Research Department
Federal Reserve
Bank of
San Francisco
July 23, 1976

Banking—Still Sluggish

The recovery is now entering its sixth quarter, but bank lending activity still fails to reflect the faster economic pace. In the first half of 1976, banks expanded their total credit—loans and investments—at a 4.9-percent annual rate (seasonally adjusted), but only because of their continued heavy investment in Treasury securities. The loan component rose a modest 1.6 percent—only half the gain in the second half of 1975—despite the type of build-up in business inventories that would normally lead to some increase in business-loan demand. Meanwhile, on the deposit side, banks experienced a record inflow of passbook savings, which permitted a further massive reduction in large-denomination certificates of deposit.

A year ago, banks welcomed this kind of respite, especially after the hectic pace of the 1973-74 period, but now they are showing signs of restiveness. They certainly did not envision a massive and prolonged decline in the key business-loan category when they proclaimed their slower growth objectives back in mid-1974. Yet there is some relationship between the two developments. In order to maintain profit margins as a means of covering high loan-loss reserves and offsetting non-earning assets, banks have been holding a wider spread than usual between loan rates and market interest rates. This pricing policy, in turn, has helped persuade business firms to continue borrowing from the capital and commercial-paper markets, rather than from the banks.

The financial environment early in the year was marked by mixed movements in the major monetary aggregates and generally declining interest rates. Banks lowered their prime business-loan rate twice in January, to 6.75 percent, and kept the rate at that level until late spring in an effort to maintain a favorable net interest differential (the difference between the rate of return on earning assets and the cost of funds to support those assets). In the second quarter, April's rapid acceleration of money-supply growth led to a tightening of Federal Reserve policy, as evidenced by a rapid rise in the Federal-funds rate roughly from 4.75 to 5.50 percent. This triggered a modest run-up in both short- and long-term market rates, as well as a quick two-step increase in the prime rate back to the late-1975 level of 7.25 percent. But around midyear, money growth decelerated and rates stabilized well below the early-recovery levels of third-quarter 1975.

Businesses and other borrowers
The modest bank-loan growth in the first half of this year came about as a substantial expansion in other categories barely offset a sharp $4.3-billion decrease in the business-loan category. Business loans dropped several times as fast as in the preceding half-year and almost as much as in the steep early-1975 recession. Borrowing demands remained very weak at those large banks, in New York City and elsewhere, that lend to national firms which also have access to the commercial-paper and (especially) the capital markets.

(continued on page 2)

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Business firms evidently had little need for bank borrowing, partly because of this increased reliance on financial market sources, but also because of a profits upturn which augmented their internal cash flows. In some cases, firms used the funds obtained from other sources to repay outstanding bank debt. But medium-sized and small-sized firms which normally don't have access to market sources significantly expanded their borrowing at regional banks, particularly towards midyear.

Increased mortgage demand provided the largest boost to bank loan portfolios, with real-estate loans increasing $5.4 billion during the January-June period—exceeding the gain for the entire preceding year. The lending pace quickened in the early part of 1976, but then slowed during the spring period as mortgage rates followed the run-up in other interest rates. The demand was concentrated in the single-family housing market, as multi-family housing has not yet recovered from the oversupply situation which arose several years ago.

Consumer lending fluctuated somewhat in the first half of 1976 following a very strong showing in the latter part of 1975. Activity accelerated in this category during April and May, reflecting in part the heavy demand for autos and other big-ticket consumer items. However, part of the increase in outstandings represented a slowdown in the amount of loan repayments, rather than an increase in credit extensions.

Costs and profits

Banks managed to keep their cost of funds under control, because most of their deposit growth occurred in passbook savings, which carry the lowest interest-rate ceiling (5 percent). These deposits increased about $19 billion in the January-June period, mostly on the basis of a 32-percent annual rate of increase in the first quarter of the year. With this massive inflow, banks were able to run off a record $13 billion in large negotiable CD's, generally their most expensive deposit category. Banks thus accomplished substantial cost benefits through this restructuring of interest-bearing deposits.

Profits remained relatively flat in the first half of 1976, but were lower than in the year-earlier period, when banks benefitted from extremely favorable operating margins. Loan revenues remained depressed due to sluggish business demand, and the picture was complicated by the large amounts placed in the non-earning category and the large amounts set aside for loan losses. Moreover, as loan rates began to decline, the hitherto wide differential between the rate of return on bank assets and the cost of bank funds narrowed significantly. But individual banks recorded widely different profits results. Smaller regional banks—with a captive clientele which cannot easily obtain funds from other sources—and banks with large foreign operations generally continued to outperform their colleagues.

Uncertain outlook
Most observers lately have argued that the resurgence of business-loan demand will come somewhat later than earlier forecast, unless an unexpected upsurge in business activity should suddenly develop. Expansion of bank lending may remain concentrated in the mortgage and consumer categories, just as it has during the past year or so. In the absence of a pickup in the business sector, banks may continue to expand their holdings of securities, possibly lengthening maturities further in order to increase rates of return.

Banks have reduced their reliance on a volatile source of funds, large negotiable CD's, but they can't be as certain as they once were about the stability of the alternative source, passbook savings. Most of these deposit inflows, representing individuals' basic savings, are still quite stable, but a significant portion lately has consisted of highly rate-sensitive large accounts. When market interest rates declined early in the year, many individuals placed their funds in passbook form instead of time certificates, in order to maintain flexibility for reinvestment and avoid early withdrawal penalties. But when market rates rose in late spring, a significant outflow developed, and similar rate movements in the future could trigger similar instability of deposit flows. Moreover, the new savings category—corporate savings deposits—may come to exhibit the same type of fluctuating seasonal pattern already evident in demand balances.

Bank profits may remain under some pressure in coming quarters because of continuing problems with high loan losses and non-earning assets, along with perhaps narrowing spreads between loan rates and rates on borrowed funds. Some large banks which have become heavily dependent on foreign operations also may suffer from loan losses or debt reschedulings occurring in overextended foreign countries. However, after last year's experience with REIT's and other domestic lending problems, most banks are moving to institute better controls over their foreign lending activities.

Meanwhile, with domestic business-loan demand still sluggish, banks may intensify their competition for larger market shares. This competition could include more aggressive bidding for domestic business by large banks that have recently curtailed their foreign-lending operations. Still, in view of their strong desire to maintain profit margins, banks may shy away from reducing loan rates, and may instead rely on such competitive tools as easier non-rate terms of lending.

Ruth Wilson

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/07/76	Change from 6/30/76	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	88,788	− 370	+ 1,681	+ 1.93
Loans (gross, adjusted)—total	67,152	− 340	+ 1,152	+ 1.75
Security loans	1,487	− 51	− 661	− 30.77
Commercial and industrial	22,211	− 297	− 971	− 4.19
Real estate	20,131	+ 4	+ 464	+ 2.36
Consumer instalment	11,242	+ 31	+ 1,267	+ 12.70
U.S. Treasury securities	9,666	+ 10	+ 1,066	+ 12.40
Other securities	11,970	− 40	− 537	− 4.29
Deposits (less cash items)—total*	89,859	− 610	+ 3,745	+ 4.35
Demand deposits (adjusted)	24,913	− 165	+ 818	+ 3.39
U.S. Government deposits	375	− 164	+ 36	+ 10.62
Time deposits—total*	62,661	− 442	+ 2,424	+ 4.02
States and political subdivisions	6,087	− 57	− 457	− 6.98
Savings deposits	26,250	+ 71	+ 5,579	+ 26.99
Other time deposits‡	27,671	− 569	− 1,463	− 5.02
Large negotiable CD's	12,471	− 587	− 3,383	− 21.34

Weekly Averages of Daily Figures	Week ended 7/07/76	Week ended 6/30/76	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	25	83	38
Borrowings	8	10	16
Net free(+)/Net borrowed (−)	+ 17	+ 73	+ 22
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales (−)	− 431	− 548	+ 1,694
Transactions of U.S. security dealers			
Net loans (+)/Net borrowings (−)	+ 180	+ 62	+ 838

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

Editorial comments may be addressed to the editor (William Burke) or to the author. . . .
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