Bank Liabilities and Credit in the Third Quarter

The third quarter witnessed a strong influx of funds at commercial banks and an accompanying shift within both the liability and asset structures of banks. With fears of a liquidity crisis reaching their peak in the latter part of June, the Board of Governors of the Federal Reserve System had suspended, effective June 24, Regulation Q interest rate ceilings on time deposits of $100,000 or more maturing in 30 to 89 days. This move enabled banks to compete aggressively for funds through massive sales of large negotiable certificates of deposit (CD's). At the same time, consumer time and savings deposits at commercial banks also rose substantially as individuals continued to accumulate liquid financial assets. The strong inflow of time and savings deposits in turn enabled banks to reduce their reliance on nondeposit sources of funds as well as to strengthen their liquidity positions.

The narrowly defined money supply grew moderately during the July-September quarter, according to tentative estimates. Total credit at all commercial banks expanded somewhat more rapidly but, as the quarter progressed and loan demand slackened, a good part of the expansion took the form of additions of large quantities of Government and other securities to banks' portfolios. Savings and loan associations and mutual savings banks continued to enjoy improved deposit flows during the period.

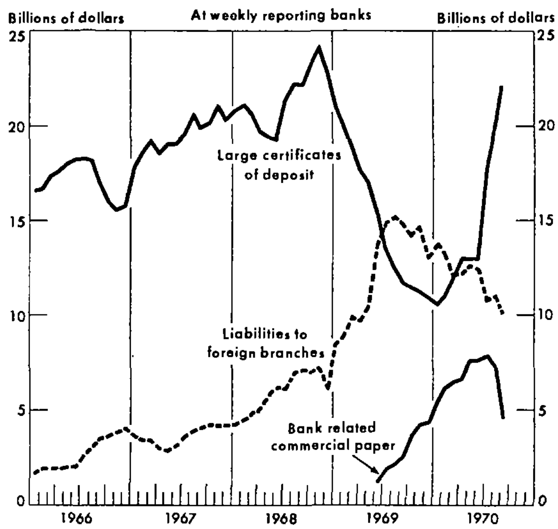
SOURCES OF FUNDS TO THE BANKING SYSTEM

The extremely rapid increase of time and savings deposits channeled a substantial quantity of funds to the nation's banking system. During the third quarter, total time and savings deposits at all commercial banks grew at a seasonally adjusted annual rate of 31.8 percent—a record pace. In contrast, in the third quarter of 1969, when money market rates were well above Regulation Q ceilings, these deposits declined at a rate of 13.3 percent. During the first nine months of 1970, time deposits advanced at a 15.7 percent annual rate as against a 5.3 percent decline for all of 1969.

The suspension of Regulation Q ceilings on large CD's maturing in 30 to 89 days enabled banks to sell these certificates in volume. Weekly reporting bank data, which are not adjusted for seasonal variation, indicate that during the third quarter large CD's outstanding at these banks climbed $9.3 billion. This rise was equal to two thirds of the cumulated runoff in CD's from their December 4, 1968 high to their February 4, 1970 low. At the end of September 1970, CD's outstanding thus totaled $22.2 billion, or only $2.1 billion below the peak of $24.3 billion recorded on December 4, 1968 (see Chart I). Other time deposits—time and savings deposits less large CD's—experienced a similar, though smaller, build[illegible] during the quarter. At weekly reporting banks, these d[illegible]posits increased by about $3.6 billion on a nonseasonally adjusted basis from the end of June to the end of September. By way of comparison, during the same period of 1969, such deposits dropped $2.4 billion, while in the third quarter of 1968 and of 1967, they had shown an average increase of about $1.7 billion.

With sizable inflows of time deposits, commercial banks have been reducing their dependence on the Euro-dollar market as a source of loanable funds. Euro-dollars consist of dollar-denominated deposits in banks outside the United States. Generally, United States banks that have obtained Euro-dollars have done so through borrowing from their foreign branches. Such borrowing began to become a significant source of funds for commercial banks —primarily the large money center banks—in the latter half of 1966 when liabilities to their foreign branches rose from just under $2 billion in June to about $4 billion by the end of the year. These liabilities continued to increase irregularly thereafter, picking up momentum in 1969 when banks turned to Euro-dollars to offset runoffs of CD's as market interest rates surpassed Regulation Q ceilings. In early 1969, liabilities to foreign branches were approximately $8 billion and, by mid-August of that year, totaled more than $15 billion. Borrowings then fluctuated narrowly, reaching their peak of $15.4 billi[illegible]

Chart I
LARGE CERTIFICATES OF DEPOSIT, LIABILITIES TO FOREIGN BRANCHES, AND BANK RELATED COMMERCIAL PAPER*



*Outstanding on the last Wednesday of each month.
Source: Board of Governors of the Federal Reserve System.

in the week ended October 15, 1969.

In the summer of 1969 the Board of Governors of the Federal Reserve System moved to make Euro-dollar borrowings a more expensive source of funds for United States banks. First, in July, the Board revised Regulation D to eliminate a reduction in reserve requirements stemming from the use of "bills payable" checks to repay Euro-dollar borrowings. Then in August 1969, the Board modified Regulations D and M, imposing marginal reserve requirements on bank borrowings of Euro-dollars, on the sale of loans to foreign branches, and on loans made by foreign branches to United States residents. The amendment to Regulation M applied a 10 percent reserve requirement to borrowings and asset acquisitions in excess of a reserve-free base, defined as the average amounts of net borrowings of member banks from their foreign branches and of assets purchased by foreign branches from their head offices in the four-week period ended May 28, 1969. If average amounts fall below the base level for a four-week computation period, the reserve-free base for future periods is reduced by the amount of the shortfall. Similarly, the August amendment to Regulation D provided for a 10 percent reserve requirement on borrowings by member banks from foreign banks when these borrowings exceed a base level.

The amendments to Regulations D and M in 1969 diminished the attractiveness of Euro-dollars and encouraged banks to look for other sources of funds. At first, the banks turned to the sale of bank-related commercial paper as an alternative source and, more recently, the inflow of large CD's and other time deposits has supplied liquidity. As a result, in 1970, domestic banks have gradually reduced their liabilities to foreign branches. These liabilities stood at just under $14 billion early in January and declined to about $11.5 billion by the week ended July 22. Since then the runoff has been more rapid, and by the final week of September liabilities to foreign branches had fallen to slightly under $10 billion. In the past, member banks had been reluctant to permit their Euro-dollar borrowings to fall below their reserve-free base, but recently several major money center banks have allowed their bases to erode.

The inflow of time deposits was, in part, also responsible for the decrease in bank-related commercial paper that occurred in the third quarter. However, much of the decline in bank-related commercial paper in August and September can be attributed to the reserve requirements imposed by the Board of Governors of the Federal Reserve System on funds acquired by banks from the sale of such paper.

Bank-related commercial paper is a short-term unsecured promissory note issued by a bank holding company or nonbank subsidiary. When a bank holding company issues commercial paper, it can use the funds raised to purchase loans or investments from the portfolio of the affiliated bank. As a result, banks are able to obtain additional funds to lend. Loan sales have usually increased concomitantly with the issuance of bank-related commercial paper. Bank holding companies and other bank affiliates began borrowing in the commercial paper market in late 1968. Regulation Q interest rate ceilings largely precluded banks from issuing short-term notes directly during periods of monetary restraint, but bank affiliates were not so restricted. In 1969, commercial paper rates were below those on Euro-dollars or Federal funds for much of the year, and the amount of bank-related commercial paper outstanding grew from about $860 million in early June 1969 (when the System first began to collect comprehensive figures on such paper) to $4.3 billion in December of that year. Bank-related paper continued to grow until it reached $7.8 billion in July 1970.

On August 17 of this year the Board announced the imposition, effective with the reserve-maintenance period beginning October 1, of a 5 percent reserve requirement on all funds raised by member banks through the sale of bank-related commercial paper with a maturity of thirty days or longer and the imposition of Regulation D reserve requirements on demand deposits on bank-related paper of less than thirty days' maturity. At the same time, the Board reduced the member bank reserve requirement on time deposits in excess of $5 million from 6 percent to 5 percent. In effect, these measures placed large CD's and bank-related commercial paper on an essentially equal basis; the special attractiveness of commercial paper as a source of funds to banks was thus largely eliminated.

Since the August 17 announcement, commercial banks have steadily adjusted to the reserve requirement changes. In the seven-week period ended September 30, the volume of bank-related commercial paper outstanding dropped by $3.1 billion, with most of the decline occurring in September. Loans sold to affiliates of large banks displayed similar movement, falling from their peak of about $8 billion in July to $7.8 billion in August and then to $5.0 billion in September.

The money supply, despite wide month-to-month variation, expanded at a seasonally adjusted annual rate of 5.1 percent during the third quarter, according to preliminary estimates. This represented a somewhat faster expansion than the 4.2 percent rate registered in the second quarter and brought growth of the narrowly defined money supply for the first nine months of the year to an annual rate of 4.4 percent. These figures must be regarded as tentative, since the annual revision of the money supply series—incorporating new data culled from various sources including the June call reports for nonmember banks and updated seasonal adjustment factors—is due soon. In the light of the growth of time deposits, the broad money supply—private demand deposits and currency plus time deposits—expanded more strongly, at an 18.4 percent seasonally adjusted annual rate in the July-September period.

Total member bank deposits subject to reserve requirements plus nondeposit liabilities[1]—the so-called adjusted bank credit proxy—rose during the third quarter at a seasonally adjusted annual rate of 17.2 percent. Growth of the adjusted proxy proceeded at rates of 18.1 percent in July and 23.2 percent in August, but tapered off to 9.7 percent in September. The slower growth of the proxy in September was attributable to the decline in nondeposit liabilities and to the slower growth of demand deposits during the month.

BANK CREDIT

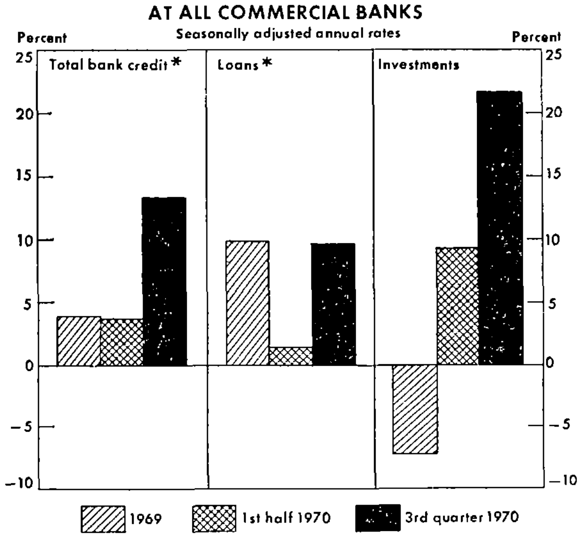
Total credit at all commercial banks advanced strongly during the third quarter at a seasonally adjusted annual rate of 13.4 percent. This is in addition to those loans bought back from bank affiliates whose commercial paper liabilities were run down. The growth was especially rapid during the first two months of the quarter; a rate of increase in excess of 15 percent was registered in both July and August. For the first nine months of 1970 bank credit expanded at an annual rate of 7.1 percent, compared with a rate of only 4.0 percent for all of 1969. (These figures include net sales of loans to affiliates during 1969 and the first half of 1970.)

Investments continued quite strong in the third quarter. Bank holdings of securities increased at an annual rate of 21.7 percent, after advancing at an 18.2 percent pace in the second quarter. Inflows of funds to the banking system, in conjunction with easing loan demand and a desire on the part of banks to rebuild liquidity, contributed to the substantial increase in investment holdings during the July-September quarter. Holdings of United States Gov-

Chart II

CHANGES IN BANK CREDIT AND ITS COMPONENTS AT ALL COMMERCIAL BANKS

Seasonally adjusted annual rates



* Including net sales of loans to affiliates.

Source: Board of Governors of the Federal Reserve System.

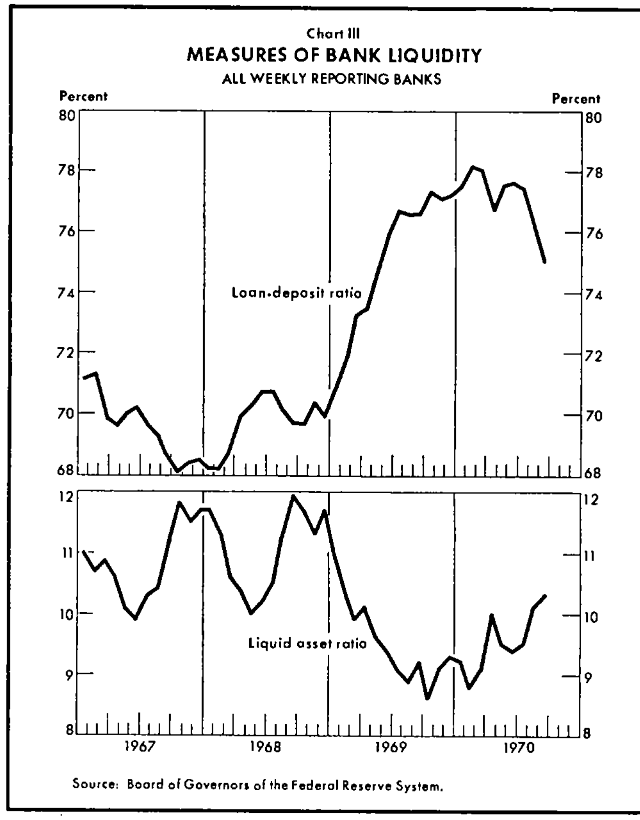
[1] Liabilities to own foreign branches, Euro-dollars borrowed directly from foreign banks or through brokers and dealers, liabilities to own branches in United States territories and possessions, commercial paper issued by bank holding companies or other bank affiliates, and loans or participation in pools of loans sold under repurchase agreement to institutions other than banks and other than banks' own affiliates or subsidiaries.

ernment securities climbed at a 23.7 percent annual rate for the quarter as a whole, with the growth concentrated in the first two months of the period. Banks added United States Governments to their portfolios at annual rates in excess of 30 percent in both July and August, reflecting bank purchases of tax anticipation bills in July and bank participation in the Treasury's refunding and cash offering in August. In September, however, bank holdings of Governments increased at only a 2.1 percent rate. On the other hand, holdings of other securities, primarily obligations of state and local governments, grew at a 31.3 percent rate in September and at a 20.3 percent pace overall in the third quarter.

Total bank loans, aside from those repurchased from affiliates, grew at a seasonally adjusted annual rate of 9.6 percent in the July-September quarter (see Chart II). This was a modest expansion by comparison with the rate at which banks increased their securities holdings during the quarter but nevertheless represented a significant upswing in bank lending, compared with the second quarter when total loans (net of sales to affiliates) declined at a 0.4 percent rate. Total loans grew quite rapidly in July and advanced modestly thereafter in the quarter. The July increase in bank lending primarily reflected the bulge in loans to nonbank financial institutions, as this loan category expanded at an annual rate of 158.1 percent in the month. Pressures in the commercial paper market became severe in late June, following the filing of the petition for reorganization of the Penn Central Transportation Company, and nonbank financial institutions turned to the banking system for financing to replace some maturities of commercial paper. As the quarter progressed, however, the commercial paper market stabilized and, in both August and September, loans to these institutions declined on a seasonally adjusted basis.

Business loans, other than those repurchased from affiliates, advanced at a 2.5 percent rate in the third quarter, a slower pace than the 5.8 percent increase posted in the preceding three months. Moreover, business loans declined in September at a 9.5 percent seasonally adjusted annual rate. Business loan demand during the week of the September corporate tax and dividend dates was smaller than anticipated, and during the following week many large banks lowered their prime lending rate from 8 percent to 7½ percent. On a nonseasonally adjusted basis, business loans at all weekly reporting banks registered a sizable gain during the week ended September 16, but a substantial portion of this increase was accounted for by banks purchasing loans from their affiliates.

Growth of both real estate and consumer loans in the third quarter surpassed their performance of the April-June period. Real estate loans moved up at an annual rate of 2.3 percent after growing at a 1.1 percent pace in the second quarter, and consumer loans expanded at a 6.6 percent rate during the third quarter, a rate about four times as large as the second-quarter advance. Securities loans experienced a large increase at an annual rate of 131.6 percent over the July-September period, when dealers borrowed heavily to finance inventory positions.



Bank liquidity improved during the third quarter, as loan growth failed to keep pace with deposit inflows. At weekly reporting large commercial banks, the expanded loan-deposit ratio—the ratio of loans (other than loans to brokers and dealers) to deposits (less cash items in the process of collection) plus liabilities to foreign branches—declined by about 2.7 percentage points, reaching 74.9 percent in September. The September figure was the lowest the ratio has been since the spring of 1969 (see Chart III).

The expanded loan-deposit ratio is not a completely satisfactory measure of bank liquidity, however, because it neglects the quality of loan portfolios and the cash flow arising from loan repayments. An alternative indicator of liquidity is the liquid asset ratio.[2] For the third quarter, the liquid asset ratio displayed a similar improvement in bank liquidity positions. In September, the ratio rose to 10.3 percent at all weekly reporting banks, well above the 1970 low of 8.8 percent posted in February and the highest since February 1969. In this context, the improvement in bank liquidity noted here is relative to liquidity positions earlier in 1970 and in 1969. The ratios indicate that bank liquidity still remains well below the levels of 1967 and 1968.

THRIFT INSTITUTIONS

Deposit flows to mutual savings banks and savings and loan associations continued strong in the third quarter, advancing at a 9.5 percent seasonally adjusted annual rate after increasing at a rate in excess of 7 percent in the second quarter. September marked the eighth consecutive month that these institutions experienced deposit growth, and preliminary evidence also indicates that, unlike recent similar periods, substantial declines in deposits did not occur following the quarterly interest-crediting period. Interest rate ceilings at thrift institutions were raised at the end of January, and in March the Treasury raised the minimum denomination on newly issued bills from $1,000 to $10,000. These actions undoubtedly helped thrift institutions attract deposits. More recently, lower short-term market yields and weakness in the stock market have probably also contributed to the inflow of funds to these institutions.

Mortgage lending at savings and loan associations and mutual savings banks increased at a moderate 7.7 percent pace in the third quarter. While mortgage extensions at savings and loan associations expanded at a fairly strong 8.9 percent seasonally adjusted annual rate during the quarter, mortgage lending at savings banks increased at a rate of 4.8 percent. Savings and loan associations experienced a more rapid inflow of deposits than did mutual savings banks during the quarter, 10.9 percent as compared with 6.8 percent, and savings banks continued to diversify their investments, thus contributing to the divergence in the growth rates of mortgage lending. In an effort to make additional funds available for housing, a new Federal Home Loan Mortgage Corporation was formed on September 2 as part of the Federal Home Loan Bank System. The Corporation is authorized to purchase residential mortgages from members of the Federal Home Loan Bank System and from financial institutions insured by an agency of the United States Government.

[2] The liquid asset ratio is defined as loans to brokers and dealers, loans to domestic commercial banks, Government securities due within one year, balances with domestic commercial banks, bankers' acceptances, municipal tax warrants, and short-term notes as a percentage of total liabilities excluding capital accounts.