Research Department
Federal Reserve
Bank of
San Francisco

March 25, 1977

Business & Financial Letter

Conservative Banking

Much has been said about the turn of events that led the economy swiftly through the phases of expansion, inflation, and recession from 1970 to 1975. Much has also been said about the cautious expansion since 1975—a period in which corporations and individuals, motivated by memories of the earlier 1970s, have opted for more conservative spending and investment patterns. For example, industrial corporations have been reluctant to finance inventories and capital expenditures, while attempting to build up liquid assets and to restructure their debt and equity. Such reactions have been spurred largely by fears of recurring economic and financial calamities that until the 1970s were generally thought to be relics of the past.

For commercial bankers as for others, the 1970s have seen three distinct phases: the period of economic expansion and surging inflation from the fourth quarter of 1970 through the second quarter of 1974, the period of declining inventory demand and sharp recession from the third quarter of 1974 through the first quarter of 1975, and the subsequent (and still continuing) period of expansion. The first and third of these periods are especially interesting, because they represent a contrast between aggressive bank expansion (the first phase) and conservative management (the more recent period).

Aggressive expansion

The first of these periods was one of unprecedented bank growth, as banks found many opportunities for lending at attractive rates. Total commercial-bank credit (net loans plus investments) increased at an extraordinarily rapid average annual rate of 13.1 percent, outpacing even the 10.2-percent growth rate of nominal GNP. The boom in consumer-durables spending and residential construction brought about a commensurate demand for consumer credit and mortgages early in the period. Business demand for short-term credit then soared as plant-equipment and inventory investment gained increasing momentum.

In retrospect, it is difficult to understand why banks were so willing during this period to incur such heavy risks in lending and investing. The answer lies largely in the difference between risk perceived before the fact and that actually observed after the fact. As late as mid-1974, most economic forecasts simply missed the impending sharp drop in economic activity. Forecasters generally expected only a modest decline in the economy, and since early 1973 they had expected a gradual subsiding of the inflation rate. Thus, at the time that these loans were made, their apparent risk did not seem unduly great in relation to their high yields.

Recession . . . and conservatism

The sharp economic decline from late 1974 to early 1975 can properly be termed a "surprise"—although after the fact we might find any number of reasons why it should not have been. The onslaught of the most severe recession since the Great Depression, the continuation

(continued on page 2)

Research Department
Federal Reserve
Bank of
San Francisco

of substantial inflation, and the increase in actual and expected defaults shook the business community. Although expectations of inflation risk had been rising throughout the early 1970s, the deep decline in output in late 1974 brought a heightened awareness of substantial business-cycle risk as well.

In light of the 1974-75 recession, expectations increasingly focused on the destabilizing effects of earlier external shocks (such as the oil embargo, quadrupled oil prices, and crop shortages), instability of government policies (such as "stop-go" monetary and fiscal policies, price and wage controls, and sharp devaluations of the dollar), and instability in patterns of economic and financial activity. Risk suddenly seemed much greater than it had been for decades.

Under pressure from equity holders—as evidenced by declining bank-stock prices—and from the regulatory authorities, banks soon adopted a more conservative posture toward growth and toward the risks they were willing to accept. As a result, bank credit has grown only modestly in the recent economic expansion, rising at a 6.3-percent annual rate between the first quarter of 1975 and the final quarter of 1976 (compared with nominal GNP growth of 11.3 percent).

Slow growth may be partly due to slack domestic-loan demand, as corporations have attempted to reduce short-term debt. But it is also the result of bankers' efforts to follow more conservative policies. For much of this period, banks have maintained an especially wide differential (spread) between their prime business-loan rate and their offering rate on large certificates of deposit. In addition, much of their credit increase has been in purchases of Treasury securities. Despite certain signs of increased aggressiveness, such as greater foreign lending and an extended maturity structure of Treasury securities, their posture generally has been quite conservative. Banks have shown this new conservatism, for example, by reducing reliance on purchased funds, by rebuilding asset liquidity, by restructuring loans, and by attempting to market greater amounts of capital.

Aggregate bank ratios

How have bank portfolio ratios been affected by the recent conservatism? According to Federal Reserve flow-of-funds accounts, there has been a clear reversal of established post-WWII trends. By the end of 1976, U.S. Treasury securities constituted 11.7 percent of commercial bank assets—a sizable increase from the 6.9-percent figure of mid-1974. Yet despite that turnaround in the Treasury security/asset ratio, the late-1976 ratio failed to approach the 1960 figure of 26 percent or the 1952 figure of 38 percent, but instead simply represented a return to the level of early 1972.

The loan/asset ratio tells a similar story. This ratio reached a post-war peak of 65.2 percent in mid-1974 and since has declined to 61.5 percent, roughly in line with the level maintained throughout most of the 1966-72 period. In contrast, the ratio was 53 percent in 1960 and 38 percent in 1952.

The structure of liabilities also shows a reversal in trend, with banks conservatively reducing their reliance on purchased funds. Measured as a percentage of assets, purchased funds—large CDs, net Federal funds, Eurodollar purchases, and loans sold to holding companies—peaked in the third quarter of 1974 at 16.0 percent. (The figure had been roughly zero prior to 1961). By the end of 1976, banks managed to reduce the ratio to 12.7 percent, about where it had been in mid-1973. The ratio of capital to assets, which had declined steadily from 9.5 percent in 1961 to a low of 8.1 percent in mid-1974, then recovered strongly to 8.7 percent by the end of 1976, approximately the figure maintained from 1968 through 1971.

The future

What do these figures tell us? First, the recent conservative direction of banking has reversed established postwar trends in the aggregate bank balance sheet, restoring a situation that existed roughly at the start of the expansion in the early 1970s. The shift has *not* taken the bank sector back to the more conservative asset and liability structures of earlier postwar years. But then, those structures may be largely outdated, partly because of the higher level of FDIC insurance and Federal Reserve efforts to prevent or lessen the impact of bank failures.

Second, the new conservatism could be reversed if bank-loan demand accelerates and banks become more bullish in an atmosphere of renewed economic growth. Already there are rumblings that large banks are "awash with liquidity" and are nervously awaiting (and making anticipatory commitments for) a pickup in domestic-loan demand. Conceivably, such a development could lead, as in the early 1970s, to a narrowed differential between bank borrowing and lending rates, rapid increases in purchased funds and in loans, and declines in bank capital ratios. Whether that will actually happen will depend largely upon supervisory pressures to maintain capital ratios and upon bankers' willingness to take risk, which in turn will depend in part on their forecasts of risks and returns. Presumably, they will retain some painful memories of the mid-1970s, but it remains to be seen how much attention they will pay to those memories if the current economic expansion continues without an inflationary upheaval. The stage is set for another bank boom, but whether it will look like the 1970-74 boom will depend largely upon bank policies.

Jack Beebe

Research Department
Federal Reserve
Bank of
San Francisco

Alaska • Arizona • California • Hawaii
Idaho • Nevada • Oregon • Utah • Washington

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 3/09/77	Change from 3/02/77	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	93,269	+ 616	+ 5,541	+ 6.32
Loans (gross, adjusted)—total	71,388	+ 372	+ 5,363	+ 8.12
Security loans	1,506	– 11	– 560	– 27.11
Commercial and industrial	23,321	+ 57	+ 393	+ 1.71
Real estate	22,040	+ 51	+ 2,468	+ 12.61
Consumer instalment	12,392	+ 5	+ 1,611	+ 14.94
U.S. Treasury securities	8,985	+ 227	+ 126	+ 1.42
Other securities	12,896	+ 17	+ 52	+ 0.40
Deposits (less cash items)—total*	92,694	+ 731	+ 4,898	+ 5.58
Demand deposits (adjusted)	26,726	+ 747	+ 2,200	+ 8.97
U.S. Government deposits	266	0	– 99	– 27.12
Time deposits—total*	64,255	+ 136	+ 2,782	+ 4.53
States and political subdivisions	5,495	– 166	– 913	– 14.25
Savings deposits	31,337	+ 137	+ 6,286	+ 25.09
Other time deposits‡	25,446	+ 129	– 2,029	– 7.38
Large negotiable CD's	8,829	+ 64	– 3,413	– 27.88

Weekly Averages of Daily Figures	Week ended 3/09/77	Week ended 3/02/77	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	+ 83	– 9	+ 9
Borrowings	1	2	0
Net free(+)/Net borrowed (–)	+ 82	– 11	+ 9
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales (–)	+ 140	+ 302	+ 1,352
Transactions with U.S. security dealers			
Net loans (+)/Net borrowings (–)	+ 108	+ 68	+ 547

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

Editorial comments may be addressed to the editor (William Burke) or to the author. . . . Information on this and other publications can be obtained by calling or writing the Public Information Section, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 544-2184.