Research Department
Federal Reserve
Bank of
San Francisco

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Banking Scorecard

Last year was a busy year for the nation's bankers—too busy in some respects, because of the very high interest rates they had to pay for the deposits needed to satisfy a soaring loan demand. Yet most banks experienced record or near-record levels of net income, as record loan rates were collected on the very large increase in loan assets. This year may be somewhat different, however, with a slowdown in the pace of business expansion. One good thing about such a showing is that it may give banks a chance to restore a better balance among both their assets and liabilities; for example, by rebuilding their security portfolios and reducing their dependence on CD money.

Scorecard results

Financial activity moved at a frenzied pace in the first half of 1973, and slowed to a more sustainable pace during the second half as monetary policy became less expansive. In this respect, the Federal Reserve made a number of restrictive moves. The discount rate was raised seven times, from 4½ percent at the beginning of the year to 7½ percent in August. At midyear, reserves on demand deposits were increased ½ percentage point, and marginal reserve requirements were placed on large denomination CD's and certain other liabilities. (A further increase in margin requirements was applied in September, but lowered toward the end of the year.) In May, all rate ceilings on large CD's were suspended, permitting banks to bid competitively for such funds.

In the face of restrictive policy moves and record high levels of loan rates, commercial-bank credit expanded $71 billion (12.6 percent) to a year-end total of $630 billion. At that point, commercial bank loans totaled $449 billion and investments totaled $181 billion. Unlike the previous year, the increase was concentrated almost entirely in loans, since security portfolios grew only modestly with a sharp reduction in Treasury security holdings.

The boom in bank lending to business dominated the credit scene; this loan category rose 21 percent over the year, almost twice as fast as in 1972 and four times the 1971 pace. However, business lending exhibited sharp fluctuations over the course of the year. The volume of business loans rose at a 38-percent annual rate in the first quarter, as credit needs were boosted by both the booming domestic economy and the international monetary crisis, and also by a shift of borrowers from the commercial paper market to the banks. Business loan growth later slackened to only a 4½-percent rate in the fourth quarter, partly reflecting the rechanneling of loan demand to the commercial-paper market as bank-lending rates regained their traditional differential over paper rates.

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The bank prime business-loan rate reached 10 percent in September, following 16 separate upward adjustments, and then began to ease off in the fall months. Indeed, short-term rates generally rose in a spectacular fashion, reflecting the overwhelming strength of the economy and the near-record price inflation. The three-month Treasury bill rate jumped over 3½ percentage points to a level of more than 8½ percent in August, but then fluctuated at lower levels during the rest of the year.

Finding funds

A major development last year was the banks' heavy reliance on large negotiable CD's as a source of funds to support the massive loan expansion. The largest increases in CD's occurred early in the spring, and again in mid-summer after the removal of rate ceilings, when aggressive bidding for such funds pushed offering rates to a record 11 percent. The role of CD's in this expansion differed from the situation in the similar 1969 boom, when existing rate ceilings held CD rates below competitive money-market rates, forcing banks to turn to such alternative sources of funds as Eurodollars and commercial paper issued through bank holding companies. In the severely restrictive atmosphere of 1969, CD's declined by $12 billion, whereas in 1973 they rose $19½ billion (43 percent).

The cost of bank funds rose last year in tandem with the soaring rise of money-market rates. As a reflection of the removal of rate ceilings, offering rates on large CD's ranged from a low of 5½ percent to a peak of 11 percent, with the year-end rate hovering around 9⅛ percent. The effective rate on Federal funds (interbank loans of unused balances with the Federal Reserve) followed essentially the same path, although ending the year just below 10 percent. Also, member-bank borrowings from the Fed became more expensive as the discount rate rose from 4½ percent in January to a final level of 7½ percent in August.

Profit margins were reduced early in the year by the limitation on loan rates imposed by the guidelines of the Committee on Interest and Dividends. In the first quarter, the prevailing prime business-loan rate rose only from 6 to 6½ percent, while market rates generally rose a full percentage point or more. This situation helped trigger a strong shift of borrowers from the commercial-paper market to the banks.

However, the situation changed considerably following the CID's development of the two-tier rate system in April. Thereafter, banks had more flexibility for adjusting the rates charged large borrowers, in exchange for continuation of relatively stable rates on loans to small businesses and households. The prime rate thus rose rapidly to a 10-percent peak in late September, and has held close to that level ever since.

Higher loan rates, when applied to the huge increase in loan assets, produced a strong level of earnings for most (but not all) banks. Some large banks with international operations benefitted from the boom conditions overseas, augmented by the favorable earnings impact of the revaluation of major foreign currencies. However, those banks that relied heavily on large CD's and borrowings to finance their expanded assets were not nearly as well off.

Uncharted territory

Bankers, like everybody else, are starting the New Year with many unanswered questions about the course of the economy in 1974. With the continuation of inflation, the general consensus is that inventories will be more costly to finance, creating increased loan demand. Also, with the shortage-imposed need for new business investment, the belief is that financing requirements will expand for both long-term and short-term loans, although some of this demand probably will be met by increased reliance on the capital markets.

Mortgage lending likely will suffer substantially from energy and other shortages, while the pace of consumer lending should lag in response to rising unemployment, rising prices of necessities, and the very heavy debt obligations of many households. As overall loan demand decelerates, however, banks should be able to rebuild their depleted security portfolios.

In view of the expectation of more moderate loan demand, loan rates may move down from their record highs of 1973. The cost of funds for banks also should fall if consumers expand their savings flows in anticipation of a softening economic situation. On the other hand, corporate treasurers may be less able to put money into CD's, partly because of their need for funds for capital-goods purchases, but mostly because of the impact of a sluggish economy on corporate profits.

The slowdown in the economy ironically could benefit banks during 1974, according to most market observers. The slowdown should ease loan demand enough to permit banks to pay lower prices for deposit and other funds. This could mean improved profit positions because of a wider spread between what banks pay for money and what they charge for their funds.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/2/74	Change from 12/26/73	Change from year ago Dollar	Change from year ago Percent
Loans adjusted and investments*	80,049	+ 747	+10,827	+ 15.64
Loans adjusted—total*	61,151	+ 744	+10,477	+ 20.68
Securities loans	1,276	− 109	− 23	− 1.77
Commercial and industrial	21,154	+ 146	+ 3,282	+ 18.36
Real estate	18,297	+ 52	+ 3,195	+ 21.16
Consumer instalment	9,128	+ 32	+ 1,322	+ 16.94
U.S. Treasury securities	6,136	− 173	− 1,106	− 15.27
Other securities	12,762	+ 176	+ 1,456	+ 12.88
Deposits (less cash items)—total*	76,154	+1,134	+ 7,501	+ 10.93
Demand deposits adjusted	22,977	+ 519	+ 1,047	+ 4.77
U.S. Government deposits	1,299	+ 285	+ 122	+ 10.37
Time deposits—total*	50,137	− 216	+ 6,163	+ 14.02
Savings	17,758	+ 201	− 557	− 3.04
Other time I.P.C.	22,435	− 370	+ 5,491	+ 32.41
State and political subdivisions	7,194	− 13	+ 805	+ 12.60
(Large negotiable CD's)	10,525	− 358	+ 3,948	+ 60.03

Weekly Averages of Daily Figures	Week ended 1/2/74	Week ended 12/26/73	Comparable year-ago period
Member Bank Reserve Position			
Excess reserves	31	115	123
Borrowings	217	172	129
Net free (+) / Net borrowed (—)	− 186	− 57	− 6
Federal Funds—Seven Large Banks			
Interbank Federal funds transactions			
Net purchases (+) / Net sales (—)	+1,852	+1,804	+ 179
Transactions: U.S. securities dealers			
Net loans (+) / Net borrowings (—)	+ 348	+ 491	+ 225

*Includes items not shown separately.

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