FRBSF Weekly Letter
October 26, 1990

Banking Performance

Concern over deteriorating asset quality, especially real estate-backed assets, has dominated the news about the banking industry recently. As nonperforming loans have risen and industry-wide earnings have fallen, several major banks have announced massive reductions in staff and increased reserves against future losses.

Reflecting investors' concerns, bank stock prices have fallen dramatically. In percentage terms, Salomon Brothers' 35-bank index has fallen about three times faster than the broader S&P 500. Moreover, a recent survey by the *American Banker* revealed that 35 percent of the public considers the banking system "unhealthy," the poorest rating since the survey began in 1984.

In this *Letter* some of the concerns about the banking industry are explored. Western banks are faced with many of the same problems as banks elsewhere. However, with the exception of Arizona, their performance has been strong, and most indicators of asset quality remain favorable. Even so, stock prices of major western banks have fallen along with the stock prices of the rest of the industry.

A long list

The list of worries facing bankers in 1990 is a long one. Currently at the head of the list is the continued deterioration of the real estate market, especially for commercial properties and for construction and land development projects. Problems in real estate markets have been particularly acute in New England, Texas, and Arizona, where even housing prices have fallen.

As a result of weakening real estate markets, the banking industry is reporting a rise in past due and nonperforming real estate loans, from an average of about five percent of the total over the prior five years to over six percent currently. Loans "charged off" as uncollectible also have risen, to 0.7 percent for the first half, nearly double the average for the prior five years.

Not only is the quality of real estate assets a concern, but the *quantity* has become a concern as well, as real estate loans outstanding have doubled since 1984, and the share of real estate loans in bank portfolios has increased dramatically. The increase in banks' exposure to real estate loans partly reflects a decline in their role as commercial lenders. Business loans outstanding have grown only 20 percent in the last five years, as major corporate customers have reduced their borrowing from banks in favor of raising funds directly in the commercial paper and long-term debt markets. In addition, intense competition from foreign banks has tended to curtail U.S. banks' role in commercial lending.

Another concern is the course of the economy and its impact on the quality of business loans. Banks now hold relatively fewer commercial credits of top-rated, lower-risk, corporate borrowers and more loans to both middle market and highly leveraged borrowers that are more likely to be sensitive to cyclical downturns. Should the economy slow appreciably and firms experience cash flow problems, commercial loan quality could deteriorate significantly.

Many money center banks are also concerned about their still-sizeable exposure to less developed country (LDC) loans, especially if the situation in the Middle East begins to have an adverse impact on non oil-producing LDCs. Finally, with personal bankruptcies at a record level, and consumer loan charge offs up slightly, consumer loan quality is another concern.

Industry performance

The performance of the banking industry in the first half of 1990 reflected these problems. Bank earnings were 18 percent lower than in the first half of 1989, and the return on assets (ROA) fell

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.

from 0.90 to 0.70. (Although ROA slipped, 0.70 still exceeds the industry average for the prior decade.) This decline also suggests that although banks have attempted to reduce staff, these cost savings have not been fully realized yet. At the same time, higher overhead expenses associated with monitoring problem loans actually have raised overhead costs.

In addition to higher overhead expenses, banks' net interest margin (NIM), which measures the difference between the return banks receive on their assets and the cost of funding those assets, declined several basis points to 3.42 percent. This reflected a shift to relatively more expensive time deposits for funding.

Sluggish asset growth also tended to constrain income growth this year. Faced with the need to raise additional capital and improve asset quality, banks were forced to curtail lending; in the first half of this year, assets grew less than 1½ percent, about half of the growth rate in 1989.

The West: better

Through the first half, bank performance in the West contrasted sharply with the deterioration seen elsewhere in the nation. Earnings at western banks increased 16 percent over the first half of 1989 and ROA rose to 1.19 from 0.91 percent. Performance throughout the region was favorable, as first half earnings rose in all the western states except Arizona. Even in Arizona improvement was notable; losses were down substantially.

Continued growth in the western economy, which spurred loan growth and kept asset quality at a high level, largely accounts for the favorable earnings picture. Unlike the experience nationally, western banks' assets have expanded rapidly in recent months. Even ignoring the $5 billion in assets gained through acquisitions of S&Ls, western banks' assets grew by over $18 billion, or at an eight percent annual rate.

Much of this growth was real-estate related. In fact, even though real estate markets in the West began to cool off at the end of last year, western banks' real estate lending continued to grow rapidly during the first half and into the third quarter of this year. Real estate loans increased at annual rates of 22 and 28 percent for the region and California, respectively. Residential mortgages and home equity lines of credit rose even faster than did total real estate loans, although some of the increase also reflects funding for commercial projects already in the pipeline before the slowdown.

On account of this rapid growth, western banks' real estate loans now amount to over 43 percent of total loans, well above the nationwide average of 37 percent. California has an even higher share, at 46 percent.

Such a large concentration of real estate loans is a source of concern. Fortunately, however, the types of real estate loans held by banks in California and the West are not as risky as those held by banks in regions that are experiencing difficulties. California banks hold more than half of their real estate loans in relatively low-risk residential loans. This is well above the national average. At the same time, California banks hold only about a 23 percent share of commercial real estate loans, compared to over 29 percent nationally and 30 to 40 percent in Texas and New England, where overbuilt commercial real estate markets have been a cause of significant deterioration in real estate loan quality.

And although California banks hold a higher share of construction and land development loans than is the case nationally, the California economy and the West in general are much less dependent on the construction industry than is true of the regions where risky construction loans have exhibited poor performance.

Finally, in the West, the most recent data provide no indication that the quality of either commercial or real estate loans has begun to deteriorate. On the contrary, the ratio of net charge-offs to total loans and leases has *fallen* slightly for large western banks' real estate and commercial loans. Likewise, the ratios of past due real estate and commercial loans to total loans have fallen.

Investor concerns

In spite of such a strong performance, the stock prices of western banks have fallen sharply along with those of banks elsewhere. Nervous investors apparently have downplayed the favorable performance of the industry in this region, and have concentrated on the potential spread of asset quality deterioration and uncertainty about the extent of further slowing in the economy. Thus, although most western banks have weathered the slowdown in the economy better than the industry in general, they are not exempt from industry- and economy-wide concerns.

Gary C. Zimmerman
Economist

REGIONAL BANK DATA

JUNE 30, 1990

(Not Seasonally Adjusted, Preliminary Data)

		DISTRICT	ALASKA	ARIZ.	CALIF.	HAWAII	IDAHO	NEVADA	OREGON	UTAH	WASH.
ASSETS AND LIABILITIES-- $ MILLION (ALL COMMERCIAL BANKS)											
ASSETS	TOTAL	487,539	4,312	30,329	338,145	16,947	8,336	14,961	23,060	11,528	39,919
	FOREIGN	41,152	0	N/A	38,464	2,256	N/A	N/A	N/A	71	361
	DOMESTIC	446,387	4,312	30,329	299,681	14,691	8,336	14,961	23,060	11,457	39,558
LOANS	TOTAL	348,777	1,922	19,911	248,369	9,641	5,601	11,215	15,746	7,489	28,883
	FOREIGN	33,140	N/A	N/A	31,980	1,034	N/A	N/A	N/A	N/A	127
	DOMESTIC	315,637	1,922	19,911	216,389	8,607	5,601	11,215	15,746	7,489	28,757
	REAL ESTATE	150,506	755	7,074	114,463	4,143	1,506	2,275	4,991	2,970	12,330
	COMMERCIAL	77,038	695	3,784	51,919	2,559	1,453	1,669	5,556	1,787	7,617
	CONSUMER	57,766	282	5,173	31,536	1,313	1,549	6,821	3,293	2,041	5,759
	AGRICULTURE	5,678	5	458	2,829	43	677	21	405	136	1,104
	INTERNATIONAL	378	N/A	12	359	0	N/A	N/A	6	N/A	0
SECURITIES	TOTAL	43,238	1,754	3,911	21,226	3,388	1,630	1,869	3,712	2,078	3,669
	U.S.T.S.	13,056	1,090	1,320	5,927	1,001	464	672	903	517	1,162
	SECONDARY MARKET	18,437	255	1,510	10,051	1,540	686	499	1,605	1,052	1,238
	OTHER SEC.	11,745	409	1,080	5,248	847	480	698	1,204	509	1,269
LIABILITIES	TOTAL	457,195	3,850	28,325	317,892	15,975	7,789	13,912	21,470	10,739	37,243
	DOMESTIC	416,043	3,849	28,325	279,428	13,719	7,789	13,912	21,470	10,668	36,882
DEPOSITS	TOTAL	385,828	3,317	26,002	267,449	15,143	6,559	8,315	17,776	9,169	32,097
	FOREIGN	35,249	0	N/A	32,700	2,109	N/A	N/A	N/A	71	369
	DOMESTIC	350,578	3,317	26,002	234,749	13,034	6,559	8,315	17,776	9,098	31,728
	DEMAND	81,531	979	4,750	58,281	2,335	1,077	2,096	3,407	1,722	6,885
	TIME AND SAVINGS	269,047	2,338	21,252	176,468	10,699	5,482	6,219	14,369	7,377	24,844
	NOW	32,602	233	2,269	20,760	1,258	746	870	2,246	1,075	3,145
	MMDA	65,926	408	4,768	45,053	2,107	1,040	1,784	3,206	1,484	6,074
	SAVINGS	31,774	357	1,311	22,449	1,419	383	858	1,412	812	2,773
	SMALL TIME	78,535	697	10,196	44,021	1,781	2,629	1,239	5,585	3,065	9,321
	LARGE TIME	59,766	626	2,692	43,892	4,132	666	1,468	1,910	938	3,442
OTHER BORROWINGS		48,636	487	1,729	32,093	388	1,147	4,810	3,055	1,407	3,521
EQUITY CAPITAL		30,344	463	2,004	20,253	973	547	1,049	1,590	789	2,676
LOAN LOSS RESERVE		7,584	41	693	5,642	146	90	205	218	146	404
LOAN COMMITMENTS		199,592	561	9,902	151,402	7,080	2,102	2,168	7,773	2,874	15,730
LOANS SOLD		61,469	42	525	59,762	54	38	187	397	64	401
ASSET QUALITY -- PERCENT OF LOANS (LARGE COMMERCIAL BANKS)											
LOAN LOSS RESERVE (ALL BANKS)		2.17	2.14	3.48	2.27	1.51	1.60	1.83	1.38	1.95	1.40
NET CHARGEOFFS, TOTAL		1.14	0.47	1.74	1.20	0.03	0.20	3.06	0.53	0.80	0.49
	REAL ESTATE	0.22	0.79	1.35	0.12	-.01	0.06	0.41	0.27	0.52	0.46
	COMMERCIAL	0.54	0.09	3.74	0.43	-.09	0.19	1.18	0.47	1.07	0.18
	CONSUMER	1.98	0.42	2.18	1.86	0.38	0.55	4.46	1.18	1.25	0.95
	AGRICULTURE	-.42	N/A	-.02	-1.2	-.03	-.15	-.02	0.52	0.42	1.14
PAST DUE & NON-ACCRUAL, TOTAL		4.14	5.56	8.73	4.09	0.93	1.66	6.15	2.34	3.71	3.04
	REAL ESTATE	3.68	8.15	15.5	3.03	0.71	1.81	3.57	3.02	4.99	4.02
	COMMERCIAL	5.02	5.53	12.6	5.42	0.68	1.77	3.44	2.16	4.18	2.61
	CONSUMER	3.12	1.80	2.19	2.80	1.96	1.51	7.87	1.47	2.32	1.81
	AGRICULTURE	6.74	43.2	14.4	7.65	5.02	2.62	0.81	4.88	1.90	3.98
EARNINGS AND RETURNS -- $ MILLION, YEAR-TO-DATE (ALL COMMERCIAL BANKS)											
INCOME	TOTAL	27,074	222	1,478	18,830	819	433	1,319	1,201	615	2,157
	INTEREST	22,448	190	1,217	15,460	729	385	1,101	1,038	542	1,785
	FEES & CHARGES	1,168	10	78	802	18	21	28	68	32	111
EXPENSES	TOTAL	22,957	181	1,507	15,833	675	364	1,060	996	541	1,800
	INTEREST	12,435	98	702	8,652	425	221	492	570	307	967
	SALARIES	4,253	41	301	2,986	127	57	97	194	84	367
	LOAN LOSS PROVISION	1,466	4	167	936	12	6	180	50	32	79
	OTHER	4,803	37	337	3,260	111	80	292	182	118	387
INCOME BEFORE TAXES		4,096	41	-29	2,979	144	69	258	205	72	356
TAXES		1,417	10	-12	1,083	51	22	90	62	21	90
NET INCOME		2,816	31	-17	2,026	93	48	169	143	51	272
ROA (%)		1.19	1.47	-.12	1.23	1.13	1.18	2.11	1.28	0.90	1.42
ROE (%)		18.6	13.5	-1.7	20	19.1	17.5	32.2	17.9	13	20.4
NET INTEREST MARGIN (%)		4.24	4.31	3.72	4.15	3.72	4.06	7.62	4.19	4.15	4.27

Editorial comments may be addressed to the editor (Barbara Bennett) or to the author. . . . Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

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MARKET SHARE STATISTICS

DEPOSITORY INSTITUTIONS REQUIRED TO HOLD RESERVES WITH THE FEDERAL RESERVE ON A WEEKLY BASIS

PERCENT OF COMBINED MARKET TOTAL FOR AUGUST 1990, 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	50	46	5	74	4	22	69	25	5	44	52	4	67	28	5	87	10	3	70	28	3	71	23	6	78	10	12	56	36	7
DEMAND	92	4	4	99	0	1	92	2	5	92	4	4	92	4	4	92	1	7	99	1	0	95	1	4	92	3	5	92	5	3
NOW	63	30	7	60	5	35	81	10	9	58	36	6	71	26	3	88	9	3	79	15	6	79	14	7	83	5	12	64	24	12
SAVINGS	48	34	18	35	3	62	54	16	30	48	39	13	47	35	18	76	12	12	70	19	10	55	26	19	57	6	37	45	21	34
MMDA	67	31	2	90	8	2	85	14	1	62	36	2	81	19	0	94	6	0	82	16	2	84	13	4	83	7	10	69	29	2
SMALL TIME	31	66	3	76	8	15	58	39	3	23	74	3	41	56	3	84	14	2	47	51	2	57	39	5	74	16	10	43	52	4
LARGE TIME	43	55	2	94	3	3	71	26	3	38	60	2	82	16	2	86	11	4	70	30	0	83	13	4	81	12	7	50	50	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 AS OF AUGUST 1990 (%)

TYPE OF ACCOUNT OR LOAN		DATE	US	DISTRICT	ARIZ	CALIF	HAWAII	IDAHO	OREGON	UTAH	WASH
MONEY MARKET DEPOSIT ACCOUNTS		JUN90	6.31	6.24	5.85	6.47	5.69	6.04	6.56	6.10	6.39
		JUL90	6.28	6.22	5.82	6.43	5.69	6.03	6.49	6.33	6.32
		AUG90	6.23	6.18	5.76	6.30	5.69	5.95	6.53	6.34	6.32
92 TO 182 DAYS CERTIFICATES		JUN90	7.81	7.40	7.33	7.77	6.66	7.61	7.37	7.71	7.16
		JUL90	7.73	7.34	7.30	7.76	6.79	7.50	7.32	7.67	7.22
		AUG90	7.64	7.25	7.13	7.58	6.79	7.48	7.29	7.51	7.25
2-1/2 YEARS AND OVER CERTIFICATES		JUN90	8.00	7.85	7.55	7.95	8.00	8.01	7.95	8.06	7.72
		JUL90	7.94	7.75	7.52	7.88	7.81	7.96	7.93	8.05	7.69
		AUG90	7.89	7.62	7.39	7.74	7.77	7.93	7.64	7.88	7.71
COMMERCIAL, SHORT-TERM*	AVE. RATE		9.72	10.24	10.09	10.30	10.43	11.92	10.05	10.42	10.01
	AVE. MAT. (DAYS		49	166	73	264	90	105	170	167	159
COMMERCIAL, LONG-TERM*	AVE. RATE		10.72	11.18	10.90	11.39	11.28	N/A	N/A	12.15	9.25
	AVE. MAT. (MONTHS)		42	27	27	21	26	N/A	N/A	38	62
LOANS TO FARMERS*	AVE. RATE		10.95	9.93	10.54	9.64	9.88	11.36	10.64	12.39	11.13
	AVE. MAT. (MONTH)		7	6	5	7	N/A	11	5	6	6
CONSUMER, AUTOMOBILE	AVE. RATE		11.89	12.45	13.25	13.09	N/A	13.00	11.40	11.83	12.12
CONSUMER, PERSONAL	AVE. RATE		15.46	15.92	16.75	19.79	N/A	13.50	12.47	15.97	14.60
CONSUMER, CREDIT CARDS	AVE. RATE		18.18	18.60	18.00	19.44	N/A	N/A	19.24	20.18	16.97

SOURCES: SURVEY OF TERMS OF BANK LENDING AND TERMS OF CONSUMER CREDIT; MOST COMMON INTEREST RATES ON SELECTED ACCOUNTS.
* DATA ARE COMPOUNDED ANNUAL RATES.