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# FRBSF WEEKLY LETTER

July 22, 1988

## Western Banking Recovery

Western bank performance in the first quarter of 1988 points to the potential for strong improvement for the year. Aggregate earnings jumped to \$850 million in the first quarter of 1988 from \$555 million in the first quarter of 1987. Earnings were up across the region, with California, Nevada, and Hawaii showing the most improvement. Over 80 percent of the region's banks were profitable in the first quarter.

More important, the improvement signals a turnaround for western banks, which are rebounding from a dismal 1987. Last year the banking industry in the West suffered an aggregate loss of \$133 million, the industry's first loss since the 1930s. One out of four banks in the West lost money during 1987. The most notable losses were suffered by the larger banks, particularly those with significant exposure to lesser developed country (LDC) debt.

Not only did the western banking industry fail to make a profit in 1987, it also failed to expand. It continued to stagnate at around \$400 billion in assets. Regulatory and market pressure on banks to consolidate and strengthen capital bases, combined with sluggish loan demand, limited growth opportunities for many banks in the West. Against this background, first quarter results showing strong earnings and an upturn in lending are encouraging.

### Improving fundamentals

Several factors account for the strong first quarter performance, and are likely to account for continued strength through the rest of 1988. First, the western economy (with the exception of Alaska) continues to perform well, and to out-perform the nation as a whole. Second, expenses associated with increased loan loss provisions are running well below year-ago levels, in part because of the continued strength of the economy. First quarter data indicate reductions in net loan charge-offs, and in the levels of nonperforming and past due loans. Moreover, this pattern is ex-

pected to continue due to forecasts of continued favorable economic conditions. Third, net interest margins, or the difference between the average return on earning assets and the average cost of funds, widened, particularly in California. Much of this improvement is due to conservative pricing of consumer-type deposits at western banks. Finally, in the aggregate, consolidation and cost control measures have helped to reduce fixed overhead costs relative to the level of assets.

### Lingering concerns

Prospects for the industry have brightened, but asset quality problems linger. Even after the extraordinary \$3.5 billion increase in loan loss reserves in 1987, western banks still may need to increase loss reserves in 1988 because of uncertainty over LDC debt reschedulings and repayments and ongoing problems with energy, real estate, and farm sector loans. In this regard, if a widespread downgrading of LDC loans were necessary, an additional boost in loan loss reserves would be required, which would have a significant impact on earnings.

Other factors besides the LDC situation also could derail the turnaround. For example, while analysts paint cautiously optimistic forecasts for the industry, some have expressed concerns about asset quality in the event of an economic downturn, especially in the area of leveraged buyout (LBO) debt. And given continued weakness in demand for bank loans, others are concerned that competition to build loan volume may lead to lower credit standards and narrower interest rate spreads on new loans. This may be particularly worrisome in the commercial lending area, where emphasis has shifted from the nation's major corporations towards smaller "middle market" firms. Aggressive lending practices, especially if they exacerbate existing asset quality problems and/or reduce spreads, would erode future earnings.

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## WESTERN BANKING

*Western Banking* is a quarterly review of banking developments in the Twelfth Federal Reserve District. It is published in the *Weekly Letter* on the fourth Friday of January, April, July, and October.

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On the positive side, however, the large increase in loan loss reserves last year means that some of the West's largest banks already have set aside reserves against a large proportion of their LDC and troubled farm and energy loans. That action provides a buffer for future earnings even if such loans are shifted to nonaccrual status or written off altogether.

## Spreads

Data on interest rates on loans and consumer-type deposits over the last year do not indicate any significant narrowing of spreads between new loan rates and the current cost of deposits. This suggests that concerns about narrowing spreads associated with increased competition in lending are at least premature. More important, because spreads on new loans remain steady, net interest margins should remain at their present levels for the near term.

Moreover, the available data indicate that spreads generally are wider in the West. Data for a sample of western banks show that in May 1988 banks in the West continued to charge higher rates on commercial and consumer installment loans than banks elsewhere in the nation. Only on agricultural production loans did western banks charge lower rates, on average.

Furthermore, survey data on interest rates paid by banks on consumer-type deposits indicate that western banks tend to pay lower interest rates than the national average. That differential has not changed substantially over the last year.

Moreover, over a period of several years, western banks' interest rates on deposits also have been lower than the rates paid by western savings and loan associations (S&Ls) and credit unions. For example, data published by the *Bank Rate Monitor* indicate that the sampled California banks have consistently paid lower rates than the leading S&Ls in the state.

## Costs vs. market share

Setting lower interest rates on MMDAs, savings accounts, and small-denomination time certifi-

cates of deposit has had an impact on western banks' market share. Because deregulated consumer deposits are moderately interest-sensitive in the long-run, banks' share of the deposit market has fallen relative to that of S&Ls and credit unions.

As recently as December 1985, commercial banks in the West held 51 percent of the domestic deposit market. Savings and loans trailed with 45 percent, and credit unions accounted for the remainder. By May of 1988, S&Ls had captured half of the market, while commercial banks' share had slipped to 46 percent, a loss of five percent of the deposit market in less than three years.

S&Ls now control 55 percent of the domestic deposits in California, the largest market in the region, and have an even wider lead if one focuses on the market for time deposits alone. Savings institutions have made significant inroads in other western states as well. In Arizona and Washington, thrifts account for around 40 percent of the deposit market.

The banking industry appears to have made a strategic decision to price consumer deposits conservatively to reduce the cost of funds. Such a pricing strategy can improve earnings in the short run, especially during a period when deposits are plentiful. However, the loss of market share may prove detrimental in the long run.

## More challenges ahead

The banking industry in the West has returned to profitability, and barring any shocks, should continue to improve in the coming quarters. As the industry recovers, though, it faces increasing challenges, not only in rebuilding asset quality and earnings, but in retaining leadership in commercial and consumer lending, and in remaining competitive in the battle for consumers' deposit dollars.

Gary C. Zimmerman

**REGIONAL BANKING DATA**  
(Not Seasonally Adjusted, Preliminary Data)

		ALL COMMERCIAL BANKS (MARCH 31, 1988)									
		DISTRICT	ALASKA	ARIZONA	CALIF	HAWAII	IDAHO	NEVADA	OREGON	UTAH	WASH
		ASSETS AND LIABILITIES (\$ MILL.)									
ASSETS	TOTAL	404,685	4,693	27,230	280,779	12,757	6,973	10,414	18,759	10,497	32,582
	FOREIGN	43,133	1	N/A	40,590	883	N/A	N/A	0	93	1,566
	DOMESTIC	361,552	4,692	27,230	240,189	11,875	6,973	10,414	18,759	10,404	31,016
LOANS	TOTAL	279,272	2,563	19,817	195,384	7,234	4,431	7,622	11,751	7,029	23,442
	FOREIGN	34,883	1	N/A	33,058	612	N/A	N/A	64	N/A	1,147
	DOMESTIC	244,389	2,562	19,817	162,326	6,622	4,431	7,622	11,687	7,029	22,294
	REAL ESTATE	99,620	1,098	8,687	69,141	3,237	1,102	1,596	3,645	2,766	8,349
	COMMERCIAL	71,216	833	5,009	48,442	1,795	1,315	1,299	4,580	1,711	6,231
	CONSUMER	49,952	187	4,052	29,713	1,133	1,229	4,428	2,365	1,884	4,960
	AGRICULTURE	4,525	7	542	2,226	18	491	18	310	106	806
	INTERNATIONAL	246	N/A	104	135	0	N/A	N/A	N/A	2	4
SECURITIES	TOTAL	41,112	1,193	3,682	22,524	2,416	1,565	1,551	3,243	1,564	3,375
	U.S.T.S.	14,111	777	1,590	6,655	979	703	589	950	505	1,362
	SECONDARY MKT.	14,278	202	423	10,430	479	352	443	714	446	790
	OTHER SEC.	12,723	214	1,670	5,439	957	510	519	1,579	613	1,223
LIABILITIES	TOTAL	382,066	4,232	25,517	266,313	11,942	6,472	9,772	17,553	9,745	30,520
	DOMESTIC	338,934	4,232	25,517	225,723	11,059	6,472	9,772	17,553	9,652	28,954
DEPOSITS	TOTAL	326,540	3,707	23,513	226,423	11,087	5,675	5,925	14,676	8,409	27,125
	FOREIGN	34,544	1	N/A	32,507	576	N/A	N/A	N/A	93	1,367
	DOMESTIC	291,996	3,707	23,513	193,916	10,510	5,675	5,925	14,676	8,316	25,758
	TRANSACTION	71,994	827	4,685	51,759	1,865	869	1,766	2,863	1,546	5,812
	NONTRANS.	220,003	2,879	18,828	142,157	8,645	4,805	4,159	11,813	6,770	19,947
OTHER BORROWINGS		32,150	466	1,588	20,420	267	716	3,463	2,106	880	2,244
TOTAL CAPITAL		38,166	622	2,185	27,489	941	596	970	1,432	1,198	2,733
LOAN LOSS RESERVE		8,891	155	402	7,192	110	85	174	187	132	453
STANDBY LETTERS OF CREDIT		1,390	15	245	766	23	84	148	24	51	35
LOAN COMMITMENTS		13,271	83	975	8,092	560	764	1,332	348	428	688
LOANS SOLD		626	19	30	420	23	22	32	33	10	37
		ASSET QUALITY--% OF LOANS (LARGE BANKS)									
LOAN LOSS RESERVE		3.18	6.05	2.03	3.68	1.52	1.93	2.29	1.59	1.88	1.93
CHARGEOFFS	TOTAL	0.76	0.95	0.86	0.66	0.22	0.47	1.85	0.94	1.14	1.07
	REAL ESTATE	0.17	1.26	0.39	0.09	0.07	0.14	0.24	0.31	0.24	0.33
	COMMERCIAL	0.93	1.14	0.92	0.83	0.42	0.58	1.05	1.06	2.01	1.85
	CONSUMER	6.24	1.05	33.8	9.45	1.65	0.51	2.69	7.80	1.67	9.90
	AGRICULTURE	0.03	N/A	1.48	- .79	0.52	1.33	N/A	0.22	0.56	0.76
NONPERFORM.	TOTAL	6.32	22.5	7.97	6.59	2.07	3.05	4.48	3.70	4.52	5.14
	REAL ESTATE	6.15	36.3	12.2	5.20	2.02	3.64	6.26	6.53	6.83	5.05
	COMMERCIAL	6.14	18.6	6.40	6.52	2.06	3.26	5.47	2.58	3.78	5.49
	CONSUMER	9.56	9.05	38	14.5	10.3	1.83	3.86	10.3	4.83	13.8
	AGRICULTURE	17.2	4.56	13	24.1	2.82	5.65	0.60	10.2	4.54	8.70
		EARNINGS AND RETURNS (\$ MILL.)									
INCOME	TOTAL	10,281	102	674	7,149	297	173	335	440	269	843
	INTEREST	8,604	85	585	5,900	260	154	294	384	236	706
	FEES & CHARGES	485	5	35	329	8	10	12	24	14	48
EXPENSES	TOTAL	9,075	107	632	6,286	251	150	272	377	249	751
	INTEREST	4,510	54	326	3,101	138	83	121	195	126	365
	SALARIES	1,921	23	138	1,350	57	26	41	80	40	165
	LOAN LOSS PROV.	539	7	43	361	7	6	34	16	23	43
	OTHER	2,104	23	125	1,474	49	34	76	85	60	177
INCOME BEFORE TAXES		1,204	-5	42	861	45	22	64	63	20	92
TAXES		399	1	7	305	14	7	19	18	4	24
NET INCOME		850	-5	40	589	32	16	44	45	16	74
ROA (%)		0.84	- .46	0.58	0.84	0.99	0.93	1.69	0.96	0.60	0.91
ROE (%)		8.91	-3.4	7.27	8.57	13.4	10.8	18.2	12.6	5.22	10.8
NET INTEREST MARGIN (%)		4.78	3.70	4.66	4.68	4.46	4.69	7.60	4.95	4.96	5.05

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MARKET SHARE STATISTICS

PERCENT OF TOTAL DEPOSITS, FOR MAY 1988, BY REGION

DEPOSIT TYPE	DISTRICT			ALASKA			ARIZONA			CALIF			HAWAII			IDAHO			NEVADA			OREGON			UTAH			WASH		
	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU
TOTAL DEPOSITS	46	50	4	71	9	20	53	43	4	42	55	3	65	29	6	86	11	4	63	33	4	65	30	5	57	34	9	53	40	7
DEMAND	94	4	2	98	1	1	92	4	4	93	4	2	93	2	4	99	1	0	98	0	2	95	2	3	91	5	3	95	3	1
NOW	60	34	6	48	15	37	62	29	8	56	39	5	71	24	5	87	7	6	80	17	4	77	19	5	67	24	9	64	24	12
SAVINGS & MMDA	57	35	9	52	9	39	64	29	7	55	38	7	60	30	11	86	9	5	65	29	6	69	22	9	60	20	21	52	33	15
SMALL TIME	26	72	2	74	17	9	39	59	2	20	78	2	40	57	3	81	17	2	35	63	3	47	50	3	41	55	4	39	58	3
LARGE TIME	33	66	1	93	6	2	44	56	1	28	71	1	81	17	2	85	11	4	54	44	2	63	34	2	64	34	2	50	49	1

CB = COMMERCIAL BANKS, SL = SAVINGS & LOANS AND MUTUAL SAVINGS BANKS, CU = CREDIT UNIONS MAY NOT SUM TO 100% DUE TO ROUNDING

INTEREST RATES ON DEPOSITS AND LOANS (%)

TYPE OF ACCOUNT OR LOAN	DATE	US	DISTRICT	ARIZONA	CALIF	HAWAII	IDAHO	OREGON	UTAH	WASH
MONEY MARKET DEPOSIT ACCOUNTS	MAR88	5.34	5.09	5.08	5.09	5.06	5.05	4.89	5.28	5.04
	APR88	5.35	5.09	5.08	5.09	5.06	5.05	4.85	5.34	5.05
	MAY88	5.40	5.12	5.08	5.14	5.14	5.06	4.82	5.31	5.09
6-MONTH CERTIFICATES	MAR88	6.50	6.06	6.20	6.09	5.67	5.75	6.05	6.04	6.23
	APR88	6.55	6.06	6.08	6.07	5.67	5.94	6.13	6.18	6.17
	MAY88	6.71	6.20	6.08	6.15	6.04	6.36	6.41	6.47	6.23
2-1/2 YEAR CERTIFICATES	MAR88	7.57	7.19	7.91	7.07	7.04	7.25	7.25	7.05	7.30
	APR88	7.58	7.20	7.72	7.08	7.10	7.39	7.45	7.07	7.26
	MAY88	7.72	7.30	7.49	7.19	7.45	7.55	7.56	7.20	7.28
COMMERCIAL LOANS, SHORT-TERM	MAY88	8.49	8.63	9.31	8.67	9.18	N/A	8.73	N/A	7.74
AVERAGE MATURITY (DAYS)		49	98	246	105	116	N/A	78	N/A	14
COMMERCIAL LOANS, LONG-TERM	MAY88	9.05	9.96	10.08	9.88	9.46	N/A	11.15	N/A	9.97
AVERAGE MATURITY (MONTHS)		49	51	33	53	34	N/A	37	N/A	80
CONSTRUCTION LOANS	MAY88	9.29	9.70	10.04	9.65	9.83	N/A	8.32	N/A	N/A
AVERAGE MATURITY (MONTHS)		11	6	N/A	6	6	N/A	7	N/A	N/A
LOANS TO FARMERS	MAY88	10.68	9.26	10.70	9.23	7.64	N/A	10.25	N/A	9.60
AVERAGE MATURITY (MONTHS)		13	6	8	5	2	N/A	11	N/A	9
CONSUMER LOANS, AUTOMOBILE	MAY88	10.55	11.08	N/A	11.21	N/A	N/A	9.74	N/A	10.78
CONSUMER LOANS, PERSONAL	MAY88	13.49	15.33	N/A	16.84	N/A	N/A	12.32	N/A	16.25
CONSUMER LOANS, CREDIT CARDS	MAY88	17.78	18.02	N/A	19.12	N/A	N/A	19.24	N/A	15.75

SOURCES: SURVEY OF TERMS OF BANK LENDING & TERMS OF CONSUMER CREDIT; MOST COMMON INTEREST RATES ON SELECTED ACCOUNTS