Commercial Banks as Suppliers of Capital Funds to Business*

Commercial banks are an important source of the funds business requires for financing expansion or modernization of plant and equipment and for other long-term needs. To be sure, commercial banks have not been permitted since 1934 to engage in underwriting new corporate securities issues. This function is performed by investment banking houses. Many smaller businesses, however, do not have access to the securities market; and larger businesses sometimes prefer to borrow capital funds for shorter periods than are typical of the bond, stock, or mortgage markets. These financing needs can be, and often are, met by banks through the offer of medium-term credits of up to eight years' maturity. Thus, commercial banks and the securities market are in many cases viewed as alternative sources of capital funds by the business borrower, who can draw on one or the other according to convenience and cost. After describing how banks participate in the provision of capital funds to business, this article examines secular and cyclical trends in the relative use of these alternatives.

NATURE AND MAGNITUDE OF COMMERCIAL BANK PARTICIPATION

Commercial banks participate in supplying capital funds to business through term loans in two different, although interrelated, ways. First, they extend intermediate-term loans that are repaid from the borrower's earnings or from other internal sources; second, they extend interim credits of one- to two-year maturity, which are repaid from the proceeds of new bond or stock issues in the securities market.

For the first type of credit, commercial banks are very attractive sources to many businesses. Many small firms that do not have ready access to the long-term securities market find bank credit the only practicable source of new capital funds. And for large businesses, borrowing from banks is often a quicker, cheaper, and more convenient method of raising long-term funds—particularly for loans with maturities of five to eight years—than the public offering of bonds or the flotation of equities in the securities market. Also, bank loans can be tailored to individual borrower needs through direct negotiations with the lending bank, thus giving the borrower more leeway in determining repayment schedules and frequently permitting more efficient use of loan proceeds.[1]

Since these bank loans are generally used by borrowers to finance capital expenditures and are repaid from internal cash flows—current earnings or depreciation allowances—they are akin to long-term credits extended by life insurance companies, pension funds, and other financial institutions and by individual investors in the bond, stock, and mortgage markets. However, the original maturity of new corporate bonds publicly offered during 1950-61 averaged about twenty-five years, whereas that of term loans outstanding at member banks is estimated to have averaged about five years recently. Consequently, commercial banks are provided each year with a relatively larger flow of repayments for relending to other customers than nonbank holders of corporate bonds, equities, and mortgages. To be sure, the funds repaid to, and relent by, banks reflect only shifts of existing credits from one business firm to another. But these shifts represent a redirection of resources—from firms that are no longer in need of them to firms seeking to increase their resources through external financing. In thus shifting existing credits among various businesses in the economy, commercial banks contribute a great deal of flexibility to the financing of capital formation.

Banks offer a second type of capital financing assistance to business by providing interim credits for financing the initial stages of new plant construction. This type of bank activity tends to come about in the following way. The need for funds in heavy capital investment projects arises only gradually as work proceeds. Some business firms, therefore, may be reluctant to borrow the full amount in

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[1] The nature of term loans and their trends at large New York City banks during 1955-60 were discussed in "Term Lending by New York City Banks", this *Review*, February 1961, pp. 27-31.

the securities market at the outset, preferring to borrow temporarily from banks—in the form of either a formalized revolving credit agreement or a short-term line of credit—with such credits remaining on the books for one to two years.[2] These arrangements enable firms to borrow only the amount needed at each stage of construction, which economizes on borrowing costs. At or near the time of completion of the project—when exact long-term credit needs are finally known—the borrower normally repays the interim bank debt from the proceeds of a new bank loan carrying a longer maturity or, more typically, from the proceeds of sales of new securities in the capital market.

This role of bank term credit as an interim substitute for securities market credit is most pronounced in the financing of capital expenditures by electric, gas, and water public utilities. On the basis of data provided by the Securities and Exchange Commission, it is estimated that during 1959-62 commercial banks initially financed nearly half of the total capital expenditures of public utilities that were ultimately financed in the securities market. In manufacturing industries, the interim financing by banks covered about one quarter of the capital expenditures eventually financed in the securities market.

The gross flow of capital funds from banks to business is sizable. During 1959-62, for instance, extensions of intermediate-term loans by banks to nonfinancial, nonfarm corporate and noncorporate businesses are estimated to have averaged nearly $7 billion annually,[3] while extensions of interim credits—granted under both revolving credit agreements and line-of-credit arrangements—are estimated at $2 billion or more per year. (Routine renewals of loans are excluded from these figures.) It happens that, over the same period, the volume of new bond issues sold by nonfinancial corporations to investors also averaged nearly $7 billion, and the volume of new stock issues about $2 billion. Although these data are on a gross basis, the comparison provides some notion of the place of commercial banks in satisfying the demands of American business for external capital financing.

TRENDS IN THE USE OF COMMERCIAL BANK AND BOND MARKET CREDITS

Over the business cycle as well as over longer periods, the role of banks in supplying capital funds to business is significantly affected by the over-all demand and supply conditions for such funds. In the last five years, the most important factor affecting business demand for capital funds has been a sharp rise in corporations' internal cash flows (comprising retained earnings and depreciation allowances) relative to their capital expenditures. According to the flow-of-funds tabulations prepared by the Board of Governors of the Federal Reserve System, internal cash flows of nonfinancial corporations were $2.6 billion a year lower in 1952-57 than corporate expenditures for fixed investment, but exceeded fixed capital expenditures by $1.9 billion per year during 1958-62.

The effects of this relative increase in the internal cash flows of corporations were a reduction in the corporate demand for bond market credit, little change in the demand for equity funds, and increased demand for intermediate-term bank credit. Chart I presents the figures given above on these major types of credit for a longer period and in a slightly different form. As this chart shows, the dollar volume of gross new bond issues by nonfinancial corporations declined sharply after 1957 to an average of about $7 billion per year during 1960-62, only slightly more than the 1952-54 average. Gross new stock issues increased slightly, from $1.7 billion to $2.0 billion per year. In contrast, gross extensions of intermediate-term loans and interim credits by banks during 1960-62,[4] at about $8 billion per year, were around 2½ times their $3 billion annual average for the years 1952-54. The relative im-

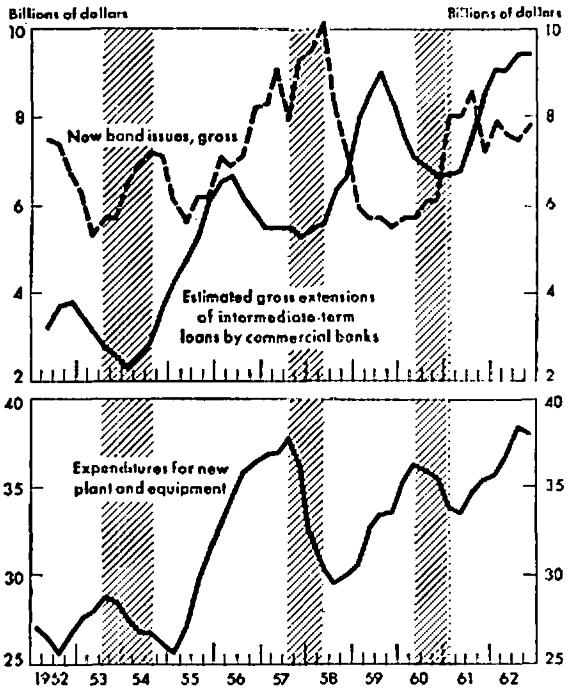
[2] The revolving credit agreement permits the borrower to draw short-term notes on the bank from time to time up to the maximum amount of the commitment, with the privilege of repaying and reborrowing during the life of the agreement. The bank's promise to extend credit is a firm commitment. The line-of-credit arrangement is similar, differing mainly in the lack of a formal agreement and of a legally binding obligation to extend credit.

[3] The figures on extensions of term loans by banks were pieced together from a number of sources, including the Commercial Loan Surveys of 1946, 1955, and 1957, conducted by the Federal Reserve System; the *Quarterly Financial Report for Manufacturing Corporations*, compiled jointly by the Federal Trade Commission and the Securities and Exchange Commission; weekly reports on term loans by large New York City banks; statistics on bank loan refundings in the securities markets, provided by the Securities and Exchange Commission; and statistical material on New York City banks, developed from bank examination sources. The estimates thus derived refer to banks' commercial and industrial loans, mortgage-secured loans to business, and single-payment loans to individuals for business purposes, all with an original maturity of more than one year. Though the estimates are rough, they are considered workable approximations for an analysis of cyclical and secular trends.

[4] The figures on bank lending, as plotted in Chart I, combine intermediate-term loans and interim credits, because their separation for years prior to 1959 was not possible. But extensions of interim credits under line-of-credit arrangements were not included in the combined figures because of the difficulty of statistically measuring their trends. This omission understates actual bank lending to business by perhaps as much as $1 billion per year on the average.

Chart I

CAPITAL EXPENDITURES AND GROSS FINANCING OF NONFINANCIAL BUSINESS



Note: All series are shown at seasonally adjusted annual rates, with bond issues and bank lending on a three-quarter moving average. Shaded areas represent recession periods, according to National Bureau of Economic Research chronology.

Sources: Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, Securities and Exchange Commission, and United States Department of Commerce (for details of derivation of estimates, see text footnotes 3 and 4).

portance of bank financing has also increased in terms of amounts outstanding; bank loans of the types indicated have grown faster than outstanding corporate bonds[5]—the primary alternative to such bank credits.

There is good reason to believe that the rise in the internal cash flows of corporations may actually have contributed in some degree to the augmented demand for bank funds. Expecting an increased flow of cash from internal sources, some companies have become able to repay borrowings in a shorter period than twenty-odd years, the typical maturity for publicly offered bonds, and bank term loans therefore have emerged as a feasible alternative.

Shifts between banks and the bond market by borrowers are also a feature of business cycles. As can be seen in Chart I, bank lending and bond financing have moved inversely over the last three cycles. Bank extensions of intermediate-term loans rose sharply in the early part of business expansions, reached a peak around the midpoints, and thereafter declined through mid-recessions; bond financing generally reached its peak around recessions, and its trough during business expansions. However, these inverse cyclical movements of the two sources of credit are not necessarily attributable entirely to direct shifts of borrower demand from one to the other. In fact, there are numerous institutional and cyclical factors that induce business firms to borrow less in one credit market and to borrow more in another during a given stage of a business cycle. Some of these factors may be described briefly.

In the first half of a business expansion, when bank funds are in ample supply, business borrowers show a strong preference for bank rather than bond market credit. One explanation is probably the relative ease of obtaining bank credit, for at that time it is simpler to borrow from banks than to go through the relatively time-consuming procedures required by the bond market. In addition, many businesses are then embarking on new capital expenditures, and there is thus an increased desire for interim bank credits, to be repaid at the completion of construction from the proceeds of new bond issues.

During recessions, the long-term borrowing undertaken by business occurs mainly in the bond market. Many businesses have by that time completed their new construction projects and turn to the long-term bond market to refund their interim bank indebtedness. Furthermore, borrowers find that during recessions the cost of borrowing in the bond market is declining, and some of them decide to refund part of their outstanding high-coupon bond debt with low-rate new issues, as happened on a relatively large scale during the 1954 recession.[6] Still other borrowers may tend to substitute bond credit for stock market financing during recessions, because stock prices are ordinarily depressed during such periods.

The role played by the alternating uses of bank credit and bond financing during a business cycle can be examined in more detail only for the most recent years.

[5] According to estimates prepared for this study, the volume of commercial banks' outstanding term loans to nonfinancial business rose between 1952-54 and 1960-62 by about 130 per cent (from an average of $12 billion to $28 billion), while in the same period the volume of outstanding bonds of nonfinancial business, according to statistics compiled by the Board of Governors of the Federal Reserve System, rose by only 70 per cent (from an average of $47 billion to $79 billion).

[6] The effect of such refunding is not evident in Chart I, since its figures on bond credit cover all new issues, regardless of purpose.

Pertinent bank loan refunding figures are available since mid-1958. These figures, which are shown in Chart II, cover repayments of bank credits from the proceeds of new corporate bond and stock issues sold in the securities market by nonfinancial corporations, as recorded in the registration files of the Securities and Exchange Commission. In bank loan refundings, as in the case of new borrowing to meet capital financing needs, bond rather than stock issues have been the main alternative in recent years.

Although the period covered by loan refunding statistics is relatively short, the figures are suggestive of the behavior of bank loan refundings during recessions. Refundings rose sharply during the second quarter of 1961, after the trough of the 1960-61 recession. As has been suggested above, such a rise is to be expected during, rather than after, recessions. To be sure, the 1961 increase in bank loan refundings lagged into the early post-recession period; but this may to some extent have been a reflection of the relatively short duration of the preceding expansion in capital expenditures. As Chart I shows, the expansion in expenditures for new plant and equipment lasted only 1¾ years in the 1958-61 cycle, compared with 2½ and 3¾ years during the 1954-58 and 1949-54 cycles. At the end of relatively short expansions many construction projects may remain uncompleted. Therefore, the upturn in refinancing may be delayed beyond the end of the recession.

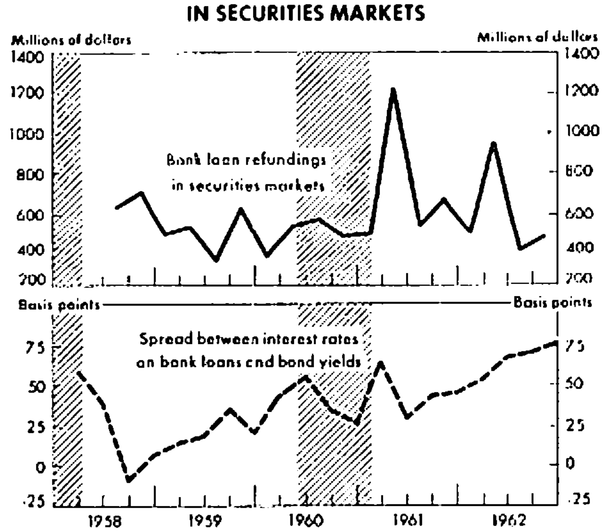
The timing of bank loan refundings in the bond market is also related to the level of interest rates in the bond market, and to the anticipations of businessmen with respect to future rate changes. If borrowers expect bond rates to decline in the near future, they have little incentive to borrow in the bond market. If they anticipate a rise in interest rates, however, they may wish to borrow in the bond market before the rise takes place. Such considerations may have contributed to the sharp rise in refundings during the second quarter of 1961. By then it was clear that an upward trend in the economy had started. Judging from historical experience, this trend could be expected to bring about a rise in interest rates on bonds.

Changes in the relative costs of bank and bond market borrowing also help explain the timing of bank loan refundings. When relative costs move in favor of bond financing, firms that have to refinance their interim bank debt have an incentive to do so through bond borrowing. And, conversely, if the cost of bond market credit becomes relatively high, business borrowers have reason to postpone their loan refundings until a more favorable situation arises.

During the 1960-61 recession and the short periods preceding and following it, bank loan refundings rose —with a lag of about a quarter of a year—after increases in the spread between bank and bond market rates in favor of the latter (see Chart II). The lag may represent the time needed by borrowers to reach their decisions and to complete the procedures necessary for a new flotation in the securities market. This two-year performance suggests that bank loan refundings are sensitive to interest rate spreads during recessionary or near-recessionary periods, when business firms have completed the construction projects financed with interim bank credits and have an option about the timing of their refunding. On the other hand, during the nonrecessionary periods covered by the data—late 1958, early 1959, and 1962—when such an option did not exist, no direct relationship could be discerned between bank loan refundings and the relative cost of bank and bond market credits. The response of business borrowers to changing relative costs of bank and bond borrowing clearly requires further analysis once figures for longer periods are available.

Chart II

BANK LOAN REFUNDINGS AND INTEREST RATES IN SECURITIES MARKETS



Note: Bank loan interest rates are rates on short-term business loans at selected commercial banks in nineteen cities, as reported in the Quarterly Interest Rate Survey published regularly in the Federal Reserve Bulletin. Bond yields refer to FHA-compiled average yields of recently issued Aaa-rated corporate bonds. The spread equals interest rates on bank loans minus bond yields. Shaded areas represent recession periods, according to National Bureau of Economic Research chronology.

Sources: Board of Governors of the Federal Reserve System, Federal Housing Administration, and Securities and Exchange Commission.

CONCLUSIONS

Commercial banks now play an important role as a source of capital finance. They act as buffers for the capital market, absorbing a significant proportion of the initial pressures for capital funds by medium-sized and large corporations. Thus they contribute to the relative stability of the market for business capital finance within a business cycle, and to more efficient financial planning by borrowers and ultimate lenders of long-term funds.

Possibly even more important, commercial banks act as significant lenders to businesses that seek intermediate-term funds. These may be borrowers who do not have ready access to the securities market and do not generate sufficient amounts of funds from internal sources to finance their new plant expansion or their more permanent working-capital needs. Or they may be firms whose internal cash flows allow them to contract for capital credits of shorter maturity than are typical in the bond market. Particularly for those borrowers who do not have access to the securities market, the possibility of borrowing from commercial banks may be the decisive factor in going ahead with expansion plans.

These activities are evidence of a changing function of commercial banks. In addition to supplying short-term funds to business—the traditional function of commercial banks—they are now also providing substantial amounts of medium-term funds and thus are emerging as an important financial intermediary in the savings-investment process. This service helps generate capital formation and is another instance of the evolutionary adaptation of the country's financial mechanisms to the economy's needs.