Research Department
Federal Reserve
Bank of
San Francisco

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FRBSF Weekly Letter

Successful Year

Last year's rapid changes in financial markets and increasingly restrictive monetary actions did not prevent the nation's commercial banks from having a prosperous year. A robust 11-percent gain in bank credit provided strong financial support for an aging, but still viable, economic expansion. Loans accounted for almost the entire $96-billion increase in bank credit, as mortgage and consumer lending continued at near-record volume and as business-loan demand became more broadly based to include large corporations. Banks again reduced their holdings of U.S. Treasury securities, but offset this decline somewhat by adding Federal Agency and municipal securities to their portfolios.

In 1978's environment of skyrocketing interest rates, banks were relatively successful in maintaining favorable spreads between their return on assets and their cost of funds. However, the adoption of several new deposit innovations built in a higher future cost structure. Money-center banks improved their profit performance significantly, and regional banks continued to achieve exceptionally high earnings.

Other suppliers of funds also increased their volume of activity during 1978. Total funds raised in financial markets reached $458 billion (annual rate) in the first three quarters of the year — roughly 15 percent ahead of the 1977 pace. Net Treasury borrowings fell significantly below previous years, due to both an increase in government receipts and a short-fall in expenditures. Furthermore, heavy foreign investment in Treasury issues reduced the share of the deficit which had to be financed by domestic markets. In contrast, net offerings by Federally sponsored agencies tripled over their 1977 levels, reflecting heavy borrowing by housing-related agencies. Municipal-bond financing also exceeded the previous record set in 1977. Corporations were less active in the capital markets than they had been during the earlier stages of the expansion, but they again relied heavily on the commercial-paper market for funds. Consequently, banks failed to win back all of the ground which they had lost earlier to these other competitors for corporate business.

Escalating rates

Credit became increasingly costly as interest rates soared to record or near-record levels, reflecting tighter policy measures in the midst of growing market pressures, along with the effects of inflationary expectations. The Federal Reserve raised the discount rate — the rate charged by Federal Reserve Banks on member-bank borrowings — in a series of five steps between January and October, from 6 to 8½ percent, and then boosted the rate to a record 9½ percent on November 1. At the same time, the Fed imposed a 2-percent supplemental requirement on all large time deposits of $100,000 and over (including negotiable CD's) and on certain other bank sources of funds.

Short-term interest rates rose by more than 3½ percentage points during the course of the year, with the sharpest increase occurring after the Federal Reserve's November 1 credit-tightening moves. Treasury bill yields

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rose at a somewhat slower pace because of heavy foreign purchases. But rates on commercial paper, large CD's and Federal funds climbed steeply to levels not far below the record highs experienced in mid-1974. Banks attempted to maintain their profit margins by raising the prime rate for their top-rated corporate borrowers 15 times during the year, to a near-record 11¾ percent — up four full percentage points from a year earlier.

Strong loan demand

Tightening monetary actions moderated bank-credit expansion in the fourth quarter, but total loans still rose a record $91 billion for the year. A $27-billion increase in business loans was noteworthy because many large corporations returned to the banks for some of their borrowing needs. As a consequence, money-center banks recorded far more substantial gains than they did in 1977, when business borrowing was largely confined to the regional banks patronized by smaller firms with few alternative credit options.

Nonetheless, the consumer sector again accounted for the major part of the total loan increase. Real-estate loans rose 19 percent, reflecting the seemingly insatiable demand for residential property, both as a place to live and as an inflation hedge. Consumer instalment loans also escalated further, particularly for auto loans, credit-card debt and home-equity borrowing.

More costly deposits

During the first three quarters of 1978, increases in both demand and time deposits supplied funds for the strong bank-loan expansion, but these sources dwindled late in the year. Roughly two-fifths of the increase in time and savings deposits occurred in the form of large ($100,000 and over) negotiable time certificates.

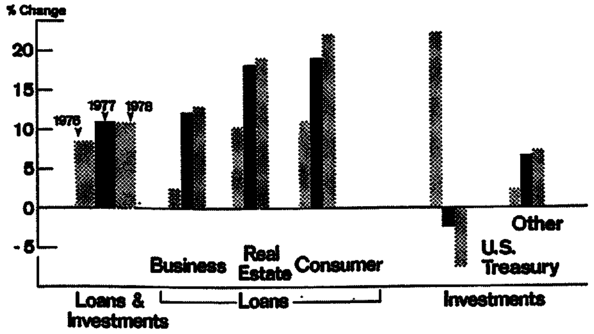
Following Federal Reserve approval, banks introduced in mid-1978 a noteworthy deposit innovation — money-market certificates tied to the 26-week Treasury bill rate. The availability of these certificates enhanced banks' ability to retain funds which otherwise might have been lost through disintermediation into market instruments. In November, banks began to offer automatic transfers from savings accounts, and this innovation also helped banks retain their deposits.

High profits

According to preliminary data, bank profits reached a new peak in 1978. The large increase in earning assets, heavily weighted toward mortgage and consumer loans, boosted income from interest payments. Banks generally maintained a profitable spread between their return on loans and their cost of funds, by making quick adjustments in loan rates whenever money-market rates increased. This was particularly true in the latter part of the year. Net income also improved, according to preliminary data, as banks experienced proportionately fewer loan losses. Earnings from foreign operations also apparently increased, as a result of higher loan volume as well as generally profitable foreign-exchange operations.

On the other hand, expenses soared as banks shifted from less costly sources of funds (those subject to deposit-rate ceilings) to more expensive sources acquired

BANK CREDIT - Three Years of Recovery



Source: Federal Reserve Board of Governors

at accelerating money-market rates. Savings deposits increased only modestly in comparison with the previous year's $18-billion increase, partly because many savers transferred their funds during the summer and fall to the new T-bill certificates, which were not subject to rate ceilings. These certificates became a relatively costly source of funds in the latter part of the year, when Treasury-bill and other money-market rates skyrocketed.

Again, as in earlier high-rate periods, banks relied heavily for funds on large CD's, which increased by $22 billion — double the previous year's gain. These funds became even more costly in November, when the 2-percent supplemental reserve requirement became effective. Another late-year cost increase resulted from the implementation of automatic-transfer accounts, which involved heavy start-up costs in addition to the 5-percent interest expense on individual funds that had formerly been held in interest-free checking accounts.

Tempered outlook

Late 1978's restrictive monetary actions already have materially affected the banking outlook for 1979. Bank-asset growth slowed significantly in the fourth quarter from the rapid pace of the last two years. Yet the past year's steep rise in loan rates has provided banks with very attractive loan portfolios — in business loans as well as mortgages and new longer-maturity consumer loans. Since reductions in the prime rate traditionally lag declines in other interest rates, bank spreads should become more favorable once market rates begin to decline.

Bank-loan demand from the business sector could remain relatively strong — at least in the short-run — because of inflation-generated needs and the reluctance of corporations to finance long-term at current rate levels. However, mortgage demand should weaken if home construction declines as expected, Also, consumer instalment borrowing could become less exuberant because of economic uncertainties and higher consumer-debt ratios.

More importantly, banks are are likely to suffer from the high cost of funds which has now been built into their liability structure. The new T-bill certificates, being issued at Treasury bill rates near 1974-peak levels, carry 6-month maturities. Many large negotiable CD's, which are now a major source of new funds, also have extended maturities. Although banks carefully costed-out their plans before offering the new automatic-transfer accounts last November, their earnings could still be affected by this innovation. On the other hand, banks should experience a new flow of funds into cheaper deposit categories if the economy slows down and interest rates decline. But there may be a lag in recovering those deposits lost through disintermediation, because many of these funds are locked into other investment instruments for some periods of time. In addition, banks face increased competition from other financial institutions, not only in the lending area but also in the fight for demand balances and savings and time deposits. On balance, then, banks will not have an easy job matching last year's profit performance in 1979.

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

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 12/27/78	Change from 12/20/78	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	124,347	201	17,523	16.40
Loans (gross, adjusted)—total	101,042	131	18,531	22.46
Security loans	1,776	− 351	− 97	− 5.18
Commercial and industrial	29,064	− 17	3,622	14.24
Real estate	35,324	99	7,969	29.13
Consumer instalment	19,039	128	4,360	29.70
U.S. Treasury securities	8,452	44	− 978	− 10.37
Other securities	14,853	26	− 30	− 0.20
Deposits (less cash items)—total*	117,473	− 215	12,030	11.41
Demand deposits (adjusted)	31,597	− 249	2,167	7.36
U.S. Government deposits	311	− 285	− 411	− 56.93
Time deposits—total*	83,655	− 528	10,554	14.44
States and political subdivisions	7,235	68	567	8.50
Savings deposits	31,422	208	32	0.10
Other time deposits‡	42,548	296	10,535	32.91
Large negotiable CD's	20,646	164	5,750	38.60

Weekly Averages of Daily Figures	Week ended 12/27/78	Week ended 12/20/78	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves(+)/Deficiency (−)	− 11	+ 39	+ 58
Borrowings	− 108	− 13	− 25
Net free(+)/Net borrowed (−)	− 119	+ 26	+ 33
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales(−)	+ 694	+ 721	− 414
Transactions with U.S. security dealers			
Net loans (+)/Net borrowings (−)	+ 369	+ 398	+ 176

*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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