Research Department
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FRBSF Weekly Letter

Western Finance

The deregulation of deposit rates hit western banks and savings and loan associations with full force in 1983. Two developments, in particular, virtually swept away the structure of deposit rate regulation and, in the process, dramatically restructured the balance sheets of depository institutions. First came the introduction of the money market deposit account (MMDA) in mid-December 1982 and the Super-NOW in January 1983. Second, the deregulation of all new time deposits with original maturities greater than 31 days followed in October. Depositors' response to these actions was unequivocal: billions of dollars flowed into these new accounts (especially the MMDA) out of lower-yielding regulated accounts and uninsured money market mutual funds.

This deregulation of deposit accounts coupled with weak loan demand greatly intensified competition among depository institutions. The tremendous inflow of funds to MMDA accounts, in particular, induced banks and S&Ls aggressively to seek out profitable lending opportunities. Because the demand for business and, to some extent, real estate loans, continued to be weak, they concentrated on consumer lending.

Increased competition notwithstanding, many depository institutions in this region managed to post significant gains in earnings. There were, however, some major differences among institutions and between the banking and thrift industries generally. While most banks reported solid earnings gains for 1983, sizeable losses sustained by several of them lowered aggregate earnings for all western banks from $1.5 billion in 1982 to $1.3 billion. In contrast, savings and loan associations recorded a phenomenal turnaround in profitability, posting $1.1 billion in earnings after a disastrous $805 million loss in 1982. Thus, although industry analysts predicted that deregulation would play havoc with banks' and thrifts' cost of funds, many depository institutions in the West demonstrated a remarkable ability to manage the risks introduced by deregulation.

Shifting market shares

By year-end, it had become apparent that a major factor in a depository institution's ability to build market share for retail savings-type deposits was its willingness to offer premium rates for MMDA deposits in the early going. This market, estimated to be about $250 billion, includes balances held in savings accounts, small-denomination time deposits, personal MMDAs and money market mutual fund shares that are purchased by households in the West. Thus, by initially offering above-market yields on MMDAs, the banking industry emerged as the clear leader in the MMDA battle in the West and in the nation. Its generally more aggressive pricing strategies induced households to sever existing deposit relationships with less aggressive institutions. And once households moved their funds, they showed little inclination to shop around for slightly higher yields.

By capturing 54 percent of the personal MMDA market, western banks' share of the overall retail savings deposit market rose by three percentage points to 45 percent. Meanwhile, savings and loans, mutual savings banks, and credit unions in the West all lost market share but were still able to attract significant new inflows with MMDAs because of growth in the market. The money market funds, on the other hand, lost not only market share, but also suffered significant net outflows of funds.

Funding with MMDAs

The introduction of the MMDA in late 1982 produced a sharp change in the structure of depository institutions' balance sheets. For example, by year-end, western banks held more than $51 billion in MMDAs and thrifts

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held $35 billion. In both cases, MMDAs accounted for more than one-fifth of total domestic deposits by the end of the year.

As much as one-third of these funds were "new" money that enabled these institutions to reduce their reliance on "purchased funds" such as large denomination negotiable CDs, fed funds and repurchase agreements. At western banks, for example, large CDs outstanding declined from 32 percent to 20 percent of liabilities. The success of the MMDAs, however, was not costless, as western banks and S&Ls also reported a $14 billion decline in 5.25 percent passbook savings deposits.

Slow asset growth

The influx of MMDA funds sent banks and S&Ls scrambling to find profitable lending opportunities in 1983, but private credit demand remained weak and kept downward pressure on loan rates. Nonetheless, western savings and loan associations recorded a dramatic 19 percent increase in their loan portfolios. Western banks, by contrast, recorded a slight contraction in their foreign loan portfolios ($56 billion at year-end) and a modest 5 percent gain (to $200 billion) in their domestic loans.

Paradoxically, improvement in the overall level of economic activity had a chilling effect on western banks' commerical and industrial lending. The general reduction in interest rates from their 1982 levels and the consequent improvement in the debt and equity markets during much of the year allowed many corporations to reduce their dependence on short-term bank borrowing. The economic rebound also improved businesses' cash flows and profits, and thereby reduced their need for external financing. In addition, there was little evidence of increased demand for capital project financing as capital expenditures were slow to pick up despite major cutbacks during the recession. Overall, then, western banks recorded a meager (3.5 percent) increase in domestic commercial and industrial loans ($65 billion at year-end).

Western consumers' renewed interest in housing and consumer durables, by contrast, translated into increased demand for mortgage and installment credit. Much of the strength in the residential mortgage market reflected the increased popularity of second mortgages, the desire of recent purchasers to refinance at lower rates, and increased usage of adjustable-rate-mortgages. Savings and loan associations extended the lion's share of mortgage credit in the West. Their mortgage loans outstanding grew by 17 percent in 1983 and their originations exceeded $45 billion for the year, while western banks' real estate loans outstanding grew only 3 percent to $73 billion.

Consumer credit provided one of the more attractive lending markets in 1983 — particularly for western banks. Timed with the rise in consumer spending on durable goods, banks' efforts to promote installment and credit card loan products produced the first sustained increase in western banks' consumer lending since 1979. Although still modest, the $1.5 billion (6 percent rate) increase in consumer loans during 1983 ($34 billion at year-end) was significant given the keen competition in this market from finance companies and thrifts.

Earnings in 1983

Earnings of western banks and S&Ls fared remarkably well in the new, deregulated

environment of 1983. MMDAs and other deregulated deposit products enabled banks and thrifts to reduce their reliance on higher-cost purchased funds. Moreover, the general decline in the level of interest rates produced a slight improvement in western banks' net interest margins and a substantial improvement in those of S&Ls.

For banks, the lower level of interest rates and weak credit demand in 1983 reduced interest *income* substantially. Western banks recorded reductions in revenues from overseas investments (down 30 percent), domestic lending (down 15 percent) and fed funds sales (down 20 percent). Only interest income from securities holdings showed an increase (5 percent), reflecting the large build-up of U.S. Treasury securities holdings early in the year. However, the decline in interest rates also reduced banks' interest *expense*.

On balance, interest expense fell more sharply than interest income, producing a slight improvement in net interest margins. Changes in banks' funding mix also helped lower the cost of funds. Thus, the combination of lower rates and reduced reliance on purchased funds enabled banks to reduce their interest expense on large time deposits by 50 percent and their offshore borrowing expense by one-third.

This modest improvement in interest margins, however, was not sufficient to offset the costs associated with the rapid deterioration in overall credit quality. Loan loss provisions were boosted by 50 percent in the West to handle the anticipated loan chargeoffs—particularly loans to less-developed countries and energy-related loans.

The main source of earnings growth for western banks, then, was the sharp increase in *non-interest* income, particularly from fees earned on deposit services. As deposit interest rates were deregulated, banks raised fees to recoup the cost of providing services that were formerly offered to customers without charge. Thus, fee income as well as fiduciary income rose by more than 25 percent.

By contrast, most of the savings and loan associations' remarkable 39 percent increase in net worth during 1983 was due not to a rise in non-interest income, but to a substantial improvement in interest margins. S&Ls enjoyed the same reduction in interest expense as banks, but because of their large fixed rate mortgage loan portfolios, did not suffer the same erosion in interest income. Moreover, S&Ls' loan losses were less problematic than those of banks.

The outlook for 1984

Loan growth in 1984 is likely to improve with the continued recovery—particularly in the area of commercial and industrial lending. The deregulation of deposit rates will allow banks and S&Ls to obtain sufficient funds to finance these increased credit demands profitably. Moreover, the increased investment and lending powers that have been granted S&Ls in recent years will enable them, like banks, to hedge better against changes in interest rates. Finally, as the last vestiges of regulated deposit products are swept away, banks and thrifts will face increasing pressure to trim non-interest expenses, such as large branch networks, while recovering the costs of providing retail banking services.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 2/1/84	Change from 1/25/84	Change from year ago Dollar	Change from year ago Percent
Loans, Leases and Investments[1] [2]	175,290	1,409	1,844	1.1
Loans and Leases[1] [5]	154,979	1,381	3,186	2.1
Commercial and Industrial	45,389	223	− 140	− 0.3
Real estate	59,022	80	1,094	1.9
Loans to Individuals	26,655	5	2,100	7.9
Leases	5,019	− 20	− 307	− 5.8
U.S. Treasury and Agency Securities[2]	12,208	69	653	5.3
Other Securities[2]	8,103	− 41	NA	NA
Total Deposits	185,308	3,360	NA	NA
Demand Deposits	44,005	3,511	NA	NA
Demand Deposits Adjusted[3]	29,050	912	NA	NA
Other Transaction Balances[4]	12,059	359	NA	NA
Total Non-Transaction Balances	129,244	− 151	NA	NA
Money Market Deposit Accounts—Total	39,636	− 56	NA	NA
Time Deposits in Amounts of $100,000 or more	38,167	− 289	− 8,645	− 18.5
Other Liabilities for Borrowed Money[5]	19,599	466	− 3,696	15.9

Weekly Averages of Daily Figures	Week ended 2/1/84	Week ended 1/25/84	Comparable year-ago period
Reserve Position, All Reporting Banks			
Excess Reserves (+)/Deficiency (−)	NA	75	256
Borrowings	NA	10	9
Net free reserves (+)/Net borrowed(−)	NA	65	247

[1] Includes loss reserves, unearned income, excludes interbank loans
[2] Excludes trading account securities
[3] Excludes U.S. government and depository institution deposits and cash items
[4] ATS, NOW, Super NOW and savings accounts with telephone transfers
[5] Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
[6] Includes items not shown separately

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