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Western Banking

The performance of the Twelfth District's banking industry in 1985 reflected the unevenness in the western regional economy. (The Twelfth District comprises Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah and Washington.) Lower interest rates, strong retail deposit growth and buoyant consumer spending boosted lending volume and earnings at many banks. But continued weakness in sectors such as agriculture, energy and mining led to a further deterioration in asset quality. At a handful of banks, this deterioration was great enough to produce sizeable losses for the year. On balance, aggregate bank earnings in the West last year declined and trailed the results for the nation as a whole.

Deposit growth

Western banks enjoyed strong deposit growth in 1985. Checkable deposits, in particular, grew rapidly, as they did nationwide. In the West, the growth in Super NOWs and regular NOW accounts accounted for $2.5 billion of the $6.5 billion growth in transactions balances. Small-denomination time and savings deposits were up as a result of rapid growth in money market deposit account (MMDA) balances, which contributed over $5 billion to bank deposit growth. Moreover, even passbook savings balances grew in 1985 in contrast to previous years when higher market interest rates made the passbook ceiling rate of 5½ percent less attractive.

The growth in checkable and other deposits at western banks can be traced to a number of developments that made bank deposits more attractive than other investments. First, lower market interest rates reduced the opportunity cost (in terms of foregone interest on alternative investments) of holding transactions deposits, particularly since many such accounts now pay interest. Second, the continuing deregulation of the banking industry enabled western banks to offer market-related yields on a wider array of products in the time and savings deposit categories. Finally, the downward trend in the rate of inflation may have made financial assets in general more attractive than real assets.

The growth in deposits from consumers and small businesses, in particular, enabled western banks to reduce their reliance on more expensive large denomination ($100,000 and over) certificates of deposit (CDs) and other managed liabilities such as Eurodollar borrowings. For example, the amount of large CDs outstanding declined by 5.0 percent in 1985, compared to an 8.3 percent rate of growth in 1984. This shift undoubtedly helped reduce western banks' cost of funds in 1985. Of course, the decline in the overall level of interest rates also had a significant impact on funding costs.

Lending patterns

Western banks' lending patterns diverged sharply during the year. For the most part, small and medium-sized banks recorded sizeable year-over-year gains in lending volume, while loans at the District's large banks grew more slowly. There were several reasons for this divergence. First, the imposition of more stringent bank capital standards by federal bank regulators tended to constrain loan growth to a much greater extent at the large banks than at the smaller banks. As a group, the small and medium-sized banks in this District had capital-to-asset ratios well in excess of the new regulatory standards imposed in March. A number of the larger banks, by contrast, had to raise capital and reduce loan growth to bring their capital-to-asset ratios up sufficiently.

A second reason for the divergence in loan growth patterns was that the overall slowdown in the economy reduced the demand for business credit. Large banks are affected more by such a slowdown because they extend most of the business loans to the corporate sector. At the same time, large banks also faced stiffened competition, especially for their largest borrowers, from other sources of business credit, such as the commercial paper market and the bond and equity markets. Small and medium-sized banks, by contrast, did not face such competition because they lend to smaller firms that do not have access to national credit markets. As a result, the growth in their business loans was moderately strong, and offset some of the weakness in this area at the larger banks.

While growth in business loans was sluggish, growth in consumer loans and, to a somewhat lesser extent, real estate loans was rapid. Again, small and medium-sized banks recorded the largest percentage increases in these latter categories as some of the larger banks moved to curtail asset growth and improve capital ratios. Overall, consumer loans grew at a 17 percent annual rate, which was only slightly slower than 1984's near-record pace of 19.7 percent.

Loan growth was most pronounced in credit card activity, even though card loan rates did not begin to decline until late in the year. The rapid growth of such revolving credit probably was due to western banks' aggressive marketing efforts and strong consumer loan demand. Automobile loans grew almost as quickly since they reflected relatively strong auto sales during the year. These growth rates, which were well above the growth in personal income, provided further evidence of the strength of consumer confidence in 1985.

Declining mortgage rates during the year promoted a continuing expansion in western banks' real estate lending. Although not as rapid as the 8.2 percent growth recorded in 1984, real estate loans outstanding grew at a solid 6 percent annual rate. Moreover, the growth in outstanding balances does not reveal the full extent of western banks' involvement in real estate lending since many banks chose to sell the loans they originated. Of the new loans banks kept in their portfolios, a sizeable proportion was related to commercial construction, reflecting the still surprisingly strong demand for commercial structures in many parts of the District.

Asset quality

For banks in the West, as across the nation, the single greatest problem in 1985 was a continuing deterioration in asset quality. Ordinarily, by the end of the third year of an economic recovery, banks can count on a significant improvement in asset quality as the financial conditions of their borrowers improve. However, a number of the region's key industries, including agriculture, energy, mining and forest products, continued to experience difficulties that led to rises in bankruptcies, loan foreclosures and problem loan workouts.

For the banking industry, the problems associated with the poor financial conditions of these industries were compounded by the decline in many asset prices in 1985. Loans that were made several years ago on the assumption that underlying asset prices would continue to rise at a healthy clip became problem credits in 1985 as lowered inflation expectations reduced the value of the collateral.

The problems that banks experienced with agricultural loans are a case in point. Many of the farmers who borrowed against inflated land values in the 1970s — a period of rising inflation — could not service their debt when the markets for many agricultural commodities turned soft in the 1980s. Bankruptcies and loan foreclosures followed, and even though banks were able to take possession of the collateral, losses still were enormous because the value of that collateral had fallen in line with the decline in farm prices and profits.

As a result of these developments, western banks experienced a substantial increase in so-called "nonperforming" loans in 1985. Recorded loan losses were up sharply. By loan category (excluding foreign loans), the loss rate was highest for banks' agricultural loans, with business loans a close second. Problematic agricultural credits plagued banks in Idaho and California, while banks in Oregon faced continued deterioration in their portfolios of loans to the forest products industry, and banks in Alaska encountered difficulties with energy credits. Moreover, large banks experienced higher loss rates than small banks, largely because of their generally more aggressive business lending activities in previous years. Continuing problems in large banks' international loan portfolios also contributed to their relatively poor loss experience in 1985. As a result, a number of banks in this District, including some of the largest, posted very poor results for the year.

The fact that losses were lower at many western banks than at banks elsewhere in the nation is of some consolation. Bank failures, the ultimate measure of bank performance, were up sharply on a nationwide basis, but did not increase at all in the Twelfth District. The problem of deteriorating asset quality also was less acute in this District largely because of the greater diversity of this region's economy and the greater asset diversification of this region's banks.

Weak earnings

In 1985, as in the last three years, the aggregate earnings of western banks were hurt by poor earnings and even losses at some of the largest banks. Also as in past years, the single most important influence on earnings was a deterioration in asset quality and the consequent increase in the provision for loan losses. In the aggregate, expenses for loss provisions rose by a third, reaching nearly $4 billion for the year. Such expenses enabled banks to replenish capital reserves following loan write-offs and to boost reserves in anticipation of future write-offs against the growing volume of nonperforming loans.

The earnings of western banks also suffered from slower loan growth in 1985, which meant reduced earnings from interest income and loan origination fees. At the large banks, asset growth, and thus income growth, were curtailed in part to meet regulators' new capital adequacy standards.

Despite these problems, many banks in the District posted strong earnings gains of 10 to 15 percent for the year. In states with strong economies, such as Arizona, Washington and even California, banks fared particularly well. Overall, western banks enjoyed a modest improvement in net interest margins — the spread between the return on assets and the cost of funds. Growth in consumer deposits as well as the decline in the level of interest rates since mid-1984 led to a larger drop in banks' interest expense than in the yield on their assets.

Earnings from fee-based income also improved as banks sought to price more of their products explicitly. Relatively new fee-based products, such as discount brokerage services and credit-related insurance, along with the rising importance of fees from mortgage banking activities, helped brighten the earnings picture. More explicit pricing of checking accounts and other deposit services, as well as the growing popularity of commercial loan fees, also added to revenues.

Summary

On balance, western banks made the most of a difficult year. While earnings were anemic compared to what one would expect for the third year of an economic recovery, most banks in the District dealt remarkably well with the industry-wide problem of deteriorating asset quality. Moreover, large loan write-offs taken during the year, as well as growth in equity capital and reserves, now place the industry in a stronger position to deal with problems in 1986. With improvements anticipated in some of the region's weaker sectors, such as forest products and agriculture, the western banking industry should see some relief from the problems it faced in 1985.

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Nevada Oregon Utah Washington

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/8/86	Change from 1/1/86	Change from 1/9/86 Dollar	Change from 1/9/86 Percent[7]
Loans, Leases and Investments[1] [2]	202,257	- 1,458	14,014	7.4
Loans and Leases[1] [6]	182,548	- 1,600	12,483	7.3
Commercial and Industrial	52,715	- 724	372	.7
Real estate	66,005	- 84	4,150	6.7
Loans to Individuals	38,688	- 69	6,329	19.5
Leases	5,543	24	261	4.9
U.S. Treasury and Agency Securities[2]	11,185	193	1	0
Other Securities[2]	8,524	- 52	1,529	21.8
Total Deposits	203,754	- 6,785	8,685	4.4
Demand Deposits	50,144	- 7,576	4,954	10.9
Demand Deposits Adjusted[3]	34,093	- 1,640	3,812	12.5
Other Transaction Balances[4]	15,488	436	2,213	16.6
Total Non-Transaction Balances[6]	138,122	355	1,519	1.1
Money Market Deposit Accounts—Total	46,046	- 1	3,409	7.9
Time Deposits in Amounts of $100,000 or more	38,277	233	- 2,414	- 5.9
Other Liabilities for Borrowed Money[5]	24,683	- 2,515	4,394	21.6

Two Week Averages of Daily Figures	Period ended 12/30/85	Period ended 12/16/85
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	97	56
Borrowings	84	44
Net free reserves (+)/Net borrowed(–)	14	12

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
7 Annualized percent change