

# Prime rate update

Randall C. Merris

A widely reported development in commercial bank lending over the past two years has been the extension of business credit at interest rates below prime. If these “super-prime” loans become widespread, they could signal structural, or long-range, changes in bank lending and the concept of the prime rate itself.

Since it originated in 1933, the modern prime rate has come to serve three major functions for banks:<sup>1</sup>

- It is the interest rate applicable to a bank’s most creditworthy customers.
- It is a base rate to which are tied, formally or informally, the higher interest rates on nonprime bank loans.
- It is an index rate for floating-rate bank loans—contracts that allow interest charges to vary up and down with market rates over the durations of the loans.

Bank borrowers have found their own meanings for the prime rate, and intentionally or otherwise, banks have fostered these ideas:

- Qualifying for the prime is a symbol of business success and a sign of a healthy enterprise.
- Qualifying for the prime in some cases is a reward to a customer of longstanding for allowing one bank to handle all his banking needs.

In short, the prime rate is expected to serve several functions—a lot to ask of a single interest rate.

Banks have tried to adopt lending practices over time that would allow the prime rate to perform its multiple tasks. But difficulties with the concept of a prime rate have been accumulating since the early 1960s. Borrowers in the prime category have

become increasingly heterogeneous, and the idea of a “most creditworthy customer” has been broadened to the limit. The floating-rate function of the prime was once fairly minor. But with the increased variability of interest rates since the early 1960s, that has become one of the most important functions. At least half of the dollar volume of business lending at many large banks is now made under floating-rate provisions. The growth of long-term bank lending has contributed vitally to the importance of this prime function. New long-term lending at many banks has been predominantly at floating rates.

## Recent lending experience

Conflicts between the functions of the prime rate have arisen several times in recent years. But the problems became especially severe in 1976 and 1977, when demand for business loans was slack at large money-center banks.<sup>2</sup> During that time banks saw the demand for loans from business in general and prime-rate borrowers in particular fail to respond to declining loan rates. Many large banks, however, were able to identify submarkets of prime-rate customers that might borrow more if bank rates were lowered.

Under these circumstances, banks were faced with a dilemma. If they lowered the prime rate, most loan customers would not borrow more. The primary effect would be simply to reduce total loan revenue. If they did not lower the rate, a large amount of loan business would be lost from submarkets that were responsive to lower rates. To complicate the problem further, there was a conflict with the function served by the prime in floating-rate contracts. If the prime was lowered,

<sup>1</sup>Methods used by banks both historically and in recent years to set the prime rate were surveyed by the author in “The Prime Rate,” *Business Conditions*, Federal Reserve Bank of Chicago (April 1975), pp. 3-12.

<sup>2</sup>Additional information about bank loan demand and the prime rate in the last three years is found in “The Prime Rate Revisited,” *Economic Perspectives*, Federal Reserve Bank of Chicago (July/August 1977), pp. 17-20.

### Floating-rate business lending is predominant at many large banks . . .

Percent of dollar amount of new short-term business loans at floating rates: 48 large banks

1977 during the week of	All sizes of loans	Loan size category (in thousands)					\$1,000 and over
		\$1-24	\$25-49	\$50-99	\$100-499	\$500-999	
February 7-12	66.5	42.0	55.3	56.7	63.5	72.4	68.4
May 2-7	63.7	43.6	49.8	53.8	54.0	60.3	68.0
August 1-6	61.6	44.4	53.6	55.1	61.1	66.9	62.2
November 7-12	71.5	38.5	48.8	61.4	67.6	77.2	74.3

banks stood to forfeit revenue from all loans already on the books at rates tied to the prime.

One way to entice borrowers that were receptive to lower loan rates was to relax other loan terms. Some banks allowed these borrowers to "double count" compensating balances. The same noninterest deposit balances were used both to compensate the bank for a credit extension and to reimburse the bank for the nonloan services it provided business customers.

The most obvious method was to lend at special rates below prime to the subcategories of borrowers that seemed receptive to lower rates. But banks moved quietly and reluctantly in this direction. Below-prime rates for some customers could lead to disgruntled prime-rate borrowers. They could lead also to reactions from other banks, either in the form of a general reduction in loan rates or charges of unsound banking prac-

### . . . especially for long-term business lending

Percent of dollar amount of new term loans at floating rates: 48 large banks

1977 during the week of	All sizes of loans	Loan size category (in thousands)			\$1,000 and over
		\$1-99	\$100-499	\$500-999	
February 7-12	74.6	59.5	76.7	84.0	74.8
May 2-7	66.9	66.1	76.4	67.2	65.9
August 1-6	81.3	65.1	76.2	67.5	84.5
November 7-12	69.0	81.0	80.7	80.0	64.2

SOURCE: Survey of Terms of Bank Lending, Board of Governors of the Federal Reserve System. Included are commercial and industrial loans other than construction and land development loans. Short-term loans have original maturities of less than one year, and term loans have maturities of one year or more.

tices. But even if below-prime pricing might not have been good strategy for these reasons, it was good economics under the circumstances.

Basic price theory can be used to show how a firm can maximize profits in a situation in which one segment of a market is fairly unresponsive to a lower price (in this case, interest rate) and another is fairly responsive. Demand in the first submarket is termed

relatively price inelastic, and demand in the second submarket is said to be relatively price elastic. The solution is to separate demands in the two submarkets and establish different prices for each. The submarket with the relatively elastic demand, then, receives a lower price than the other submarket and a lower price and a larger volume of sales (here, loans) than would be the case if both submarkets were treated together to establish a common price.

Theory also is useful in identifying the submarket with the most elastic demand. It is the customers with the most or best substitutes for the product or service. Prime-rate borrowers with the best alternative sources of funds were identified as corporations that issue commercial paper and multinational companies with access to the Eurocurrency credit markets. These are often the same companies.

Commercial paper is unsecured debt issued by large corporations either directly or through dealers and sold to large-volume investors. Eurocurrency credits are overseas bank loans extended and repayable in currencies other than the currency of the lending bank. Both the commercial paper and the Eurocurrency markets have grown dramatically since the early 1960s, measured in terms of either the volume of credit or

the number of participants.

By not letting the prime rate fall as fast as the three-to-four month commercial paper rate, bankers allowed the prime-paper rate spread to increase to over 1 percentage point in early 1975 and to 1½ percentage points by early 1976. The spread has narrowed again since last summer. But through the first quarter of 1978, it was still about 1¼ percentage points. And as a result, competitive pressures for below-prime lending to issuers of commercial paper have persisted.

### **Special rates**

Since last November, two large money center banks have offered new lending programs to approved lists of corporations that issue commercial paper. Loans under these programs allow corporations to postpone new issues of paper in anticipation of lower paper rates or when the market for a particular maturity is weak. Under one program, loans are granted in maturities up to ten days. Under the other, maturities go up to 29 days.

Under both programs, loan rates are based on the incremental cost of funds to the lending bank and are kept competitive with commercial paper rates. Loans under one program have fixed-rate interest charges. Under the other, floating-rate charges are revised daily. The first rate quotations for one of these programs last November were a little over ¼ percentage point above the three-to-four month commercial paper rate and nearly

1 percentage point below the 7¾ percent prime rate in effect at the time.

In March 1978, another large bank announced it had initiated a program several months earlier to provide credit to multinational corporations at special rates and in maturities competitive with commercial paper. This newest program is in contrast to plans at the other two banks, which are aimed only at corporate financing for less than a month before commercial paper sales. By offering maturities on loans from a day to 180 days or longer, the program of this third bank provides a direct substitute to commercial paper for short-term corporate financing.

All three banks have emphasized that they do not consider their new lending programs as temporary measures dependent only on current money-market conditions. Since these plans were announced, some other large commercial banks have disclosed informally that they are also making special efforts to attract commercial paper issuers as borrowers. Included in these efforts are special lending rates.

One factor determining whether banks with special lending programs expand them and whether other banks formally announce such programs will be the spread between the prime rate and the commercial paper rate. If banks narrow the spread soon, the need for the special lending programs could disappear for a while. But because the basic conflicts between the functions of the prime rate are endemic to modern banking, the problems of 1976 and 1977 are apt to reappear.