FRBSF Weekly Letter

Number 93-11, March 19, 1993

On the Changing Composition of Bank Portfolios

In recent years, U.S. banks appear to have been eager to invest in government securities but reluctant to lend. In fact, with the recent buildup in government securities holdings, banks now hold more securities than they do business loans. These developments have raised concerns in Congress and elsewhere that U.S. banks have gotten away from their "proper" role of lending to consumers and to small and medium-sized businesses. Critics claim that banks are beginning to look more like mutual funds than lending institutions.

In this *Letter,* I put these recent developments in perspective by looking at the historical behavior of bank portfolio composition. During the past 40 years, bank portfolios have changed dramatically. For example, since the early 1950s, the proportion of bank portfolios allocated to securities has declined significantly, while the proportion invested in mortgage loans has increased. In addition to long-term changes, bank portfolio composition exhibits cyclical behavior. These cyclical changes reflect efforts by bankers to adjust their portfolios to the changing opportunities that arise over the course of the business cycle. The recent behavior of bank portfolio composition reflects long-term structural effects, cyclical adjustments, and more recent changes in the banking environment.

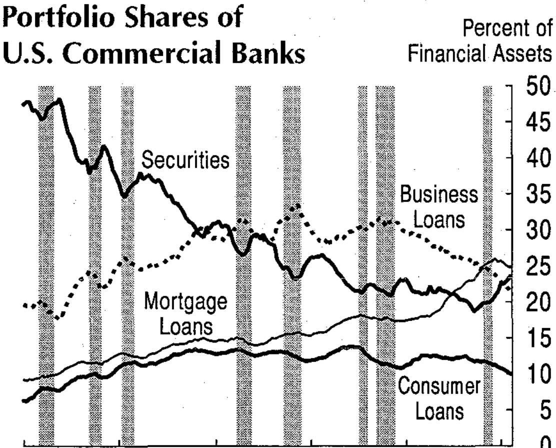
Bank portfolios since the 1990 recession

The National Bureau of Economic Research (NBER) has dated the starting point of the last recession as mid-1990. From that point to the third quarter of 1992, total financial assets of the commercial banking sector increased about 10 percent according to the Flow of Funds data published by the Federal Reserve. During the same period, total loans on the books of the nation's banks rose less than 3 percent, business loans actually fell over 4 percent, and banks' holding of securities increased by over 30 percent. The rapid growth in securities was fueled largely by increased holdings of federal government securities (Treasuries and agency issues, including mortgage-backed securities), which rose almost 50 percent from the second quarter of 1990 to the third quarter of 1992.

Long-term trends in bank portfolios

While these recent portfolio shifts are striking, it is useful to consider them from a longer-term perspective. The figure shows the proportion of total bank financial assets allocated to four major categories for the period from the early 1950s to the early 1990s. The shaded areas represent recessions as determined by NBER.

Portfolio Shares of U.S. Commercial Banks



Source: Flow of Funds Accounts

Several long-term trends are evident in the figure. Perhaps the most obvious feature is the secular decline in the proportion of securities in bank portfolios. In the early 1950s, securities made up almost half of total bank financial assets. By the mid-1970s, this percentage had declined to roughly one-quarter of bank assets. The change in the proportion of securities held by banks actually displays two distinct segments: The first is a rather steep drop from the early 1950s through the early 1970s; the second shows that securities have remained at a roughly constant proportion of bank portfolios since the mid-1970s.

Another development shown in the figure is the rise in the proportion of business loans in bank portfolios from the early 1950s through the mid-1970s. Business loans were less than 20 percent of bank assets in the early 1950s and rose to over 30 percent of assets by the mid-1970s. This rise in business lending coincided with the decline in bank securities holdings. From the 1950s through the mid- to late-1970s, banks engaged in a portfolio substitution away from securities and toward business loans and, to some extent, mortgage loans.

Beginning in the early 1980s, however, the proportion of bank portfolios allocated to business loans declined steadily, and was less than 22 percent of assets by the third quarter of 1992. Contrary to some popular perceptions, the drop in the share of business loans in bank portfolios is not a recent phenomenon but, instead, has gone on for some time. This decline is especially notable because it occurred during the long economic expansion of the 1980s. It reflects the increasingly competitive market for short-term business loans, as banks lost market share to nonbank financial institutions such as finance companies. The 1980s and 1990s also witnessed rapid growth in the markets for commercial paper and other forms of "nonintermediated" debt. A growing number of companies during this time were able to bypass banks and sell debt securities directly to the open market.

Another trend in the figure is the significant and steady rise in mortgage loans held by the banking system throughout the 40-year period. At the end of 1951, mortgages were less than 10 percent of total bank assets. By 1990, these holdings had increased to over 25 percent of bank portfolios, based on Flow of Funds data. The increase in bank mortgage loans exhibits two distinct phases: a gradual rise through the mid-1980s, followed by more rapid growth since then. Among other factors, this growth spurt corresponds to the decline of the savings and loan industry in the late 1980s. Notably, the period of more rapid growth in the portfolio share of mortgage loans also coincides with the period of declining share of business loans. The period since the mid-1980s has largely been one of portfolio substitution for banks away from business loans and toward mortgage loans.

Bank portfolio composition and the business cycle

While several long-term trends are evident from the figure, the data also exhibit distinct cyclical patterns. Most notably, business loans as a proportion of total assets typically decline during recessions (the shaded areas in the figure) and rise during expansions. The converse is true for securities holdings; that is, banks increase securities holdings as a share of assets during recessions and reduce them during expansions.

Looking at the eight postwar business cycles covered in the figure, business loans as a proportion of assets held by banks rose an average of 7 percent in the two years prior to the business cycle peak (the start of a recession) and then fell by 4.5 percent in the two years after the peak. The share of bank assets held as securities, in contrast, fell over 10 percent in the two years before the beginning of a recession and then rose an average of 5 percent in the two years after the onset of a recession. These patterns represent a reasonable response by banks to cyclical influences. Loan growth, especially growth in business loans, declines during and after a recession, as credit demand falls and banks tighten loan standards in the face of higher loan losses. In the absence of abundant lending prospects, banks shift a higher proportion of their assets into securities.

Analysis of recent developments

During the most recent recession, bank portfolios exhibited a cyclical pattern of falling business loans and rising securities holdings. However, compared to earlier business cycles, recent experience is somewhat unusual in that the proportion of business loans fell and the share of securities holdings rose more than in previous episodes. For example, instead of rising in the two years before the business cycle peak, business loans as a percent of assets actually fell 6 percent from mid-1988 to mid-1990. In the two years after the start of the 1990 recession, the business loan share fell by an additional 12 percent, almost three times the postwar average. The proportion of assets held in securities also differed form earlier business cycles, falling by only 3 percent in the two years before the start of the 1990 recession, and then increasing by over 15 percent in the two years after the peak, again roughly three times the historical average.

This behavior suggests that factors in addition to the business cycle are influencing recent bank portfolio allocation decisions. In the case of business loans, the current weakness appears to be, in part, a continuation of a longer-term decline that began in the early 1980s. Banks continue to face strong competition from nonbank sources of credit and from direct debt markets. On top of the declining bank share of the market for business loans, business loan demand during and after the most recent recession was especially weak. Among possible explanations for this unusual weakness in loan demand are a lower than normal economic recovery and a concerted effort by businesses to restructure their balance sheets from the debt overhang of the 1980s. Additionally, changes in the regulatory environment also may have contributed to slow loan growth at the nation's bank. There is evidence that capital standards have become more stringent in recent years and that concerns about bank capital may have exerted a constraining effect on loan growth. It also is possible that loan loss exposures and high problem loan ratios may have made banks more cautious in their lending. It is unclear which of the effects is most important, though it is likely they all have contributed to the particularly steep declines in business loans shown in the figure.

The recent sharp increase in bank securities holdings also appears to be, in part, the result of structural factors. A significant change in bank regulation in the 1980s made the most recent recession different from earlier ones and may have accentuated the cyclical effects. A typical feature of earlier recessions was disintermediation as deposits exited the banking system when market interest rates rose above Regulation Q ceilings. The outflow essentially cut off an important source of funds for bank loan growth. The Reg Q ceilings were abolished in the early 1980s, and the 1990 recession was the first to occur without the associated interest rate restrictions. Notably, the kind of disintermediation that characterized earlier recessions did not occur in the most recent cycle. While banks allowed large CDs to run off, so-called core deposits stayed in the banking system. Faced with extremely weak loan demand, banks may have decided to invest these funds in safe and relatively lucrative government securities.

Will banks become mutual funds?

For the first time in 20 years, banks are allocating more of their asset portfolios to securities holdings than to business loans. While some suggest that this means that banks are getting away from their proper role in the economy, this charge seems premature, especially in light of the longer-term behavior of bank portfolios. Recent portfolio shifts appear to be a response to a combination of cyclical effects and both short- and long-term structural changes in bank markets. Continued portfolio adjustments should be expected in the future as long as the environment in which banks operate continues to evolve.

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Printed on recycled paper with soybean inks.

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The *FRBSF Weekly Letter* appears on an abbreviated schedule in June, July, August, and December.