
FRBSF WEEKLY LETTER

November 16, 1984

Asset Quality and Western Bank Earnings

Historically, business expansions have brought in their wake an improvement in banks' loan and asset quality as they improved the economic conditions of bank customers. This process takes time, but a significant improvement in bank loan quality usually can be observed by the second year of a recovery. The current expansion, however, appears likely to prove the exception. Despite a vigorous economic expansion now nearing the end of its second year, a significant improvement in banks' loan and asset quality does not seem imminent.

Nevertheless, the earnings of western (Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah, Washington) banks have rebounded as improved net interest margins and moderate asset expansion have offset the deterioration in asset quality caused by high real interest rates, a strong U.S. dollar, and significant changes in the economy. This *Letter* reviews some of the major challenges facing the banking industry and the improvements that have allowed western banks, on net, to increase their earnings.

Lagging asset quality

As we approach the third year of the expansion in business activity, there are several indications that credit quality will continue to act as a drag on bank earnings. One factor is the high level of real interest rates during the current recovery (Chart 1), which has increased the real debt burden of many firms. With few signs that real rates will decline to typical post-War average levels, banks can expect only minor improvement in this determinant of asset quality in the near-term.

High real interest rates in the U.S. are also complicating the international debt repayment situation. They, along with the strong U.S. dollar, have increased the repayment burden for dollar-denominated debts, especially among the lesser developed countries (LDCs). Because prospects for a solution to the economic problems of LDCs seem unlikely in the near future, large banks probably will be plagued for some time by their loans outstanding to these nations.

High real interest rates and the strong dollar also have contributed to weakness in several important segments of the domestic economy. The strong dollar has curbed the overseas sales of many firms in the export sector, while stiff competition from imported products has hurt competing domestic industries. Furthermore, changes in relative prices have weakened many so-called "smokestack" industries to the detriment of the regions in which they are located. The troubled agriculture, steel, timber, and mining industries have increased banks' exposure to problem loans, and even a robust economy is unlikely to improve the prospects of repayment by some firms in these struggling industries. Moreover, persistent weakness in the markets for petroleum products will continue to depress the energy industry which has already accounted for many troubled credits.

No silver lining

The major causes of problem loans are not likely to be resolved in the near future. Most analysts are not expecting real interest rates to take a nosedive; the dollar also is expected to remain strong; and it will take time for depressed industries to bounce back. Still, even if there were significant improvements in these factors, there will be a long lag before they show up in improved asset quality for banks.

Indeed, in recent months, bankers have indicated that they do not expect a sudden improvement in asset quality. Some of them have taken steps to boost their loan loss reserves by large increments while others have taken sizeable charge-offs while still maintaining loss reserve levels. Some banks have used extraordinary gains (building sales, for example) to boost their loss reserves rather than their earnings. These actions reduce current earnings and demonstrate the depth of bankers' concerns about credit quality.

Western performance

Despite the asset quality problems, banks in the western region have generally reported a significant improvement in earnings for 1984. For example, over the first six months of this year, aggregate earnings were up nearly thirty-seven percent over the level for the first half of 1983. Partial

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third-quarter-1984 results are likewise encouraging. While there is considerable variation in the performance of the region's 776 commercial banks, as a group they are expected to post their first year-over-year increase in net income (excluding extraordinary gains/losses) since 1980.

Improved interest margins

Thus far in 1984, banks in the West have been able to improve their net interest margins in several important areas. On the funding side, the deregulation of interest rates on consumer time and savings deposits, and particularly the market pricing of money market deposit accounts (MMDAs), have had less of an impact on interest expenses than might have been expected. Throughout much of the year, the interest rates paid on money market deposit accounts, which total over twenty percent of western banks' total domestic deposits, were well below those paid by competing money market mutual funds or by banks on large-denomination time certificates of deposit (CDs)—an alternative source of funds (Chart 2). While this MMDA pricing strategy resulted in some erosion of MMDA balances, it represented a significant cost savings, especially as the difference between MMDA and the other rates widened over much of the year.

Banks also boosted net interest margins (with some added risk of potential loan losses as well) by shifting from lower to higher return assets. For example, the twenty-nine largest banks in the West ran off over \$1.5 billion in securities during the first half of 1984 as commercial lending took off. In addition, institutions continued to increase the flexibility of the return on various assets by pricing a larger portion of new real estate and consumer loans on a variable rate basis. Thus, when interest rates rose earlier in the year, banks were able to maintain more favorable interest rate spreads than if these loans had been made on a fixed rate basis.

Uneven growth

Not only were banks able to improve their net interest margins in the first half but, in the aggregate, western banks were also able to expand their assets moderately. Such growth was considerably uneven across banks, however, with most of the expansion reported by smaller institutions. Growth at small community banks and regional institutions in the western states resulted from rapid increases in mortgage and consumer lending.

These institutions, even more than their larger rivals, benefitted from the renewed willingness of consumers to borrow, even at historically high real rates, to finance acquisitions of autos, other consumer durable goods and housing postponed over the last several years.

Assets at most of the West's largest banks, and especially those in California, showed little growth during the first half, with a few banks even reporting small declines. This is not surprising however, since growth at many of the largest banks was constrained by the need to build up capital and to reduce their leverage in accordance with new capital guidelines proposed by the regulatory agencies. Yet, while total assets stagnated, loans grew at a moderate pace as institutions restructured their asset portfolios by liquidating securities and converting other assets into loans.

Business loan demand at large banks in the West picked up sharply during the first two quarters as the improved financial health of the corporate sector increased its appetite for bank financing for mergers and acquisitions, investment in new plant and equipment, and inventory accumulation. Commercial loans at these banks increased by \$3.5 billion (a 15-percent annual rate) during the first six months.

Large western banks were also successful in their efforts to expand lending to individuals. Consumer loans, paced by new automobile purchases, increased nearly \$2 billion (a 12-percent annual rate) over the first six months. Real estate loan growth was less robust, climbing by \$1.5 billion (less than a 5-percent annual rate), despite a relatively high level of new lending activity. Many larger institutions with sizeable mortgage portfolios sell most of the new loans they originate to generate fee and service income and to avoid the risk of holding these assets should rates move adversely.

Asset quality's impact on profits

The improvement in western bank earnings does not mean that they escaped the lagging recovery in asset quality that afflicts the banking industry elsewhere. As did banks across the nation, western banks increased their loan loss provisions in 1984 in response to continued high levels of non-performing loans and defaults which were heaviest in agricultural, energy, and construction portfolios. Even though the economic climate has im-

Chart 1
Real Treasury Bill Rate*

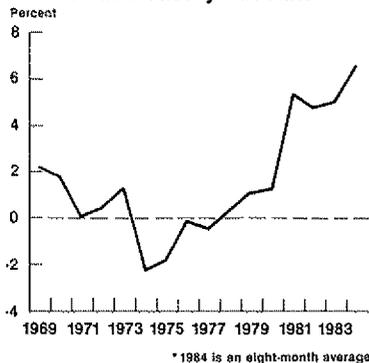


Chart 2
Improved Interest Margins

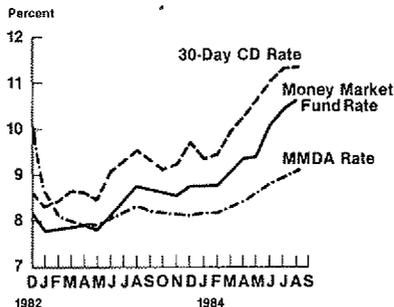
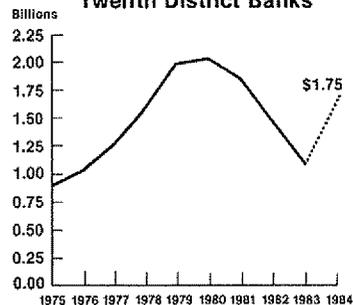


Chart 3
Aggregate Net Income
Twelfth District Banks



proved since 1982, nonperforming loans rose in 1984 to new highs at many banks and dampened earnings growth. Moreover, actual loan charge-offs at western banks were up during the first half, reaching \$1 billion, and exceeding even the record 1983 pace.

Even without any large defaults, major multinational banks continue to face considerable earnings risk if LDC credits were to be renegotiated on unfavorable terms. At mid-year the foreign assets of the twenty multinational banks in the nine western states accounted for about sixteen percent of these banks' \$375 billion in assets. While most of these banks' foreign loans are not LDC-related, the combined loans to Mexico, Brazil, Argentina, and Venezuela exceed primary capital at four of the five largest west coast banks. Thus, LDC loans renegotiated at lower than market rates could have a considerable negative impact on banks' interest margins.

1984 results

Western banks in the aggregate have lagged well behind the industry in earnings performance over the last three years primarily because of large loan losses suffered by a few banks. In 1984, they are likely to show a stronger improvement in net income and returns on equity and assets than banks nationally. Furthermore, in the absence of major interest rate changes or defaults during the last quarter, western banks will record higher net in-

terest margins for the year and report moderate asset expansion.

Interest margins should remain large as banks take advantage of their ability to price MMDA interest rates below alternative rates and to take advantage of the tendency when rates decline (as they have recently) for loan rates to lag temporarily behind the decline in funding costs. While loan demand from the corporate sector has weakened during the second half of 1984, western banks should continue to be able to increase their lending to the household sector. The result is that this region's banks will record a moderate expansion in domestic assets even though foreign assets will probably decline slightly.

Together, the positive factors will offset the continued need for large provisions for loss reserves and allow annual earnings for western banks in 1984 to reach \$1.75 billion (net of extraordinary gains or losses). This figure is well up from last year's depressed \$1.1 billion profit, but below the record \$2 billion earnings for 1980 (Chart 3). Still, the turnaround following successive declines in earnings since 1980 is important, especially in light of continued credit quality problems. Strong earnings will allow western banks to generate a substantial increase in much needed capital, and will give concerned institutions the opportunity to continue to build their cushion against potential loan losses.

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Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding	Change from	Change from 12/28/83	
	10/31/84	10/24/84	Dollar	Percent ⁷
Loans, Leases and Investments ^{1 2}	185,720	1,734	9,695	6.5
Loans and Leases ^{1 6}	167,020	1,699	11,665	8.8
Commercial and Industrial	50,558	664	4,595	11.8
Real estate	61,163	44	2,264	4.5
Loans to Individuals	30,593	186	3,942	17.4
Leases	5,074	23	11	0.2
U.S. Treasury and Agency Securities ²	11,573	25	— 934	— 8.8
Other Securities ²	7,127	10	— 1,036	— 14.9
Total Deposits	191,652	2,186	655	0.4
Demand Deposits	45,530	2,191	— 3,707	— 8.8
Demand Deposits Adjusted ³	29,300	19	— 2,031	— 7.6
Other Transaction Balances ⁴	12,279	223	— 496	— 4.5
Total Non-Transaction Balances ⁶	133,843	— 229	4,858	4.4
Money Market Deposit Accounts—Total	38,552	66	— 1,045	— 3.1
Time Deposits in Amounts of \$100,000 or more	41,171	— 263	3,006	09.3
Other Liabilities for Borrowed Money ⁵	22,516	2,197	— 491	— 2.5
Two Week Averages of Daily Figures	Period ended 10/22/84	Period ended 10/08/84		
Reserve Position, All Reporting Banks				
Excess Reserves (+)/Deficiency (—)	13	102		
Borrowings	102	67		
Net free reserves (+)/Net borrowed(—)	— 89	35		

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