Research Department
Federal Reserve
Bank of
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FRBSF Weekly Letter

Roller Coaster

The nation's bankers, like everyone else, have had to contend this year with an unparalleled range of experiences, from speculative boom to steep recession. During the first quarter, they suffered through a soaring inflation and an unprecedented rise in interest rates. During the second quarter, in striking contrast, they experienced a steep decline in interest rates, along with a massive weakening in other economic indicators.

Still, banks generally adapted well to this roller-coaster environment. During the first quarter, banks found the funds to meet overheated credit demands by purchasing nondeposit funds (such as Federal funds, Eurodollars, and securities sold under repurchase agreements), and also by issuing large amounts of time certificates (especially six-month money-market certificates and large negotiable CD's). Banks incurred high costs, however, by acquiring these funds at such record interest rates, and their earnings situation consequently deteriorated. But then, as the second quarter progressed, they were able to run off some of these high-cost liabilities because of declining credit demands and a growing inflow of low-cost demand- and savings-deposit funds. As a result, earnings recovered for many banks as the spring months progressed.

This volatility of earnings illustrates banks' sensitivity to changes in the level of interest rates. Traditionally, banks borrow short-term funds and relend them for somewhat longer periods. However, in so doing, banks assume a risk of loss from rising interest rates because, as liabilities mature, they must be replaced with increasingly expensive liabilities. In recent years, with the growing volatility of interest rates, banks have tried to match the maturities of their assets and liabilities, but frequently with imperfect results. As the first half of 1980 demonstrated, the mismatch hurts earnings when rates rise, but helps earnings when rates fall. In a stable rate environment, then, bank earnings benefit from lower interest-rate risk and are consequently less volatile.

Managing the credit boom

Bank credit expanded rapidly at the outset of the year, with total loans and investments growing at a 15-percent annual rate in January and February. Borrowers turned increasingly to banks to meet inflation-bloated credit demands, which were aggravated by a widespread fear that inflation would not be brought under control without a severe liquidity crunch. Bank-credit demands also grew because of borrowers' inability to obtain funds from the temporarily moribund bond market.

This credit expansion was costly to banks, because of the sluggish growth of "core" deposits (demand and savings deposits), which forced them to rely heavily on high-cost purchased funds. Relatively strong demand-deposit growth during the early part of the year was virtually cancelled by a huge outflow of savings deposits. Disintermediation from savings deposits had been a problem since late 1978, as investors began to switch funds to investments offering higher rates of return. Most of these funds, however, still remained in the banking system. Many depositors moved their funds into money-market certificates (MMC's), and many others shifted into money-market mutual funds, which then invested much of their funds in bank CD's. (CD's comprise roughly half of all money-fund assets.) But the competition for these and other interest-sensitive funds drove interest rates upward, increasing banks' overall cost of funds.

Interest-rate spreads generally narrowed in the early months of the year, as this sharp rise in costs outpaced the rise in yields on bank assets. Most banks carried a substantial portion of their assets in fixed-rate consumer and real-estate loans, which had been placed on

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the books at a time when much lower interest rates prevailed. Also, banks were reluctant to raise the prime rate (and associated rates) as rapidly as market rates rose, partly to retain good corporate customers, and partly to maintain competitive positions against foreign-bank and commercial-paper lenders.

Applying the brakes

The Federal Reserve's tightening efforts in February helped bring about a sharp contraction in money-supply growth, and growing competition for funds—along with the Fed's March 14 credit-restraint program—further increased banks' cost of funds and dramatically reduced their lending pace. (The program limited banks' loan growth to a 6-to-9 percent annual rate, established 15-percent reserve requirements on increases in consumer credit and money-market fund assets, and raised the marginal reserve requirement on large CD's and certain other "managed liabilities" from 8 to 10 percent.) In this situation, banks found it necessary to raise lending rates and cut back lending programs. Still, many banks experienced a continued narrowing of interest margins, and since they could not offset low margins with high lending volume, their earnings continued to suffer.

In March, a deteriorating economy served to reduce overall credit demands, as did also the credit-restraint program, which led consumers to repay outstanding debt. Indeed, by June, each of the major loan categories—business, mortgage, and consumer—was actually declining (see chart). The competition for lendable funds consequently slackened, despite further outflows of core deposits, and interest rates tumbled at a rate that astounded veteran observers.

The second-quarter decline in lending activity was most obvious in the business-loan category, where outstandings declined at an 8.3-percent annual rate as a reflection of the recession-caused drop in loan demand—and also as a reflection of the recovery in the bond market. Corporations that had been unable or unwilling to borrow long-term funds during the period of soaring interest rates rushed to the bond market throughout the spring months, setting new records for new corporate issues. In many cases, they used the proceeds from these issues to repay high-cost, short-term bank loans.

Period of repositioning

Throughout the second quarter, many banks widened the spread between the average yield on their loan portfolios and their marginal cost of funds, in an attempt to repair the earlier damage to their interest margins and earnings. By maintaining high loan rates, they lost lending opportunities to the bond and commercial-paper markets. However, they also gained time to restructure their liabilities. By allowing credit to contract, banks were able to replace some of their maturing liabilities (acquired when rates were high) with much lower-cost funds, thereby improving earnings.

This restructuring process became particularly evident in June. Demand deposits, which had been declining earlier in the quarter, increased substantially in June as the Fed supplied more reserves to the banking system in an attempt to bring money growth back on target. In addition, households switched funds to passbook savings as rates on alternative investments (especially MMC's) declined and investors sought increased liquidity. But despite the expansion of core deposits, banks did not put much effort into expanding credit. Instead, they used the inflow of core deposits to replace high-cost liabilities, such as large CD's, that matured in June.

Interbank comparisons

Wholesale (commercially oriented) banks experienced a more noticeable earnings improvement than retail (consumer oriented) banks between the first and second quarters. The liabilities of wholesale banks are heavily concentrated in short-term, interest-sensitive funds—such as 30- to 90-day CD's and overnight funds—and so they suffered the sharp-

est increase in cost of funds. However, they were able to prevent severe margin deterioration by raising rates on their large portfolios of floating-rate loans. During the second quarter, wholesale banks, with their short average-maturity structure, were the first to benefit from the rapid decline in interest rates. As rates began to fall, they moved quickly, replacing liabilities acquired when rates were high with dramatically lower-cost liabilities. Meanwhile, by lowering their prime rate at a relatively slow pace, they were able to achieve wider-than-average interest margins.

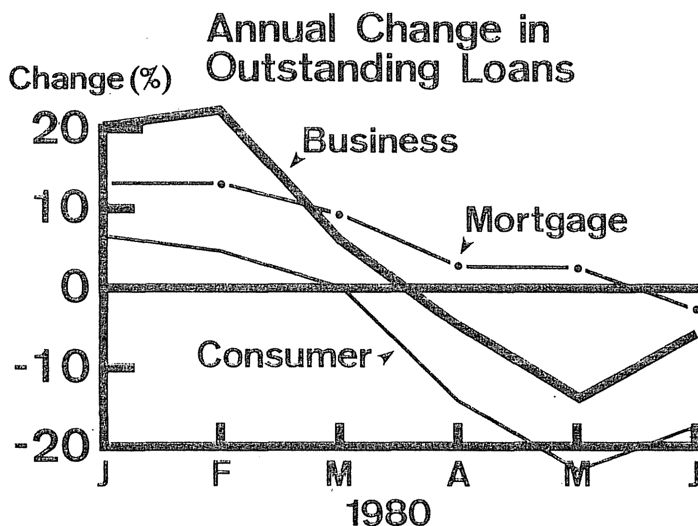
Retail banks, with their substantial core-deposit base, did not experience the extremely rapid rise in average cost of funds experienced by wholesale banks during the first quarter. However, retail banks' margins still deteriorated because, in the face of the sharp rise in MMC rates, their large portfolios of fixed-rate assets prevented them from raising average yields rapidly. Retail banks also recorded a less dramatic improvement during the rate decline of the second quarter, because their liabilities are concentrated in 6-month MMC's and relatively long-term time deposits. This spring's rapid decline in rates will not cause a substantial reduction in their cost of funds until after the high-cost certificates purchased last winter finally mature this fall. On the other hand, their interest margins have already improved somewhat because of a second-quarter inflow of low-cost core deposits.

Improved outlook?

The nation's banks are not likely to repeat their profits performance of 1978 or 1979, but many could still post relatively strong earnings during the remainder of this year. Bank credit may expand somewhat because of the phase-out of the credit-restraint program, but much of this effect will be dissipated because of the continued weakness of economic activity. By the same token, slow credit growth will reduce competition for lendable funds and help stabilize rates on purchased funds at relatively low levels.

In that stable rate environment, banks with relatively high-cost liabilities still on the books should be able to run off those liabilities and improve their interest margins. (The removal of the special reserve requirement on managed liabilities also will help reduce their effective cost of funds.) Overall, earnings should benefit from a relatively stable rate environment and from a wider spread between what banks earn and what they pay for funds.

Barbara Bennett



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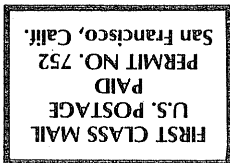

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/9/80	Change from 7/2/80	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	136,640	– 186	7,573	5.9
Loans (gross, adjusted) — total#	115,104	– 274	8,546	8.0
Commercial and industrial	33,310	– 319	1,865	5.9
Real estate	46,555	44	7,748	20.0
Loans to individuals	23,603	– 76	1,188	5.3
Securities loans	1,001	48	– 674	– 40.2
U.S. Treasury securities*	6,276	20	– 1,358	– 17.8
Other securities*	15,260	68	385	2.6
Demand deposits — total#	44,564	– 221	299	0.7
Demand deposits — adjusted	32,139	1,184	– 75	– 0.2
Savings deposits — total	28,576	368	– 2,074	– 6.8
Time deposits — total#	61,615	– 951	11,473	22.9
Individuals, part. & corp.	53,247	– 791	11,662	28.0
(Large negotiable CD's)	22,003	– 580	4,555	26.1

Weekly Averages of Daily Figures	Week ended 7/9/80	Week ended 7/2/80	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	10	– 35	– 4
Borrowings	2	11	281
Net free reserves (+)/Net borrowed(–)	8	– 46	– 285

* Excludes trading account securities.
# Includes items not shown separately.

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