Research Department
Federal Reserve
Bank of
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FRBSF Weekly Letter

Western Bank Earnings

News of bank failures, increases in problem loans, and other financial market troubles have beset the banking industry of late. Banks in the nine western states that comprise the Twelfth Federal Reserve District escaped neither scrutiny nor the unexpected depth of the recession, but they did come through the setbacks of the first half of 1982 with a brightened outlook for the second half. This *Letter* reviews the developments in Western banks in the first six months of this year.

Overview
Western banks' traditional retail orientation added to the challenges presented by the first half's environment of high interest rates and deposit deregulation. Over the years, emphasis on consumer banking provided Twelfth District banks with a stable base of core deposits and profitable retail banking markets. But since 1980, a heavy concentration in fixed-rate assets, combined with the rising cost of consumer deposits, have made it increasingly difficult for Western banks to maintain interest margins and earnings. By contrast, banks elsewhere in the country, not as strongly oriented toward retail banking, will likely post a small gain in earnings for the first half of 1982.

Western banks' earnings, while still substantial, declined 19.6 percent from $980 million in the first half of 1981 to $788 million for the first six months of this year. Earnings among individual banks in the West have shown considerable variation, however, depending upon an institution's ability to maintain net interest margins and asset quality, increase lending volume, and control overhead expenses.

Smaller interest margins
Both net interest margins and lending volume play important roles in determining bank earnings. The net interest margin reflects the difference between interest *income* on loans and securities and interest *expense* arising from both deposit and nondeposit borrowings. Wider margins improve an institution's earnings, even without any increase in lending volume. On the other hand, an increase in the volume of earning assets, even with net interest margins unchanged, will also lead to a rise in earnings.

In the first half of 1982, neither net interest margins nor lending volume provided banks in the West with significant relief from their profit squeeze. Interest expenses continued to grow at a faster rate (11.4 percent increase over the first half of 1981) than interest income (9.3 percent), while increases in earning assets provided only a slight offset to the decline in margins.

As elsewhere, margins at Western banks have been under pressure for some time. The yield on assets has responded slowly to high and rising interest rates while the costs of funding continue to be driven up by the high cost of competing for consumer balances. Western banks have been caught in this earnings squeeze to a much greater extent than their counterparts elsewhere in this country because of their historical emphasis on long-term fixed-rate loans.

At midyear, Western banks' real estate portfolios, totaling $70 billion, accounted for thirty-nine percent of total loans. Nationally, banks held only about thirty percent of their loan portfolio in real estate loans. The bulk of real estate loans consists of long-lived, fixed-rate single family mortgages, yielding rates well below current levels. With the slower turnover rate of residential properties these days, many of these loans are likely to be on the books for years to come at the same low yield.

Twelfth District banks have taken steps to make the yield on their earning assets more responsive to movements in market interest rates by focusing new lending efforts on

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shorter-term and floating-rate loans. At the moment, this change has provided only limited relief from earnings pressures because loan portfolios, like super-tankers, are hard to redirect quickly.

In addition to the challenges posed by a heavy concentration of long-term fixed-rate loans, Western banks (along with their counterparts nationally) have had to cope with rapid and expensive changes in their liabilities. The deregulation of interest rate ceilings on consumer deposits, in particular, has had a dramatic impact on banks' cost of funds.

Once a relatively stable and inexpensive source of funds, consumer deposits now represent a growing interest cost. Indeed, during the first half of 1982, interest expenses for consumer deposits at Western banks rose far more rapidly than interest expenses on either large-denomination time deposits ($100,000 and over) or deposits at foreign offices. The increased expense of consumer deposits reflected not only the high interest rates that prevailed through mid-year, but also Western banks' traditionally heavy reliance on consumer deposits for funding assets and the continued movement of funds from passbook savings deposits into market-return deposit instruments. The shift of consumer checking balances into NOW accounts also increased costs, although the added cost was offset in part by additional fees for consumer banking services.

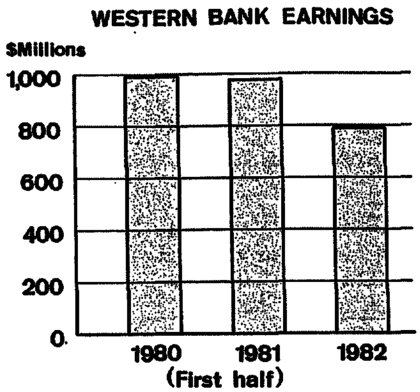
Western banks, despite intense competition from both money market funds and thrifts, reported a sizable increase in their issuance of consumer time deposit balances. Most of this increase, however, appears to have come from a reshuffling of consumer deposits. By midyear 1982, passbook savings balances at Twelfth District banks had fallen below the $28 billion level, a 30-percent reduction from just four years ago. Western banks have replaced those inexpensive savings balances with much more expensive funds held in the form of six-month money market certificates ($31 billion as of June 1982), one-year tax-free All Savers certificates ($3 billion), thirty-month small savers certificates ($7.5 billion), and ceiling-free IRA/Keogh accounts (nearly $1 billion).

Slow assets growth

In recent years, the earnings of Western banks have benefitted from an earning assets growth rate that was higher than those of banks elsewhere in the nation. Consequently, even when interest margins have narrowed under pressure from rising funds costs and relatively static yields on earning assets, the level of Twelfth District banks' earnings has kept pace with or exceeded that of banks nationally. This situation changed in the first half of 1982 when the rate of growth in Western bank assets slowed to 5 percent—just below that recorded by the rest of the nation's banks. Asset growth in the first half of 1982 was therefore not sufficiently rapid to compensate for Western banks' lower net interest margins, especially since overall weakness in loan demand placed additional downward pressure on loan rates.

Like their counterparts in the rest of the country, whatever strength in loan demand that Western banks encountered during the first half resulted from commercial lending operations. Business loans to domestic firms and construction loans for commercial projects were the only "bright" spots in an otherwise anemic economy. However, even these strengths were often a source of concern, since many firms were borrowing to meet temporary working capital requirements, that is, to tide them over periods of cash flow difficulty. Other firms, temporarily forced out of the market for long-term debt by high interest rates and a disorderly bond market, also relied heavily on banks for short-term financing. But business loan demand may weaken because the declines in long-term rates since July are likely to attract firms back to the debt and equity markets and encourage them to repay their loans from banks.

Sluggish consumer loan demand played a key role in slowing the overall growth in bank



loans. Nationally, high real interest rates and a weak economy severely dampened demand for consumer credit during the first half. In the Western states, and California in particular, sky-high housing prices and high mortgage rates limited demand for mortgage loans by pricing many buyers out of the market. High financing costs and economic uncertainty also took their toll on sales of automobiles and consumer durables in the West, leading to continued extreme weakness in installment credit.

Other factors

Just as the rate of growth of interest expenses exceeded the rate of growth of interest income over the first half of 1982, non-interest expenses also rose faster than non-interest income. Western banks reported significant increases in income arising from leasing operations and service charges. However, these increases were overshadowed by a 12.2-percent increase in salary and benefit expenditures over the first half of 1982, and surges in occupancy expenses (up 23.7 percent over the same period in 1981) and loan loss provisions (up 46.0 percent over 1981).

As the first half progressed, and the recession in the West continued, credit quality became an increasingly important factor in the earnings picture, both at the larger institutions holding troubled national and international credits and at the smaller institutions faced with severely depressed local markets. In the first half of 1982, Western banks' $191 million increase in provisions for loan losses was a major determinant of the District's 19.6 percent decline in net income. Such increases in provisions were necessary, however, in light of high loan delinquency rates, increases in non-performing loans, and increases in the probability of sizable loan write-offs in the second half.

Indeed both nationally and in the West, much of the uncertainty surrounding the level of bank earnings for the remainder of the year hinges on the timing and extent of actual write-offs and banks' efforts to maintain an adequate cushion against losses.

Second-half prospects

Earnings prospects for the remainder of the year look more favorable because of the steep decline in rates over the third quarter. Western banks' earnings performance may still lag behind the national standard but this region's bank earnings should show the positive effects that declining rates are already having on margins. In particular, the slow reduction in the prime rate relative to the declines in rates on Federal funds and large denomination certificates of deposit helped to boost margins on commercial lending operations and should be reflected in an increase in third quarter earnings.

Sizable reductions in Treasury bill rates will also gradually lower the cost of consumer deposits, the yields of which are tied to those rates. Indeed, if rates remain near their present levels the end of the year may see a significant widening of margins as many high-cost, short-term consumer deposit instruments mature and are replaced by deposits paying lower rates.

Although in 1982 Western banks are unlikely to reach the earnings plateau attained in 1980 and 1981, their second half performance should show considerable improvement. Most of that improvement is likely to come from improved margins because both commercial and consumer loan demands are likely to remain sluggish through year-end. Twelfth District bank earnings should also benefit from some improvement in credit quality because lower interest rates should improve borrowers' ability to meet debt service obligations. However, while improvement on the bottom line is likely for Western banks in general during the last two quarters, individual institutions' performance will depend on their ability to hold down overhead expenses and to manage problems of credit quality.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 10/20/82	Change from 10/13/82	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	162,706	− 200	9,814	6.4
Loans (gross, adjusted) — total#	142,995	− 30	11,041	8.4
Commercial and industrial	45,974	24	6,226	15.7
Real estate	57,627	17	2,616	4.8
Loans to individuals	23,375	10	154	.7
Securities loans	2,569	− 288	908	54.7
U.S. Treasury securities*	6,588	26	992	17.7
Other securities*	13,123	− 196	− 2,219	− 14.5
Demand deposits — total#	39,604	−1,449	124	.3
Demand deposits — adjusted	27,858	−1,008	45	.2
Savings deposits — total	31,888	− 139	2,439	8.3
Time deposits — total#	100,868	− 636	14,980	17.4
Individuals, part. & corp.	90,685	− 624	12,649	16.2
(Large negotiable CD's)	38,306	− 799	4,906	14.7

Weekly Averages of Daily Figures	Week ended 10/20/82	Week ended 10/13/82	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	89	63	47
Borrowings	1	12	9
Net free reserves (+)/Net borrowed(−)	88	51	38

* Excludes trading account securities.
# Includes items not shown separately.

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