FRBSF Weekly Letter

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Stock Prices of Large Banks

In recent years, we have seen increasing concern about bank earnings, credit risks, and even bank failures. Turbulent economic and financial markets on the one hand and banking deregulation on the other have created what is commonly thought to have been a precarious environment for banks. Since 1982, escalating numbers of failures among thrifts, banks, and government securities dealers seem to have reinforced the fears of many observers.

One way to assess the market's overall evaluation of the developments of recent years is to look at what has happened to the stock prices of the institutions involved. Unfortunately, most of the 20,000-odd banks and thrifts in this country (let alone credit unions, government securities dealers, and so forth) do not issue stocks that are actively traded in public markets. But, as a first pass, we can examine the price behavior of the common stocks of the relatively few institutions whose shares are actively traded on the major stock exchanges.

The analysis in this *Letter* is confined to the stock prices of seventy-seven large bank holding companies, each with year-end 1981 assets of over $1 billion, for the period from July 1972 through March 1985. The evidence presented does not necessarily pertain to small banks, thrifts, or other institutions that normally have portfolios, operations, and markets different from those of the large bank holding companies.

The environment

Many events since the late 1970s have left their impacts on banks. Since 1979, the U.S. economic environment has been characterized by a boom and bust in the domestic energy-producing sector, two economic recessions, prolonged unemployment with lasting differential impacts across sectors and geographic areas, and rising inflation followed by disinflation. U.S. interest rates have remained high, especially relative to the decelerating inflation rate, while the real (inflation-adjusted) trade-weighted value of the U.S. dollar has risen fifty percent since 1980. Disinflation and high interest rates have had a depressing effect not only on domestic markets such as real estate but, in tandem with the strong dollar, have had especially deleterious impacts on U.S. industries that compete in world markets, such as agriculture, mining, timber, and many manufactured goods.

Banks, like many other players in the markets, were surprised by the economic events of the 1980s. Many large banks found themselves saddled with the debts of lesser developed countries (LDCs) at a time when worldwide disinflation, high interest rates, and a strong U.S. dollar boosted these borrowers' debt burdens. Low earnings and high debt servicing costs of U.S. companies in troubled industries also resulted in increased problem loans and defaults. Moreover, some banks and most savings and loans held large positions in fixed-rate mortgages and found their net worth positions suffering under high interest rates. Default rates on real estate loans also increased in some areas of the country.

At a time when the economic and financial environment was full of surprises, deregulation of U.S. banking proceeded at a rapid pace. Beginning with the money market certificate (MMC) in 1978 and proceeding through the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982, deposit rate ceilings were all but eliminated for banks and thrifts. The new environment increased the scope for both price and product competition in banking markets. Removal of deposit rate ceilings was the major factor, but other changes were important as well. For example, thrifts were given widely increased powers to compete directly with banks by offering checking accounts, expanding into consumer and commercial lending, and broadening their holding company activities.

It is clear that the period since 1979 brought surprises and rapid change to U.S. banking. In view of the complexity of the developments, it would be virtually impossible to separate out the effect of each factor. In the evidence that follows, the behavior of stock prices portrays the *net* effect of the combination of factors. Contrary to what one might surmise, the stock prices of large bank holding companies have fared well on average since

1979. However, loans to domestic energy firms had severe repercussions for some of the institutions and lending to Latin American LDCs also had a decidedly negative impact on many of the larger holding companies. A few large banks heavily involved in domestic energy lending have actually failed or been required to reorganize.

Evidence for large banks

The chart depicts indices of stock prices for the Standard and Poors (S&P) 500 and for two groups of large bank holding companies (hereafter "banks")—twenty-two with assets over $10 billion at year-end 1981 and fifty-five with assets of $1–10 billion. For the full span of over 12 years, the stock prices of large banks generally kept up with the S&P 500, although there were some periods of notable exception. The indices for bank stocks and the S&P 500 showed significant declines in value during 1974. Moreover, the $1–10 billion banks—often referred to as "regional" banks—suffered considerably larger stock price declines in 1974 and took longer to recover than did the $10+ billion banks, many of which are "money center" banks.

Looking at the early post-1979 period, say through 1982, it is evident that stock prices of large banks were very volatile—first rising into 1981, then declining through mid-1982 but reaching new highs by early 1983. Especially for the $1–10 billion group, the gains from their lows of early 1980 were particularly striking.

The post-1979 period as a whole has been extremely favorable to the stock prices of the $1–10 billion banks. Their compound annual rate of return (excluding dividends) has been over 22 percent, a figure that exceeds the returns of the $10+ billion banks and the S&P 500 by a wide margin. The continued strong stock returns within the $1–10 billion group since early 1983 suggest that the deregulation of consumer deposits at that time (particularly the money market deposit account, or MMDA, introduced in December 1982) may have been instrumental in raising the market's assessments of those banks.

When the MMDA was first introduced, regional banks that did not have access to the prime national CD market maintained that the new account would lower their marginal cost of funds. Many of these banks normally had paid well above the national rates for large CDs, holding company commercial paper, and other wholesale funds. The consumer-oriented MMDA promised to attract funds at a substantially lower rate. In contrast, the $10+ billion money center banks would be helped by the MMDA, but not as much as the regional banks would be since the money center banks already had access to wholesale funds at favorable rates.

Especially since early 1983, the price performance of the group of $10+ billion banks has differed widely from that of the $1–10 billion group. From April 1983 to March 1985, the average stock price in the group of $10+ billion banks did not change much, while the average stock price in the $1–10 billion group rose by 41 percent.

The lackluster stock performance of the $10+ billion banks well after early 1983 at the same time that the other group had excellent stock performance suggests that there were some important factors distinguishing the two groups besides the differential effect of deregulation. One possible factor is that LDC loan exposures of the largest banks may have affected their stock prices adversely. Such loan exposures are concentrated predominantly within the group of $10+ billion banks.

Statistical analysis performed across individual banks within the $10+ billion group indicates that LDC debt exposures had a large negative impact. However, banks with the worst stock price performance also were laden with problem loans in the domestic energy-producing sector. After the individual $10+ billion banks with massive energy-loan losses were removed from the $10+ billion bank group, statistical analysis applied across the remaining 20 banks in the group suggests that loan exposures to the Latin American countries of Argentina, Brazil, Mexico, and Venezuela explain the wide discrepancy in the stock price performances of the two bank groups. (See this Bank's *Economic Review*, Winter 1985, for a detailed analysis.)

It is not surprising that both energy loans and LDC debt were important factors, and that energy loans seemed to be the predominant factor affecting a few of the largest banks that were major energy lenders. Energy loans resulted in a rash of actual defaults and chargeoffs which were confined to relatively few banks. Indeed, two $10+ billion banks (Seafirst and Continental Illinois, neither of

which is included in the index of twenty-two $10+ billion banks) had to be taken over or re-formed primarily because of domestic energy loan losses. In contrast, the foreign lending problem up to this point has resulted primarily in reschedulings and fears of default. Moreover, since the foreign loan problem affects almost all large banks, the market might expect more government intervention in the event of a crisis than with the energy loan problem.

Conclusion

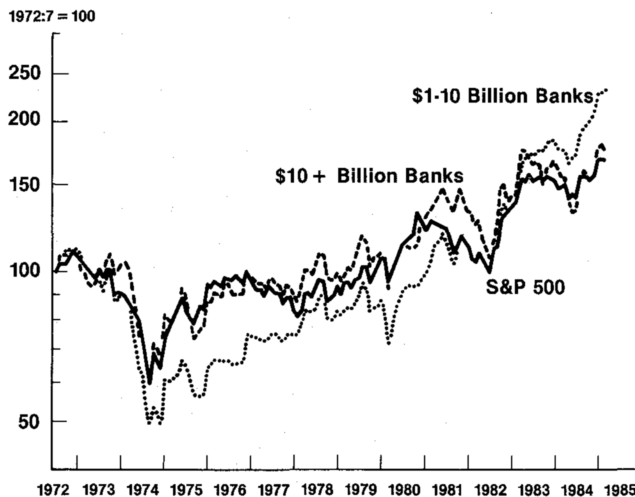
In conclusion, an analysis of the stock price performance of banks with assets over $1 billion, suggests that, at least until 1983, the post-1979 economic and deregulatory environment was not unfavorable on average to these banks and was favorable overall to the regional bank holding companies with assets ranging from $1 billion to $10 billion. However, since early 1983 there has been no gain in the valuation, on average, of equities of the very large bank holding companies, those with assets over $10 billion. The poor performance of the $10+ billion bank holding companies relative to the $1–10 billion bank holding companies seemingly can be explained by the relative impact of consumer deposit deregulation, domestic energy loan losses at a few of the banks, and Latin American debt exposures across a broad array of the largest banks.

A few caveats regarding the analysis of bank stock prices need to be brought out. First, the stock analysis of large bank holding companies should not be extrapolated to small banks, thrifts, or other financial institutions. Second, it is plausible that the public has come to expect greater government protection of banking and this expectation has helped to raise the stock prices of bank holding companies, particularly large ones, since 1979. Certainly the increase in the deposit insurance limit from $40,000 to $100,000 in March of 1980 had a favorable impact on banks and thrifts.

But changes in other forms of government protection are not as easy to pinpoint. For example, until 1984, the FDIC claimed that in the case of failure it would adhere only to a partial payout on deposits over $100,000. But in the case of Continental Illinois, May through about July of 1984, it protected all deposit and even nondeposit liabilities. Subsequently, FDIC officials have talked publicly of reverting to partial payouts. These governmental policy changes have affected bank stock prices in complex ways and their effects are compounded by the market's own assessment of bank stock values independent of government policies.

Jack H. Beebe

Monthly Stock Prices*
July 1972 - March 1985



* Month-end closing price levels calculated from returns, excluding dividends. The bank stock indices are based on equally weighted average returns for the population of all 22 bank holding companies in the $10+ billion size group, excluding Seafirst and Continental Illinois, and a sample of 55 bank holding companies in the $1–10 billion size group. Had Seafirst and Continental Illinois been included in the $10+ billion index, the level of that index in 1985 would have been slightly lower.

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

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 6/26/85	Change from 6/19/85	Change from 6/27/84 Dollar	Percent[7]
Loans, Leases and Investments[1] [2]	191,817	− 62	10,210	5.6
Loans and Leases[1] [6]	173,401	− 364	10,830	6.6
Commercial and Industrial	51,822	− 227	1,546	3.0
Real estate	63,422	103	2,882	4.7
Loans to Individuals	34,542	127	6,161	21.7
Leases	5,380	7	391	7.8
U.S. Treasury and Agency Securities[2]	11,459	278	− 474	− 3.9
Other Securities[2]	6,956	23	− 145	− 2.0
Total Deposits	195,154	−1,907	8,395	4.4
Demand Deposits	45,309	−1,441	1,823	4.1
Demand Deposits Adjusted[3]	29,700	− 862	1,240	4.3
Other Transaction Balances[4]	13,134	− 436	1,306	11.0
Total Non-Transaction Balances[6]	136,710	− 31	5,264	4.0
Money Market Deposit Accounts—Total	44,218	− 11	5,737	14.9
Time Deposits in Amounts of $100,000 or more	38,399	16	− 1,726	− 4.3
Other Liabilities for Borrowed Money[5]	22,389	−1,578	2,541	12.8

Two Week Averages of Daily Figures	Period ended 6/17/85	Period ended 6/03/85
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	76	− 3
Borrowings	11	32
Net free reserves (+)/Net borrowed(−)	65	− 35

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change