FRBSF WEEKLY LETTER

April 28, 1989

Record Earnings For Western Banks

Western banks overcame the woes of 1987 with record earnings in 1988. Strong industry performance was reported across much of the Twelfth District. For the first time in this decade, western banks reported higher returns on assets and equity than did their counterparts in the rest of the country.

Both nonrecurring and fundamental factors accounted for the turnaround. The region's major banks, in particular, enjoyed gains from nonrecurring factors, such as reduced expenses for loan loss provisions, the resumption of interest payments by Brazil, and reduced tax liability from tax loss carryforwards. More importantly, most western banks benefitted from improved fundamental factors, including the continued strength of the western economy, improvements in asset quality, higher net interest margins, stable overhead expenses, and growth in assets. Still, the industry in the West may not be entirely out of the woods, as asset quality concerns linger and 119 of the region's 750 banks still reported losses for the year.

Strong performance

Bank performance in 1988 was by far the best this decade. Overall, bank earnings in the region topped $3.7 billion, nearly twice the previous record set in 1980. The return on assets (ROA) rose to 0.88 percent and return on equity (ROE) to 14.9 percent. Both measures exceeded the national averages (based on preliminary data) of 0.84 and 13.6 percent for ROA and ROE, respectively.

Banks in four states (Hawaii, Oregon, Nevada, and Washington) had both record earnings and ROAs of 1.15 percent or better. Earnings of California banks topped a record $2.7 billion, generating a return on assets of 0.93 percent. Net income also increased in Idaho, Utah, and Arizona, although performance in Utah and Arizona was well below the average for the region. Finally, even in Alaska, where losses remained substantial, an improving trend was evident.

Sound economy

The economy in the West continued to expand as the national economy moved towards its seventh consecutive year of growth. This strength helped western banks in 1988. It provided ample deposit growth, buoyed demand for consumer-oriented credit, and improved the business sector's financial condition, thereby improving loan asset quality.

But there were some trouble spots. At the top of the list was Alaska, which has been hit hard by the weakness in the energy sector. The losses incurred by Alaskan banks clearly reflect the all-pervasive troubles. Likewise, the slowdown in the real estate market in Arizona had a detrimental impact on the earnings of Arizona banks.

Asset quality

These trouble spots notwithstanding, the most dramatic improvement in earnings in 1988 resulted from improved asset quality. The continued strength of the western economy reduced the volumes both of nonperforming loans and of domestic loans that had to be charged off as losses. The ratio of nonperforming loans to total loans declined from 6.46 percent in 1987 to 5.11 percent in 1988. Nonperforming loan ratios declined for all the major loan categories, including real estate, commercial, consumer, and agricultural loans. Moreover, western banks improved asset quality during the year by charging off, swapping and/or selling troublesome loans. Banks with less developed country (LDC) loans, in particular, reduced their nontrade-related LDC exposure by $3 billion.

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.

With this improvement in asset quality, banks were able to reduce their additions to loan loss reserves. (Additions to banks' loan loss reserves are counted as expenses which reduce current earnings.) In 1988, these expenses dropped to $2.7 billion, the lowest level since 1984, and far lower than the record $6.4 billion expense in 1987, when the largest banks in the region dramatically increased their loan loss reserves against troubled LDC, real estate, and energy loans.

Wider margins, stable overhead
Western banks also enjoyed improved net interest margins in 1988. This difference between the cost of funds and the yield on assets widened by 17 basis points over its level in 1987, largely because loan rates rose more rapidly than did rates on some types of retail deposits. For example, banks' prime lending rate rose by 175 basis points over the year. In contrast, rates on NOWs, savings, Money Market Deposit Accounts (MMDAs) and to a lesser extent, small time certificates, rose much more sluggishly. In particular, MMDA rates quoted by western banks increased by only 40 basis points in 1988, even though yields on competing money market mutual funds rose by 149 basis points during the year. In addition, large banks' net interest margins got a boost from the resumption of interest payments from Brazil.

Western bank earnings also benefitted from improved cost control and increased fee income in 1988. In the aggregate, the ratio of net noninterest expense to assets, a measure of a bank's net overhead expenses, declined slightly over the year. Labor costs declined by 2.8 percent, in part because banks reduced staff by 6.7 percent and reduced the number of branches modestly.

Growth
Western banks provided a stronger base for continued growth by adding over $2 billion in common equity (book value). The aggregate ratio of equity capital to assets now stands at 5.78 percent, compared to 5.61 percent in 1987. Retail deposit inflows remained the single most important funding source in 1988. However, there were signs that the deposit market tightened over the year, especially in the face of strong interest rate competition from money market funds. Total deposit growth for the region was only 3.9 percent, below the 5.7 percent growth rate for assets. As a result, western banks increased their reliance on generally more expensive nondeposit sources of funds, such as federal funds, repurchase agreements, and eurodollar borrowings, by nearly one-third, to $37 billion at year-end.

Virtually all the growth in lending focused on the household sector, despite concerns about debt burdens. Real estate and consumer loans grew at 11.8 percent and 8.5 percent rates, respectively. And home equity lines of credit increased by more than 50 percent. In contrast, commercial loan growth, especially from the largest corporate borrowers, remained weak, except for merger financing, which accounts for about five percent of large western banks' business loans, versus about 11 percent for large banks nationally.

Outlook for '89
In the future, as in the past, earnings at western banks will hinge on continued improvement in asset quality. Here, the outlook is good; continued strength in the region's economy means that domestic asset quality should continue to improve. But several questions remain. Variable rate consumer, energy, construction, and real estate loans, as well as loans to finance leveraged buyouts, may be especially vulnerable to a downturn. And although exposure to LDC debt has been reduced, over $9 billion still remains on the books. Moreover, the market value of many of these LDC loans has deteriorated.

Another concern is that gains in interest margins and cost control are likely to be less dramatic in 1989 than in 1988. For example, margins may narrow as banks rely more heavily on borrowed money to fund growth. Competition from money market funds also may drive up the cost of retail deposits.

Thus, although western bank performance in 1989 still should be strong, it may not match 1988's performance unless these lingering problems can be resolved.

Gary C. Zimmerman
Economist

REGIONAL BANKING DATA

December 31, 1988

(Not Seasonally Adjusted, Preliminary Data)

	DISTRICT	ALASKA	ARIZONA	CALIF	HAWAII	IDAHO	NEVADA	OREGON	UTAH	WASH
ASSETS AND LIABILITIES -- $ MILLION (ALL COMMERCIAL BANKS)										
ASSETS TOTAL	428,917	4,527	28,204	297,297	13,892	7,470	13,325	19,494	11,125	33,583
FOREIGN	40,082	1	N/A	37,907	1,437	N/A	N/A	0	119	618
DOMESTIC	388,835	4,526	28,204	259,390	12,454	7,470	13,325	19,494	11,006	32,965
LOANS TOTAL	297,637	2,280	19,886	207,661	8,600	4,768	10,292	12,569	7,196	24,386
FOREIGN	32,676	1	N/A	31,489	761	N/A	N/A	0	N/A	424
DOMESTIC	264,962	2,279	19,886	176,172	7,839	4,768	10,292	12,568	7,196	23,962
REAL ESTATE	111,165	1,043	8,769	78,641	3,952	1,237	1,664	3,885	2,883	9,090
COMMERCIAL	74,115	781	4,902	50,519	2,081	1,298	1,516	4,777	1,681	6,561
CONSUMER	54,670	227	4,197	30,548	1,261	1,324	6,818	2,750	1,938	5,607
AGRICULTURE	5,112	8	501	2,680	19	567	18	361	114	843
INTERNATIONAL	249	N/A	32	213	0	N/A	N/A	0	2	2
SECURITIES TOTAL	43,908	1,346	3,836	24,247	2,384	1,452	1,981	3,501	1,811	3,350
U.S.T.S.	13,838	925	1,650	6,534	816	524	623	1,048	458	1,259
SECONDARY MARKET	16,711	199	649	11,991	543	493	365	788	796	887
OTHER SEC.	13,359	222	1,537	5,722	1,025	435	992	1,665	557	1,204
LIABILITIES TOTAL	404,115	4,185	26,486	281,022	12,999	6,956	12,548	18,178	10,353	31,387
DOMESTIC	364,033	4,184	26,486	243,115	11,562	6,956	12,548	18,178	10,234	30,769
DEPOSITS TOTAL	344,955	3,748	23,400	240,966	12,181	6,114	6,510	15,302	8,754	27,979
FOREIGN	33,224	0	N/A	31,299	1,238	N/A	N/A	N/A	119	567
DOMESTIC	311,731	3,747	23,400	209,667	10,943	6,114	6,510	15,302	8,635	27,412
DEMAND	82,094	926	4,839	59,976	2,006	1,036	1,908	3,267	1,759	6,377
TIME AND SAVINGS	229,637	2,821	18,562	149,691	8,937	5,078	4,602	12,035	6,876	21,035
OTHER BORROWINGS	37,014	385	2,680	21,785	324	759	5,497	2,096	1,142	2,346
EQUITY CAPITAL	24,802	342	1,718	16,275	892	514	777	1,315	772	2,196
LOAN LOSS RESERVE	8,131	83	402	6,477	132	88	234	169	151	397
STANDBY LETTERS OF CREDIT	32,972	27	703	29,016	414	102	160	568	257	1,725
LOAN COMMITTMENTS	139,221	365	5,442	112,032	3,789	957	1,354	3,992	1,602	9,689
LOANS SOLD	125,081	33	242	124,262	109	25	19	151	31	211
ASSET QUALITY -- PERCENT OF LOANS (LARGE COMMERCIAL BANKS)										
LOAN LOSS RESERVE (ALL BANKS)	2.73	3.62	2.02	3.12	1.53	1.84	2.27	1.34	2.10	1.63
NET CHARGEOFFS, TOTAL	1.18	8.61	1.49	1.15	0.17	0.73	1.73	0.85	1.39	0.88
REAL ESTATE	0.40	14.90	1.01	0.13	0.03	0.27	0.45	0.68	0.58	0.54
COMMERCIAL	0.74	4.98	1.52	0.62	0.12	1.18	1.55	0.54	2.12	0.75
CONSUMER	1.63	1.28	1.84	1.75	0.31	0.75	2.11	1.12	0.96	1.17
AGRICULTURE	-.13	N/A	0.98	-.99	1.54	1.27	0.04	0.84	0.64	0.90
PAST DUE & NON-ACCRUAL, TOTAL	5.11	17.70	8.79	5.25	1.31	2.14	2.62	2.91	4.34	3.89
REAL ESTATE	5.60	27.80	14.00	4.68	1.08	2.06	4.20	4.73	5.46	5.56
COMMERCIAL	5.00	13.10	7.55	5.31	1.34	2.31	3.67	2.28	3.56	3.42
CONSUMER	2.62	1.95	2.12	2.99	2.21	2.07	2.13	2.03	2.68	2.19
AGRICULTURE	10.30	3.55	3.98	14.20	11.70	3.41	0.65	5.78	5.26	6.94
EARNINGS AND RETURNS -- $ MILLION (ALL COMMERCIAL BANKS)										
INCOME TOTAL	43,468	416	2,693	30,177	1,319	729	1,602	1,854	1,111	3,565
INTEREST	36,446	354	2,346	24,938	1,125	653	1,433	1,628	987	2,982
FEES & CHARGES	1,988	18	142	1,360	33	40	46	98	56	195
EXPENSES TOTAL	37,954	549	2,620	26,073	1,078	650	1,289	1,561	1,059	3,075
INTEREST	18,847	212	1,277	12,941	599	357	601	817	534	1,510
SALARIES	7,669	89	519	5,406	232	108	169	326	158	662
LOAN LOSS PROVISION	2,676	115	309	1,643	40	40	176	73	118	162
OTHER	8,762	133	515	6,083	207	145	344	345	249	740
INCOME BEFORE TAXES	5,466	-133	72	4,071	240	77	313	286	51	490
TAXES	2,036	-1	9	1,573	86	24	104	84	17	141
NET INCOME	3,702	-133	67	2,727	154	53	210	209	35	379
ROA (%)	0.88	-2.90	0.24	0.93	1.16	0.72	1.64	1.17	0.32	1.15
ROE (%)	14.90	-39.00	3.88	16.80	17.30	10.30	27.00	15.90	4.55	17.30
NET INTEREST MARGIN (%)	4.20	3.09	3.92	4.11	3.97	4.02	6.52	4.53	4.16	4.47
NUMBER OF BANKS	750	10	47	442	22	22	16	52	49	90

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MARKET SHARE STATISTICS

PERCENT OF TOTAL DEPOSITS, FOR FEBRUARY 1989, BY REGION

	DISTRICT			ALASKA			ARIZONA			CALIF			HAWAII			IDAHO			NEVADA			OREGON			UTAH			WASH		
DEPOSIT TYPE	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	72	9	19	53	43	4	41	55	3	64	31	5	87	10	3	66	31	3	65	30	5	66	24	10	54	40	7
DEMAND	94	4	2	97	1	2	93	4	3	93	5	2	94	3	3	99	1	0	100	0	0	96	2	2	93	4	3	95	4	1
NOW	60	33	7	49	15	35	66	26	8	56	38	6	73	24	3	88	7	5	77	16	7	76	18	6	72	17	11	64	24	12
SAVINGS & MMDA	58	33	8	53	8	39	67	25	8	56	37	7	61	29	10	88	8	4	71	24	5	68	22	9	66	13	21	56	30	15
SMALL TIME	26	71	3	71	19	10	40	57	2	19	78	3	38	59	2	82	16	2	35	63	2	50	47	3	53	41	7	40	57	4
LARGE TIME	32	67	1	94	4	1	37	62	1	28	71	1	77	21	3	85	11	5	63	37	0	67	30	2	71	25	4	44	55	1

CB = COMMERCIAL BANKS; SL = SAVINGS & LOANS AND 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	DEC88	5.87	5.54	5.40	5.63	5.51	5.45	5.00	6.05	5.11
	JAN89	5.93	5.54	5.40	5.62	5.63	5.53	5.00	6.10	5.11
	FEB89	6.01	5.67	5.55	5.79	5.63	5.62	5.14	6.19	5.09
6-MONTH CERTIFICATES	DEC88	7.84	7.28	7.15	7.24	6.81	8.10	7.55	8.03	6.94
	JAN89	8.00	7.37	7.43	7.35	6.93	8.10	7.58	8.15	7.00
	FEB89	8.16	7.59	7.64	7.61	7.12	8.42	7.61	8.19	7.13
2-1/2 YEAR CERTIFICATES	DEC88	8.39	8.13	8.05	7.98	8.58	8.62	8.45	8.53	7.92
	JAN89	8.46	8.20	8.05	8.09	8.61	8.70	8.46	8.66	7.95
	FEB89	8.58	8.37	8.34	8.33	8.61	8.86	8.51	8.71	7.99
COMMERCIAL, SHORT-TERM*	FEB89	10.97	10.84	10.59	10.72	11.06	12.41	10.87	12.18	11.38
AVERAGE MATURITY (DAYS)		44	52	73	38	95	47	54	124	81
COMMERCIAL, LONG-TERM*	FEB89	11.71	11.06	12.09	10.72	13.14	12.55	N/A	13.44	11.86
AVERAGE MATURITY (MONTHS)		53	84	46	93	35	52	N/A	30	66
CONSTRUCTION LOANS*	FEB89	12.09	11.17	12.29	11.38	N/A	N/A	11.20	N/A	11.26
AVERAGE MATURITY (MONTHS)		12	4	4	8	N/A	N/A	13	N/A	11
LOANS TO FARMERS*	FEB89	12.28	11.58	12.37	11.44	10.97	13.05	11.28	12.74	11.85
AVERAGE MATURITY (MONTHS)		15	7	7	4	29	18	10	44	9
CONSUMER LOANS, AUTOMOBILE	FEB89	11.76	12.19	N/A	12.64	N/A	15.00	11.10	12.50	11.65
CONSUMER LOANS, PERSONAL	FEB89	15.22	16.40	N/A	18.98	N/A	15.00	12.44	17.50	17.05
CONSUMER LOANS, CREDIT CARDS	FEB89	17.83	18.35	N/A	19.42	N/A	N/A	19.24	19.25	15.75

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

* U.S. DATA ARE COMPOUNDED ANNUAL RATES, DISTRICT AND STATE DATA ARE SIMPLE ANNUAL RATES.