

Research Department Federal Reserve Bank of San Francisco

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In the Paper Market

The outstanding volume of dealer-placed commercial paper has dropped by almost \$4 billion since the beginning of the year. This decline contrasts starkly with the situation in previous periods of monetary restraint, when the commercial-paper market was called upon to finance large volumes of short-term credit because of restrictions on the expansion of bank credit.

In 1973 to date, commercial-bank credit has expanded roughly \$17½ billion, partly of course because of the demands generated by the business boom, but also because of the attractiveness of bank loan rates vis-a-vis the rates on dealer-placed paper. Meanwhile, directly-placed commercial paper—issued by the largest (and most creditworthy) finance companies and banks—has risen about \$5½ billion, reflecting the upsurge this year in consumer financing of autos and other durables. The decline in dealer paper thus contrasts sharply with the increases recorded in other segments of the business-financing picture. Although dealer paper accounts for a relatively small share of the paper market, it is emphasized here because of its unique behavior during the last several tight-money periods.

Signs of a shift in this market have occurred over the past month or so, with a modest recovery in dealer-placed paper and a net paydown in bank loans. This phenomenon

might well continue, since the recent sharp drop in money-market rates has brought the dealer rate into closer alignment with the bank prime-loan rate.

Market features

Commercial paper serves as a vehicle for short-term unsecured corporate debt. The market has two major segments; dealer-placed paper is dominated by numerous nonfinancial corporations operating through about a half-dozen major dealers, while directly-placed paper is dominated by a relatively few large finance companies that have a continual demand for short-term credit. (Direct paper now accounts for about three-fourths of total outstandings, as against slightly less than two-thirds of the market a year ago.) Bank holding companies sell their paper in both segments of the market, but they generally rely more heavily on direct paper. Bank-related paper began to enter the market in volume only when banks encountered a market imperfection—Regulation Q rate ceilings—that made it difficult for them to attract enough deposit funds to meet their loan commitments.

Since the direct-paper segment of the market is dominated by a relatively small number of well-known firms with sizable sales organizations, the rates on directly-placed paper tend to be below both the dealer rate and the bank prime business-loan rate. In mid-September, directly-placed finance-com-

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pany paper (one-month maturity) paid 9¼ percent, as against a 10½-percent rate on one-month prime dealer paper and a 10-percent bank prime rate.

One market feature is the use of bank lines of credit to back up issues of commercial paper. Another feature is the lack of a secondary market; hence, each issue is tailored to satisfy the rate and maturity preferences of both issuer and lender, so that the purchaser will hold the issue to maturity. Even so, most contracts contain "buy back" provisions to cover cases where the purchaser has a sudden need for funds.

Nonfinancial corporations are the major purchasers of both direct and dealer-placed paper. Commercial banks formerly were heavy buyers of dealer-placed paper, but they are now less active in that field. However, commercial-bank trust departments frequently maintain standing arrangements with finance companies to purchase certain amounts of paper for allocation to individual trust accounts.

Market crises

The importance of the commercial-paper market as an alternative to bank financing became evident during the 1966 tight-money period. In 1966, the growth of the adjusted

bank-credit proxy fell to 5 percent, from 9 percent in 1965. Business capital expenditures meanwhile greatly exceeded the amount of internally generated funds, so corporations turned not only to the capital market but also to the paper market. Consequently, outstanding commercial paper jumped by \$5½ billion between mid-1966 and March 1967. Dealer-placed paper in particular reacted to the diminished supply of bank credit with a sharp increase in volume, while directly-placed paper also increased, although largely as a reflection of the cyclical rise in consumer-credit demands.

Commercial paper played an even more important role in meeting business-financing needs during the next tight-money period in 1969, as rate ceilings on large negotiable CDs became a binding restraint on the expansion of bank credit. Short-term market rates exceeded Regulation Q ceiling rates by a considerable margin, and consequently outstanding CDs declined by over \$12 billion and the adjusted credit proxy grew by less than one-half percent.

The commercial-banking system responded by turning to sources of funds not subject to Q ceilings—Eurodollars and bank-related commercial paper. Paper of this type doubled in volume, to \$6½ billion, between the end of 1969 and mid-1970. (Bank-related paper represented 40 percent of the growth of the overall paper market in the first half of 1970.) During this period,

commercial paper served as a substitute for bank credit, rather than a complement to that source of credit, as it normally does.

This somewhat distorted situation was quickly brought to an end, after the Federal Reserve imposed reserve requirements on bank-related paper and eliminated rate ceilings on some types of large denomination CDs. The policy change then helped to bring about a rapid shift in the composition of bank liabilities. In the last half of 1970, CD funds rose by \$11½ billion and nondeposit sources declined by \$9 billion, with more than half of that loss in bank-related paper.

The shift in the paper market was also hastened when the Penn Central Co. filed for bankruptcy (June 1970) with \$82 million of outstanding commercial paper on its books. However, the Federal Reserve's subsequent remedial actions helped to diminish the loss of confidence in the market. The aftermath was an exodus of less-creditworthy firms from the market and a general rise in the quality of commercial paper. For some time after the Penn Central debacle, borrowers paid down substantial amounts of paper and instead relied heavily on the securities markets for new funds.

Different role in '73

This year has been different from earlier periods of rapid credit expansion and high interest rates. In 1973, Regulation Q ceilings have not inhibited the role of banks as inter-

mediaries in the credit process. Ceilings on short-term CDs (less than 90 days) were lifted during the mid-1970 crisis, and ceilings on all maturities were then removed this May. Banks consequently obtained greater flexibility in managing the maturity structure of their liabilities, as well as greater capacity for raising funds to respond to 1973's phenomenal loan demand.

Without Reg Q ceilings to constrict the flow of bank credit, there was no reason for borrowers to shift from the banks to the commercial-paper market. Indeed, credit flows shifted the other way; bank-loan rate guidelines developed by the Committee on Interest and Dividends kept the cost of bank borrowing low in relation to commercial-paper rates, particularly prior to the development of the two-tier prime business-loan rate.

Business firms flocked to the banks and used at least part of their borrowings to pay down substantial amounts of dealer paper. Even the finance companies, who are normally heavy issuers of direct paper, borrowed more from the banks than they did from the market. As was noted at the outset, however, the pendulum may now be swinging back again, in line with the recent sharp drop in money-market rates.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 9/19/73	Change from 9/12/73	Change from year ago	
			Dollar	Percent
Loans adjusted and investments *	75,717	+ 281	+ 11,403	+ 17.73
Loans adjusted—total*	58,885	+ 524	+ 11,699	+ 24.79
Securities loans	2,018	+ 236	+ 745	+ 58.52
Commercial and industrial	20,408	+ 139	+ 3,418	+ 20.12
Real estate	17,387	+ 108	+ 3,078	+ 21.51
Consumer instalment	8,649	+ 28	+ 1,333	+ 18.22
U.S. Treasury securities	5,120	- 101	- 1,007	- 16.44
Other securities	11,712	- 142	+ 711	+ 6.46
Deposits (less cash items)—total*	72,939	- 273	+ 9,294	+ 14.60
Demand deposits adjusted	21,209	- 556	+ 1,078	+ 5.35
U.S. Government deposits	713	+ 268	- 88	- 10.99
Time deposits—total*	49,792	+ 125	+ 8,214	+ 19.76
Savings	17,376	- 4	- 850	- 4.66
Other time I.P.C.	23,517	+ 152	+ 7,262	+ 44.68
State and political subdivisions (Large negotiable CD's)	5,885 12,532	- 26 + 104	+ 765 + 6,833	+ 14.94 + 119.90
Weekly Averages of Daily Figures	Week ended 9/19/73	Week ended 9/12/73	Comparable year-ago period	
Member Bank Reserve Position				
Excess reserves	+ 33	- 9	-	5
Borrowings	86	184		75
Net free (+) / Net borrowed (-)	- 53	- 193		80
Federal Funds—Seven Large Banks				
Interbank Federal funds transactions				
Net purchases (+) / Net sales (-)	- 148	+ 241		+ 312
Transactions: U.S. securities dealers				
Net loans (+) / Net borrowings (-)	+ 668	+ 905		+ 649

*Includes items not shown separately.

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