1913, Sections 13 and 14, broadly outlined the authority of the Federal Reserve System with respect to regulation of the purchase and sale of bankers' acceptances. This authority, along with that contained in Sections 9 and 19 of the Act, was used to promulgate the detailed Regulations A, D, and H of the Board of Governors of the Federal Reserve System and the regulations relating to open market operations of the Federal Reserve System. The following highlights the nature of these regulations.

The Federal Reserve may "acquire" acceptances under three sets of conditions. First, it may initiate purchases (and sales) of bankers' acceptances in open market operations. Second, a bank that is a

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Bankers' acceptances—conditions and characteristics governing eligibility, reserve requirements, and acceptance liability

Bankers' acceptance categories	Federal Reserve System treatment: Eligible for discount[1]	Eligible for purchase[2]	Reserve requirements[3]	Aggregate acceptance limits[4]
1. To cover specific international transactions				
a. U.S. exports or imports.				
Maturity-6 months or less	yes[5]	yes	no	yes
6 months to 9 months	no	yes	yes	no
more than 9 months	no	no	yes	no
b. Shipment of goods *between* foreign countries.				
Maturity-6 months or less	yes[5]	yes	no	yes
6 months to 9 months	no	yes	yes	no
more than 9 months	no	no	yes	no
c. Shipment of goods *within* a foreign country.				
Maturity-any term	no	no	yes	no
d. Storage of goods within a foreign country (readily marketable staples secured by warehouse receipt).				
Maturity-6 months or less	yes[5]	no	no	yes
6 months to 9 months	no	no	yes	no
more than 9 months	no	no	yes	no
e. Dollar exchange—required by usages of trade in approved countries only.				
Maturity-3 months or less	yes	no	no	yes
more than 3 months	no	no	yes	no
2. To cover specific domestic transactions (i.e., within the U.S.)				
a. Domestic shipment of goods—*with* documents conveying title attached at time of acceptance.				
Maturity-6 months or less	yes[5]	yes	no	yes
6 months to 9 months	no	yes	yes	no
more than 9 months	no	no	yes	no
b. Domestic shipment of goods—*without* documents conveying title.				
Maturity-6 months or less	no	yes	yes	no
6 months to 9 months	no	yes	yes	no
more than 9 months	no	no	yes	no
c. Domestic storage—*readily marketable staples* secured by warehouse receipt.				
Maturity-6 months or less	yes[5]	yes	no	yes
6 months to 9 months	no	yes	yes	no
more than 9 months	no	no	yes	no
d. Domestic storage—*any goods* in the U.S. under contract of sale or going into channels of trade and secured throughout their life by warehouse receipts.				
Maturity-6 months or less	no	yes	yes	no
6 months to 9 months	no	yes	yes	no
more than 9 months	no	no	yes	no
3. Marketable time deposits (finance bills or working capital acceptances) not related to any specific transaction.				
Maturity-any term	no	no	yes	no

NOTE: This table is based, in part, on an unpublished paper from the 7th Annual CIB Conference at New Orleans, October 13, 1975, by A. Bardenhagen, Vice President, Irving Trust Company, New York.

[1]In accordance with Regulation A of the Board of Governors as provided by the Federal Reserve Act.

[2]Authorizations for the purchase of acceptances as announced by the Federal Open Market Committee on April 1, 1974.

[3]In accordance with Regulation D of the Board of Governors as provided by the Federal Reserve Act.

[4]Member banks may accept bills in an amount not exceeding at any time 50 percent (or 100 percent if approved by the Board of Governors of the Federal Reserve System) of unimpaired capital stock and surplus (as defined in FRB, Chicago Circular No. 2156 of April 2, 1971). Acceptances growing out of domestic transactions are not to exceed 50 percent of the unimpaired capital stock and surplus. The aggregate limit for a bank accepting dollar exchange bills is 50 percent of unimpaired capital stock and surplus over and above the aforementioned 100 percent limitation. (Section 13(7) and (12) of the Federal Reserve Act.)

[5]The maturity of nonagricultural bills may not exceed 90 days at the time of discount.

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member of the Federal Reserve System may submit acceptances to its district Federal Reserve Bank for discount (technically rediscount) at the "discount window"; if the Fed discounts the acceptance, the proceeds are credited to the member bank's reserve account. Third, a member bank may pledge acceptances as security against an advance or loan requested from the Federal Reserve.

Ongoing involvement of the Federal Reserve in the acceptance market has been largely confined to open market dealings. Buying and selling activity in the open market is carried out for two primary reasons. First, as a part of the System's implementation of monetary policy, it may acquire acceptances from dealers to hold for its own account (outright purchases). Alternatively, the Fed may enter into repurchase agreements with acceptance dealers whereby the Fed acquires acceptances for a short period of time—typically a week or less. These purchases, or repurchase agreements, allow the Fed to temporarily increase the amount of reserves in the banking system in the same way as if it were to purchase, sell, or enter into repurchase agreements covering U.S. Treasury securities.

The second reason for which the Fed periodically enters the acceptance market is to function as an "agent" for foreign customers, primarily foreign central banks, who wish to acquire the instruments for investment purposes. Until recently, the Federal Reserve added its own endorsement (i.e., "guarantee" of payment), thus enhancing the security of the investment. This practice was discontinued in November 1974.

Acceptances that are purchased by the Federal Reserve, used as collateral against a loan to a member bank by the Federal Reserve, or discounted at the Federal Reserve must meet certain requirements (see table). In creating acceptances banks try to adhere to these requirements, even though they may have no intention of selling or discounting them with the Fed. This is for two major reasons. First, acceptances meeting the conditions for *eligibility for discount* or *eligibility for purchase* are more readily salable in the market than are acceptances that do not meet these conditions—*ineligible* acceptances. As such, they provide a greater degree of liquidity for the accepting bank. Second, as will be explained later, acceptances that are *eligible for discount* are not subject to reserve requirements.

The distinction between *eligible for discount* and *eligible for purchase* by the Federal Reserve is important for two reasons: one reason derives from certain restrictions imposed by the Federal Reserve Act.[3] Section 13(7) and (12) of the Act limits the amount of acceptances that a bank can create for any individual, and have eligible for discount by the Federal Reserve, to 10 percent of that bank's paid-up and unimpaired capital and surplus (unless the acceptance is "adequately secured"). Further, the Act limits the aggregate amount of acceptances, *eligible for discount* with the Federal Reserve, created by a bank to 50 percent (100 percent with approval of the Board of Governors of the Federal Reserve System) of that bank's capital and surplus. Acceptances that are *eligible for purchase* or are *ineligible* for either discount or purchase by the Federal Reserve *are not* subject to Section 13 quantity limitations.

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[3]The market's reaction to the technical distinction between acceptances *eligible for discount*, acceptances *eligible for purchase*, and *ineligible* acceptances does not appear to follow this clear differentiation. As reflected by the terminology of bankers involved with acceptances and as reflected by rates quoted by acceptance dealers, *eligible* acceptances are those technically *eligible for discount*. *Ineligible* acceptances include the rest: *eligible for purchase* and *ineligible*. The relative willingness of acceptance dealers to deal in acceptances *eligible for purchase* as compared with *ineligible* acceptances appears to be the major distinction between these categories—a nonprice differentiation.

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Second, as noted above, the applicability of reserve requirements to acceptances outstanding varies according to the "eligibility" category of the acceptance. According to Regulation D, Section 204.1 (f) 5, of the Federal Reserve Board a banker's acceptance that meets the conditions that make it *eligible for discount* may be sold by the creating and discounting bank without subjecting the proceeds of the sale to reserve requirements. Thus, a member bank that sells an acceptance that meets such eligibility requirements is free from the obligation to set aside a certain portion of its funds in noninterest-bearing balances with the Federal Reserve. Conversely, a member bank must maintain reserves against the proceeds of the sale of acceptances "undertaken . . . as a means to obtaining funds to be used in the banking business . . ." that do not meet the *eligibility for discount* conditions of Section 13 of the Federal Reserve Act.

Purchase of acceptances by the Federal Reserve is governed not only by the *eligibility* requirements, but also by the underlying "quality" of the instrument. The Federal Reserve purchases only "prime" acceptances. A prime classification is based upon a number of factors including the marketability of the instrument (which is importantly dependent upon the view held by the acceptance dealers), the financial condition of the bank accepting the paper, the volume of transactions in the acceptance market carried out by the accepting bank (bank size itself is not a determining factor), and a set of physical standards and forms of documentation that are to be adhered to in the instrument itself. Even the designation of an acceptance as prime does not guarantee that at any given time an acceptance created by a particular bank will be purchased by the Federal Reserve because of restrictions on the proportions of acceptances from any one source that the Federal Reserve will acquire.

Regional distribution of acceptances

Historically, the majority of bankers' acceptances outstanding have been acceptances of banks located in New York and San Francisco. At the end of 1975 nearly 84 percent of acceptances outstanding were from banks located in these two Federal Reserve districts. This stems from East and West Coast banks having been traditionally more heavily involved in international transactions and in financing international trade than the inland banks. Moreover, New York has been the traditional financial center of the United States, hosting the most active domestic money market where acceptances can be readily traded. It is also the home base for the relatively few dealers that are active in the acceptance market.

Chicago ranks as a distant third in the value of acceptances outstanding from banks in that Federal Reserve District—about 4.5 percent of the national total at the end of 1975. During the post-World War II period Chicago's share of acceptances outstanding has ranged from about 2.5 percent at the end of 1950 to 6 percent at the end of 1971. Of course, as noted earlier, the volume of acceptances outstanding nationwide increased markedly over the postwar period—more than 47 times from 1950 through 1975. The volume of acceptances outstanding from Chicago district banks increased more than 80 times over the same period. It has been over the last five years, however, that the bulk of the dollar volume surge has occurred. Chicago district acceptances outstanding increased from $353 million at the end of 1970 to $837 million at the end of 1975. Over the same five-year period bankers' acceptances outstanding nationwide increased from $7.1 billion to $18.7 billion.

Conclusion

For many years bankers' acceptances have been an important element in the

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financing of international trade. Over time, improved lines of communication between parties involved in international transactions and the development of other financial instruments and modes of settlement of international transactions have reduced the overall importance of the acceptance. Only a relatively small portion of world trade is financed by means of bankers' acceptances. For example, estimates based on the average amount of export and import acceptances outstanding during 1975, assuming a 90-day maturity, suggest that only about 15 percent of U.S. merchandise trade was financed by acceptances. Nevertheless, acceptances continue to play an important role as a highly specialized financial instrument for facilitating international commerce, a role for which they are ideally suited.

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A, as amended effective October 25, 1974, Extensions of Credit by Federal Reserve Banks. (Also, 12 C.F.R. 201.)

D, as amended effective December 25, 1975, Reserves of Member Banks. (Also, 12 C.F.R. 204.)

H, as amended effective March 10, 1976, Membership of State Banking Institutions in the Federal Reserve System. (Also, 12 C.F.R. 208.)

Federal Open Market Committee. Regulation Relating to Open Market Operations of Federal Reserve System. (Also, 12 C.F.R. 270.)

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How weak are business loans?

Business loan demand continues to lag well behind the upswing in economic activity thus far in the current recovery. Commercial bank loans to nonfinancial businesses declined about $10 billion, or 5 percent, from their peak in late 1974 through the first quarter of this year. Twelve months after the economy bottomed out in the most severe recession since the thirties, they were still falling. Business loans normally lag other economic indicators cyclically, but the degree of liquidation in the past year represents a marked departure from patterns in previous recoveries.

Business loan growth is widely expected to be resumed as the expansion proceeds, but the pace seems likely to be moderate, reflecting the position of both lenders and borrowers. Despite the recent weakness, business loans are still at high levels relative to long-term trend, and concern about greater-than-normal loan losses has caused many banks to adopt cautious lending policies. Meanwhile, improved liquidity will limit the extent to which businesses will need bank credit in the near future.

Business loans and their significance

Statistics on bank loans to businesses are followed with perhaps even greater interest by economic and financial market analysts than by the participants themselves. What are these numbers and what do they mean to these analysts? All commercial banks are required to file reports at regular intervals showing a breakdown of their loan portfolios. One of the loan categories specified is "commercial and industrial loans," which is defined to include *all loans made to individuals, partnerships, and corporations for commercial and industrial purposes* **except** *loans primarily secured by real estate, loans made to financial institutions or to nonprofit institutions such as schools and hospitals, and loans for the purposes of purchasing and carrying securities or financing agricultural production.* "Business loans" for purposes of this article are commercial and industrial (C&I) loans thus defined. Most of these loans represent financing of current operations and capital expenditures for business customers. They may be short term or long term, single payment or instalment. Commercial paper and acceptances that may have been purchased are also included in business loans.

Reports from all banks are available only infrequently and with a significant processing lag. However, more than 300 major banks that account for almost 70 percent of the total dollar volume of these loans file weekly reports with the Federal Reserve. About one-half of these banks, in turn, account for more than 80 percent of outstandings at all the weekly reporters. This group also provides an industrial and maturity classification of their business loans weekly. As a consequence, most current analysis on the trend of business loans relies heavily on the weekly reports of the big banks.

Business loans tend to rise as business activity increases and level off or decline when the economy falters, although often lagging in both directions. Business loans at all commercial banks rose 19 percent in 1965, 20 percent in 1973, but only 5 percent in 1971, while the average annual percentage growth rate of the past 15 years was 10 percent. Loans at the larger banks tend to be more volatile than those at smaller

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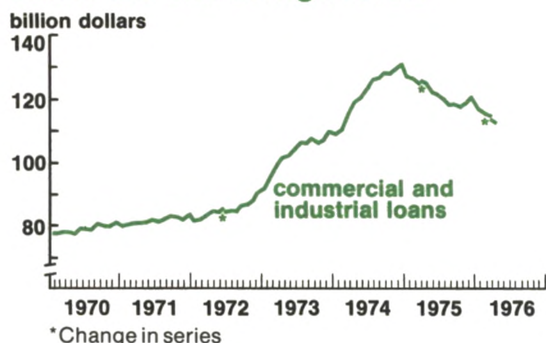
Outstanding credits at the major banks are still at high levels



*Change in series

banks. For example, from the 1974 peak through the end of March large banks reported a decline of $16 billion, compared with the net reduction of $10 billion estimated for all banks.

Changes in the weekly readings at the large banks are often interpreted as an indication of business strength or weakness. Such interpretations have to take into account normal seasonal and cyclical patterns as well as considerable short-run random fluctuation. Even with such allowances, the relationship is loose, especially in the short run. Loan demand may not pace business activity closely on the upside to the extent that financing is provided either from internal sources or borrowings in the money and capital markets. Nonbank financing is generally more feasible for large firms than for small ones, and the choice is heavily influenced by relative cost. Conversely, bank credit may be required to finance the involuntary buildup of inventories for some time after sales have turned weak.

The willingness of banks to make loans is another factor affecting lending volume. When bank liquidity is low and the cost of funds high, restrictive loan policies may slow loan expansion. Nevertheless, if their major customers want credit, most banks will aggressively seek loanable funds to accommodate them.

Because of the presumed relationship between business loans and monetary policy, a pattern has developed in the financial markets in response to the weekly statistics. Reports of large increases in business loans may trigger declines in the prices of outstanding securities. This is especially evident at times when it is anticipated that monetary restraint soon will be required to prevent excessively rapid economic expansion. Such response reflects market participants' expectations that a less accommodative posture by the Federal Reserve in supplying the reserves necessary to support further increases in bank loans and deposits will cause a rise in market interest rates and a corresponding decline in the prices of outstanding fixed income obligations. However, the loan statistics are only one of many factors impinging on this general market judgment.

More basically, changes in bank credit are a reflection of the ability and desire of business firms to finance capacity expansion and working capital requirements. Sustained changes often portend future economic conditions. Rapid growth over a number of months may evidence an overheating in business expenditures leading to accelerated inflation and an unsustainable boom. Net paydowns following a period of rapid growth often reflect restoration of needed liquidity, but declines sustained over many months may be symptomatic of either weakening activity or a shortage in the supply of credit available. On the other hand, such a reduction in bank credit may simply reflect the availability of funds from other sources.

Importance to banks

The business of banking is lending, and commercial and industrial loans comprise the largest category in the portfolios of the commercial banking system—a third of all loans and 20 percent of total assets. Because much of the dollar volume

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Business loans are concentrated at large banks

	Size of total deposits (million dollars)				All commercial banks
	Less than 25	25-100	100-500	Over 500	
Number of banks	10,663	3,075	676	183	14,597
Business loans *(billion dollars)*	12.9	22.7	28.8	115.6	180.0
Distribution of business loans *(percent)*	7.1	12.6	16.1	64.2	100.0
Business loans as *percent* of					
Total loans	20.8	27.1	32.9	43.4	36.0
Total assets	10.4	14.1	17.4	23.8	19.2

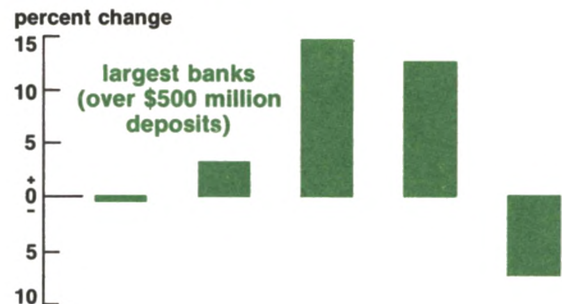
Note: As of June 30, 1976.

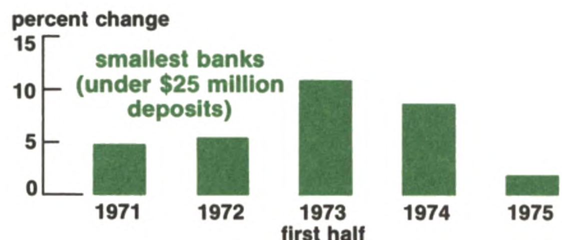
represents loans to big businesses that are served by very large banks, these loans are heavily concentrated in those banks. As of mid-1975 (the most recent date for which detailed statistics for all commercial banks are available) nearly two-thirds of the C&I loans outstanding were accounted for by about 180 banks with deposits over $500 million. Such loans comprised one-fourth of the assets in these banks. By contrast, banks with deposits of less than $25 million—almost three-fourths of the nation's 14,500 banks—accounted for only 7 percent of C&I loans, and these loans made up only 10 percent of their assets. Comparison of changes in the first half of the past five years illustrates the difference in cyclical fluctuations at large and small banks (see chart).

Five recoveries compared

Business loans outstanding registered an absolute decline during 1975—the first since 1954. The current economic recovery is unique in that these loans have continued to decline—the only net decline in the 12 months following the five recession troughs since 1950 (see chart). Also unique, however, was the extent of the expansion that preceded the recession. The peak level of business loans was reached in November 1974. Over the previous two

Cyclical impact is much greater at the large banks





years these loans had increased almost 45 percent. Even with the recent liquidation, they remain 35 percent higher than at the end of 1972 and higher in relation to bank assets than at that time. Besides booming activity, price inflation—which increased the dollar value of every purchase that had to be financed—was a factor in the rapid loan expansion during 1973 and 1974.

Because of the very high loan volume and the heavier loan loss problems compared with experience in earlier recessions, many banks have welcomed some reduction in their loan portfolios and have been placing strong emphasis on the margins between the return on loans and their cost of funds. Whereas six months after the 1970 recession trough the prime interest rate was only 50 basis points above the cost of borrowing for three months in the commercial paper market, this spread was more than 150 basis points at the same point of the current recovery. At times during 1973 and 1974 this spread was negative.

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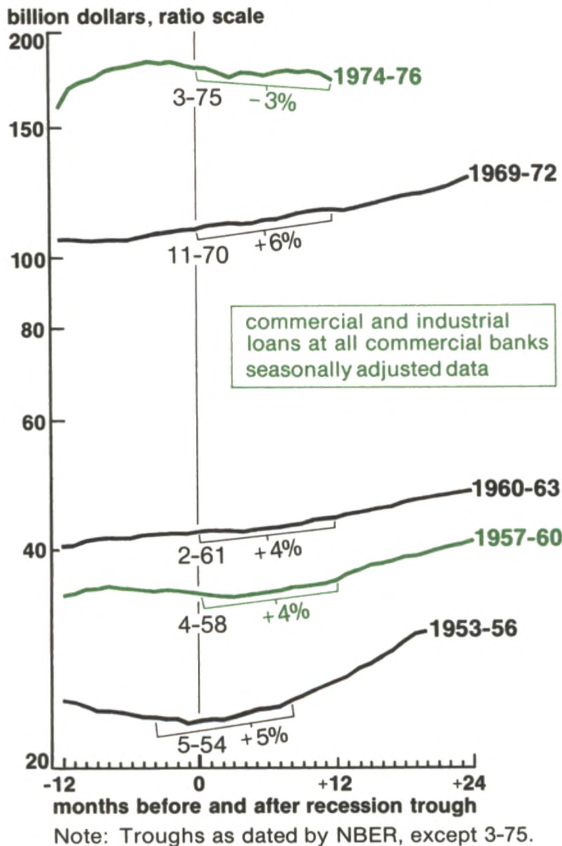
In contrast to earlier upswings, business loans declined through the first full year of this recovery



Note: Troughs as dated by NBER, except 3-75.

The relatively high interest rates on bank loans is not the only reason for the weak performance of business loans in recent months. Outstanding commercial paper issued by nonfinancial companies also declined in the first 12 months of recovery. The need for bank credit was reduced as corporate inventories were pared down and profits rose. Moreover, a record amount of securities was sold in the capital markets with much of the proceeds used to repay bank loans and acquire liquid assets.

Borrowers in most industries have paid down both long- and short-term loans

Business loan categories	Short-term		Long-term*	
	Amount 3/31/76 (billion dollars)	Change from year ago (percent)	Amount 3/31/76 (billion dollars)	Change from year ago (percent)
Durable mfg.	7,108	- 34.0	8,822	- 18.0
Nondurable mfg.	5,920	- 17.2	4,806	- 11.7
Petrol ref. & mining	2,008	+ 3.3	6,589	+ 32.6
Trade	9,720	- 4.9	3,541	- 10.3
Public utilities	4,532	- 28.0	9,146	- 5.1
Services	5,410	- 7.6	5,368	- 6.7
Other domestic	8,486	- 16.6	4,614	- 2.7
Acceptances	3,285	+ 45.4	—	—
Foreign	2,386	+ 35.2	2,984	+ 18.0
Total classified	48,855	- 13.4	45,950	- 3.9

*Original maturity over one year.

Across-the-board contraction

Large banks that provide information about the distribution of their commercial and industrial loans by type of borrower and by maturity accounted for about 90 percent of the reduction in major city bank loans in the year ended March 31. Such information shows that only three major loan sectors rose in that period: (1) petroleum refining and mining, reflecting activity in the energy field; (2) bankers' acceptances, which are held in bank portfolios mainly when other loan demand is weak; and (3) loans to foreign businesses. About a third of the overall decline was in term loans, which constitute about half of classified loans other than acceptances.

Banker surveys in mid-May still failed to indicate any significant strengthening in loan demand, but did suggest increasing interest in loan business and some efforts to attract borrowers by easing lending terms. While recent experience will undoubtedly make banks more selective, there is no evidence that the expansion will be stalled by lack of available financing to creditworthy borrowers.

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