Changing Picture?

At first glance, the banking environment in January-June 1977 might seem to resemble the situation in the comparable period of 1976. There was the same early-year stability in interest rates and the same early-spring upsurge in the money supply, followed by (just as last year) a modest tightening of monetary policy and run-up in short-term interest rates. But there were substantial differences as well. In particular, bank credit expanded at a 10½-percent annual rate ($41 billion) during the January-June period—faster than in either half of 1976.

Bank lending was the dominant element in this credit expansion, reflecting both the more robust health of the economy and the improvement in bank liquidity obtained after two years' heavy investment in securities. Meanwhile, on the deposit side, savings flows decelerated somewhat yet still added a substantial $24 billion to banks' sources of funds. Banks generally reported higher earnings, because of a higher volume of loans and a generally favorable spread between the rates they received on their assets and the rates they had to pay for funds.

Business lending mixed

Business lending, after beginning to recover during the second half of 1976, increased further—at a 10-percent annual rate—in the first half of this year. But again, there was little activity at the big money-center banks, especially the New York banks, which are oriented toward large corporate borrowers. Despite a flurry of bank borrowing in the first half of June, large firms continued to rely on the capital market for longer-term financing and on the commercial-paper market for short-term credit needs, reflecting in the latter case the wide rate differential between the banks' prime rate and the commercial-paper rate. For that matter, corporations needed relatively little short-term financing because of their strong earnings, greatly improved liquidity and modest capital-spending plans.

The business-lending pace was much stronger at two other types of banks—the small regional banks and the large money-center banks outside New York. Those banks benefited from the substantial demands of small and "middle market" firms for inventories, receivables and capital equipment, because of an expanding economy and a relative lack of borrowing alternatives for such firms elsewhere. Many of these firms, unlike large national corporations, have little or no access to the capital or commercial-paper markets. Hence, they depend for their funds upon the banks—including the large Western branch-banking systems, which for years have maintained strong customer relationships with many such firms.

(continued on page 2)
Mortgage, consumer loans soar
Bank mortgage lending continued
to outperform business lending,
with a 14-percent annual rate of
increase during the first half of
1977. This situation reflected both
the single-family housing boom
and the increased aggressiveness of
banks with extra money to lend
because of the lack of demand from
their large corporate customers. In
some areas of the country, especial­
ly California, the imbalance be­
tween a backlog in housing de­
mand and limited new supplies led
to escalating prices, higher mort­
gage rates, and intensive specula­
tive activity. However, a rising vol­
ume of residential construction is
now improving the supply situation
and helping to stabilize the mort­
gage market. In addition,
mortgage-lending institutions have
begun to defuse the speculative
boom by restricting mortgages to
owner-occupants or imposing
higher rates and stringent borrow­
ning conditions on non-occupant
borrowers.

The late-winter speed-up in con­
sumer spending sparked an up­
surge in bank instalment lending
this spring. Auto financing ac­
counted for most of the gain, but
other important factors included a
rise in home-improvement loans
and, in May, an increase in credit­
card activity. An interesting new
wrinkle in consumer financing
meanwhile developed in the form
of the home-equity loan—a mort­
gage loan offered by many West
Coast banks for consumer pur­
poses. This type of loan permitted
many home owners to take advan­
tage of the inflation-boosted rise in
their home values to finance house­
hold purchases on advantageous
terms. Being collateralized by a
junior lien on the borrower’s prop­
erty, the home-equity loan allowed
consumers to borrow larger
amounts for longer time periods,
and at significantly lower rates, than
they could under regular instal­
ment loans.

Pricing and income
The price of money rose during the
spring months, but the sharp rise
which many money-market analysts
had anticipated failed to material­
ize. Most of the action took place
between mid-April and late May,
when the key Federal-funds rate—
the rate paid on overnight loans of
unused reserves—rose from about
4.70 percent to 5.45 percent, re­
flecting the Federal Reserve’s pres­
sure on bank reserves in response
to April’s upsurge in the money
supply. Banks thereupon raised
their prime rate, but by a lesser
amount and with some lag, because
of the continued weakness of
business-loan demand. The rise in
the prime—from 6.25 percent to
6.75 percent—took place in two
steps, but several banks subse­
quently rescinded the second of
those increases and lowered their
prime to 6.50 percent.

While banks paid more for what
they borrowed in the Fed-funds
market, they were able to obtain
funds at the Federal Reserve dis­
count window at the unchanged
rate of 5.25 percent, and this factor
helped account for a heavier vol­
ume of borrowing at the window.
Meanwhile, interest costs for de­
posit liabilities remained relatively
low, reflecting the high proportion
of funds held in the form of savings deposits. However, the composition of deposits began to shift during this period. The second-quarter gain in savings deposits was only one-fourth the size of the first-quarter increase, while the inflow of funds into higher-priced time certificates accelerated.

On balance, many banks were able to benefit from a widening spread between the rates they earned on their funds and the rates they paid for those funds. Still, their income reports apparently benefited even more from the expanded loan volume in those categories bearing high rates of return. In addition, banks continued to recover from the impairment they suffered in the mid-1970's, as they were able to reduce the amounts set aside for loan losses, and also to reduce the charges against income required because of actual loan losses and nonperforming loans (including those that were renegotiated as well as those not accruing interest).

Regional banks generally reported better income gains than large money-center banks, reflecting the briskness of their mortgage and consumer lending as well as the strength of demand from their small and medium-sized business customers. Some large banks, suffering from weak business-loan demand at home, continued to obtain a larger share of income from overseas operations.

Tempered optimism
The uncertainties that surfaced during the first half of 1977 are likely to be evident in the second half of the year as well. Many analysts expect higher money-market rates as the year continues, if only because of a higher level of business activity and borrowing demands. Those borrowing pressures will grow as the Treasury shifts from being a net repayer of debt in the second quarter to a large net borrower in the present quarter, and also as Federal housing agencies continue their activity in the market. In this shifting environment, banks could suffer a reduction in the spread between what they earn and what they pay for funds. In line with past experience, their prime rate may not rise as rapidly as most money-market rates, and meanwhile, their cost of funds might increase with a continuation of the recent slowdown in that relatively low-cost source of funds, savings deposits.

If large corporations continue to be modest borrowers, the recent sharp competition in all categories of business lending would probably intensify. This situation could lead to a further erosion in business-loan pricing and lending terms, including reduced compensating balances and fee requirements, fixed rather than floating loan rates, and narrower rate spreads above the prime for non-prime borrowers. Much of the slack could be filled by the continued strength of mortgage and consumer borrowing, although perhaps not at the booming pace of the first half of the year. Yet overall, banks with their ample liquidity are well able to accommodate increased credit demands, as they continue to search for new financing outlets and to create innovative lending programs.

Ruth Wilson
BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT  

(Dollar amounts in millions)

<table>
<thead>
<tr>
<th>Selected Assets and Liabilities</th>
<th>Amount Outstanding</th>
<th>Change from 6/29/77</th>
<th>Change from year ago</th>
<th>Dollar</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans (gross, adjusted) and investments*</td>
<td>98,656</td>
<td>+ 36</td>
<td>+ 9,514</td>
<td>+ 10.67</td>
<td></td>
</tr>
<tr>
<td>Loans (gross, adjusted)—total</td>
<td>75,866</td>
<td>+ 360</td>
<td>+ 8,476</td>
<td>+ 12.58</td>
<td></td>
</tr>
<tr>
<td>Security loans</td>
<td>2,419</td>
<td>+ 303</td>
<td>+ 966</td>
<td>+ 66.48</td>
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</tr>
<tr>
<td>Commercial and Industrial</td>
<td>23,697</td>
<td>- 67</td>
<td>+ 1,617</td>
<td>- 7.32</td>
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</tr>
<tr>
<td>Real estate</td>
<td>24,201</td>
<td>+ 154</td>
<td>+ 3,835</td>
<td>+ 18.83</td>
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</tr>
<tr>
<td>Consumer Instalment</td>
<td>12,908</td>
<td>+ 16</td>
<td>+ 1,750</td>
<td>+ 13.56</td>
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<tr>
<td>U.S. Treasury securities</td>
<td>9,128</td>
<td>- 526</td>
<td>- 562</td>
<td>- 5.80</td>
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<tr>
<td>Other securities</td>
<td>13,652</td>
<td>+ 204</td>
<td>+ 1,600</td>
<td>+ 13.26</td>
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</tr>
<tr>
<td>Deposits (less cash items)—total*</td>
<td>97,888</td>
<td>+ 1,776</td>
<td>+ 7,690</td>
<td>+ 8.53</td>
<td></td>
</tr>
<tr>
<td>Demand deposits (adjusted)</td>
<td>27,971</td>
<td>+ 698</td>
<td>+ 2,936</td>
<td>+ 11.73</td>
<td></td>
</tr>
<tr>
<td>U.S. Government deposits</td>
<td>525</td>
<td>+ 302</td>
<td>+ 153</td>
<td>+ 41.13</td>
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</tr>
<tr>
<td>Time deposits—total*</td>
<td>67,692</td>
<td>- 128</td>
<td>+ 4,211</td>
<td>+ 6.70</td>
<td></td>
</tr>
<tr>
<td>States and political subdivisions</td>
<td>5,703</td>
<td>+ 234</td>
<td>- 435</td>
<td>- 7.09</td>
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<tr>
<td>Savings deposits</td>
<td>31,913</td>
<td>+ 110</td>
<td>+ 5,568</td>
<td>+ 21.13</td>
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<td>Other time deposits</td>
<td>27,311</td>
<td>- 424</td>
<td>- 436</td>
<td>- 1.57</td>
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<tr>
<td>Large negotiable CD's</td>
<td>10,383</td>
<td>- 416</td>
<td>- 2,110</td>
<td>- 16.89</td>
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</tbody>
</table>

Weekly Averages

<table>
<thead>
<tr>
<th>Member Bank Reserve Position</th>
<th>Week ended 7/6/77</th>
<th>Week ended 6/29/77</th>
<th>Change from year ago</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excess Reserves (+)/Deficiency (-)</td>
<td>+ 32</td>
<td>- 54</td>
<td>+ 26</td>
</tr>
<tr>
<td>Borrowings</td>
<td>1</td>
<td>4</td>
<td>8</td>
</tr>
<tr>
<td>Net free(+) / Net borrowed (-)</td>
<td>+ 31</td>
<td>- 58</td>
<td>+ 20</td>
</tr>
<tr>
<td>Federal Funds—Seven Large Banks</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interbank Federal fund transactions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net purchases (+)/Net sales (-)</td>
<td>- 725</td>
<td>- 1,302</td>
<td>- 431</td>
</tr>
<tr>
<td>Transactions with U.S. security dealers</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net loans (+)/Net borrowings (-)</td>
<td>+ 19</td>
<td>- 402</td>
<td>+ 180</td>
</tr>
</tbody>
</table>

*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 7762, San Francisco 94110. Phone (415) 544-3184.