FRBSF Weekly Letter

Number 91-37, October 25, 1991

Earnings Plummet at Western Banks

Earnings at western banks fell sharply in the second quarter of 1991, mainly because of a near doubling of expenses for loan loss provisions. Net income fell to $618 million for the quarter, down from $1.2 billion in the first quarter. Banks in Nevada and Oregon were the hardest hit, with second quarter earnings off almost 90 percent from the first quarter. In California, the drop for the period was more than 50 percent. And in Arizona, after showing a small profit in the first quarter, banks recorded a loss for the second quarter.

This earnings performance is reflected in aggregate return on assets (ROA) for District banks; it plunged from a healthy 0.95 percent in the first quarter to a weak 0.49 percent in the second quarter. And, California, with an ROA of only 0.41, slipped well below the aggregate ROA for the nation, 0.55 percent, for the first time since 1987.

Bank earnings typically follow a pattern determined by changes in asset quality. The recession that began in the third quarter of 1990 has caused a deterioration in real estate and commercial asset quality. Although U.S. data for the second quarter showed a slight improvement in asset quality, banks in this region continued to experience an increase in problem loans.

In this *Letter,* the second quarter performance of western banks is examined. Regional data indicate the breadth and magnitude of the performance problems in the West. However, they also highlight strong performances by banks in several states.

Loan problems mount

As of June 1991, problem loans (defined here as 30 days or more past due and non-accrual loans) as a percent of total loans rose to 5.66 percent in the region. Just a year ago this ratio was 4.14 percent. Still, for both periods, the ratios are well below national figures--5.14 percent in 1990 and 6.41 percent in 1991.

Deterioration in asset quality over the last year was most evident in California, Nevada, and Oregon. In California, problem loans have risen from 4.11 percent of total loans as of June 1990 to 6.16 percent as of June 1991.

Higher levels of problem loans usually indicate banks' need to increase loan loss provision expenses. Banks maintain a cushion of equity capital (stock and retained earnings) and loan loss reserves against potential losses in their loan portfolio and disruptions to their earnings stream. Therefore, in the second quarter of 1991, as problem loans increased, loss provision expenses jumped to $1.6 billion from only $860 million in the first quarter. This large increase in expenses severely eroded second quarter earnings, especially at some of the region's largest banks.

Real estate woes

Problem real estate loans as a percent of all real estate loans were up to 6.05 percent for the region, an increase from 3.64 percent a year earlier; but this is still well below the 8.16 percent figure for the nation (up from 6.07 percent a year ago). As of June, only Arizona, at 9.08 percent, had a ratio that exceeded the national average.

At the national level, a positive sign in the second quarter was a decline in problem construction and commercial real estate loans, possibly indicating that the deterioration is hitting bottom. But this sign was not evident in the region. In the second quarter, the region's largest banks (over $100 million in assets) reported a $630 million increase in troubled real estate loans, bringing the total to almost $10 billion. The bulk of these are concentrated in construction lending for land

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.

and development (about $4.7 billion) and commercial real estate ($3.2 billion), especially office buildings.

Real estate is likely to remain a problem for banks. Some real estate analysts foresee further deterioration in light of high vacancy rates and softening rents. And a Federal Reserve survey of major banks' lending officers in June raised concerns about further deterioration in construction lending as well.

Across the country, a large volume of "miniperm" construction loans--that is, loans with a maturity of usually five to eight years--will mature over the next year. The repayment history on these loans over the last year was not encouraging. The majority were not repaid as scheduled, forcing some to be temporarily extended and some to move into foreclosure proceedings. In some other cases, banks provided permanent financing when no other lenders were found. Similar problems are likely to occur with loans maturing in the next year, since only about one-fifth of them have permanent, nonbank lenders in place.

Commercial loans also turn sour

While problem real estate loan ratios in this region are still below the national average, continued deterioration in western banks' business loan portfolios has pushed the problem loan ratio up to 6.75 percent of total business loans, well above the national average of 6.11 percent. A year earlier, both ratios were at about 5 percent. The most serious deterioration in commercial loan portfolios has occurred in Nevada, where problem business loans were 11.0 percent of total business loans; Arizona, at 10.4 percent, and California, at 7.4 percent are not far behind. On the other hand, Hawaii, Idaho, and Washington, with problem business loan ratios of 3.1 percent or less, have thus far not experienced any significant deterioration in their portfolios.

Commercial credits, especially loans associated with highly leveraged transactions (HLTs), also have contributed to some larger banks' asset quality problems. Both banks and regulators have become more concerned about the risk associated with credits extended to highly leveraged firms, as a number of them have faced difficulties given the weakness in the economy.

Households to the rescue?

The household sector is expected to play a significant role in any economic recovery, so the "health" of consumer loans (comprising autos, mobile homes, revolving credit, and so forth) is an important indicator to watch. Nationally, the problem loan ratio for consumer loans in the second quarter was 4.34 percent compared to 3.66 percent a year earlier, as the household sector struggled with record levels of bankruptcies, weak growth in personal income, softness in consumer confidence, and high levels of unemployment associated with the recession. However, the second quarter ratio *is* a slight improvement over the first quarter.

In the West, this indicator is at 3.88 percent--above the year-ago level of 3.17 percent, but still below the national average. The region's performance was helped by declining problem loan ratios for consumer loans in Alaska, Hawaii, Idaho, Oregon, and Washington; the ratios rose in Arizona, California, Nevada, and Utah, however.

Outlook

After three years of leading the industry in performance, banks in the region, and especially California, have fallen off the pace. A number of the major banks in the West have reported weak earnings, and several have even experienced losses as asset quality problems have grown. While medium-sized and smaller banks have not escaped the ills that face the industry, so far, many have not experienced the same degree of loan quality deterioration reported by some of the West's major banks.

Furthermore, in states where the economic conditions have remained stronger, banks generally have reported more favorable earnings. For example, banks in Alaska, Hawaii, Idaho, Utah, and Washington all reported ROAs of 1 percent or more in the second quarter, a level considered excellent for the industry.

In other states, the deterioration in asset quality arising from the recession and weak real estate markets is a major challenge for many banks. Prospects for stabilizing and improving asset quality will hinge on improvements in the commercial real estate outlook and a turnaround in the overall economy, both nationally and in the region.

Gary C. Zimmerman
Economist

REGIONAL BANK DATA*

JUNE 30, 1991

(NOT SEASONALLY ADJUSTED, PRELIMINARY DATA)

		DISTRICT	ALASKA	ARIZ.	CALIF.	HAWAII	IDAHO	NEVADA	OREGON	UTAH	WASH.
ASSETS AND LIABILITIES -- $ MILLION (ALL COMMERCIAL BANKS)											
ASSETS	TOTAL	507,734	4,420	34,409	348,625	19,776	9,055	13,293	25,522	13,183	39,451
	FOREIGN	35,767	0	N/A	33,859	1,709	N/A	N/A	24	60	115
	DOMESTIC	471,967	4,419	34,409	314,766	18,067	9,055	13,293	25,498	13,123	39,336
LOANS	TOTAL	369,159	2,023	22,362	261,404	12,542	6,034	9,121	17,197	8,391	30,085
	FOREIGN	30,983	4	N/A	29,523	1,353	N/A	N/A	5	N/A	99
	DOMESTIC	338,176	2,019	22,362	231,881	11,190	6,034	9,121	17,192	8,391	9,986
	REAL ESTATE	170,525	811	7,589	129,166	6,270	1,750	2,619	6,394	3,102	2,824
	COMMERCIAL	77,949	721	3,316	53,467	2,947	1,471	1,330	5,233	1,775	7,688
	CONSUMER	58,387	303	5,210	32,569	1,263	1,690	4,658	3,435	2,841	6,418
	AGRICULTURE	5,879	8	421	2,924	18	754	15	443	150	1,145
	INTERNATIONAL	180	N/A	7	173	0	N/A	N/A	N/A	N/A	0
SECURITIES	TOTAL	45,741	1,812	4,538	22,529	4,015	1,728	1,848	3,148	2,524	3,599
	U.S.T.S.	13,829	900	1,512	6,480	1,481	425	646	694	474	1,218
	SECONDARY MARKET	20,897	454	2,136	11,010	1,660	820	629	1,556	1,401	1,231
	OTHER SEC.	11,015	459	891	5,038	873	483	573	898	649	1,151
LIABILITIES	TOTAL	473,349	3,891	31,882	326,290	18,454	8,457	12,111	23,539	12,130	36,596
	DOMESTIC	437,581	3,891	31,882	292,431	16,745	8,457	12,111	23,515	12,069	36,481
DEPOSITS	TOTAL	407,641	3,358	29,554	280,755	16,010	7,020	8,862	20,004	10,289	31,788
	FOREIGN	34,698	0	N/A	32,918	1,550	N/A	N/A	5	60	164
	DOMESTIC	372,942	3,358	29,554	247,837	14,460	7,020	8,862	19,999	10,229	31,623
	DEMAND	80,588	968	4,739	57,690	2,229	1,150	2,088	3,328	1,690	6,706
	TIME AND SAVINGS	292,355	2,390	24,815	190,147	12,230	5,871	6,775	16,671	8,539	24,917
	NOW	35,698	255	2,721	22,493	1,349	817	986	2,468	1,229	3,380
	MMDA	77,400	436	6,066	53,704	2,115	1,097	2,052	3,816	1,757	6,356
	SAVINGS	35,304	446	2,181	23,680	1,810	461	1,232	1,594	925	2,975
	SMALL TIME	88,811	668	11,497	50,122	2,354	2,785	1,366	7,055	3,670	9,294
	LARGE TIME	54,702	563	2,338	39,939	4,601	706	1,137	1,653	954	2,811
OTHER BORROWINGS		43,505	484	1,641	27,473	1,904	1,341	2,367	2,935	1,634	3,726
EQUITY CAPITAL		34,385	529	2,527	22,336	1,322	598	1,182	1,983	1,054	2,855
LOAN LOSS RESERVE		8,446	36	601	6,206	192	90	281	388	194	458
LOAN COMMITTMENTS		194,413	520	17,843	134,813	6,048	2,213	1,984	9,811	5,802	15,378
LOANS SOLD		36,523	15	391	35,292	140	35	32	274	115	229
ASSET QUALITY-- PERCENT OF LOANS (LARGE COMMERCIAL BANKS)											
LOAN LOSS RESERVE (ALL BANKS)		2.29	1.79	2.69	2.37	1.53	1.49	3.08	2.26	2.31	1.52
NET CHARGEOFFS, TOTAL		1.18	0.20	1.64	1.20	0.09	0.41	3.86	1.03	1.32	0.51
	REAL ESTATE	0.42	-.04	2.29	0.33	0.00	0.02	0.04	0.83	0.48	0.33
	COMMERCIAL	1.15	0.31	2.59	1.14	0.07	0.85	4.92	1.22	1.74	0.43
	CONSUMER	2.70	0.69	1.62	3.09	0.58	0.66	5.75	1.39	2.47	1.13
	AGRICULTURE	0.21	N/A	3.02	-.07	-2.00	0.09	-.05	0.00	0.11	-.03
PAST DUE & NON-ACCRUAL, TOTAL		5.66	4.72	5.24	6.16	1.46	1.98	10.70	4.50	4.36	3.69
	REAL ESTATE	6.05	5.55	9.08	6.35	1.12	2.15	3.67	5.65	6.53	5.04
	COMMERCIAL	6.75	5.06	10.40	7.42	2.03	2.25	11.00	5.17	4.22	3.10
	CONSUMER	3.88	2.13	2.05	3.52	1.84	1.60	14.10	1.61	2.88	1.98
	AGRICULTURE	5.88	38.20	7.45	7.47	7.30	2.74	0.74	5.18	3.24	3.16
EARNINGS AND RETURNS -- $ MILLION, YEAR-TO-DATE (ALL COMMERCIAL BANKS)											
INCOME	TOTAL	27,411	223	1,678	18,827	922	454	1,139	1,345	736	2,086
	INTEREST	22,836	190	1,350	15,728	832	400	868	1,098	627	1,743
	FEES & CHARGES	1,320	11	92	894	18	24	31	84	36	130
EXPENSES	TOTAL	24,417	176	1,661	16,837	751	380	978	1,237	646	1,751
	INTEREST	11,907	87	791	8,281	461	219	310	559	325	875
	SALARIES	4,553	45	327	3,160	144	59	107	240	96	376
	LOAN LOSS PROVISION	2,478	3	136	1,741	19	15	210	204	59	90
	OTHER	5,479	42	407	3,655	126	88	350	234	166	411
INCOME BEFORE TAXES		2,976	47	17	1,975	171	74	161	108	90	335
TAXES		1,171	13	-3	860	61	25	52	27	29	106
NET INCOME		1,803	34	20	1,111	109	49	109	81	62	229
ROA (%)		0.71	1.54	0.12	0.64	1.16	1.09	1.53	0.64	0.94	1.18
ROE (%)		10.50	12.7	1.57	9.95	16.5	16.3	18.5	8.19	11.70	16.00
NET INTEREST MARGIN (%)		4.32	4.73	3.32	4.27	3.93	4.05	7.85	4.26	4.61	4.47
NUMBER OF BANKS		788	8	40	477	21	22	19	51	55	95
NUMBER OF EMPLOYEES		243,134	2,709	19,248	156,325	8,401	4,809	6,423	15,517	7,173	22,529

* Beginning with June 1991 data, the sample of all insured commercial banks used was updated to match the sample used by the Board of Governors. For the District, this change added 77 banks (mostly FDIC insured industrial banks) and increased total assets by $8.4 billion (1.7%) as of December 1990.

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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Research Department
Federal Reserve
Bank of
San Francisco
P.O. Box 7702
San Francisco, CA 94120

MARKET SHARE STATISTICS

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

PERCENT OF COMBINED MARKET TOTAL FOR AUGUST 1991, 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	53	42	5	73	4	23	93	1	6	47	49	4	69	28	3	88	9	3	70	26	4	82	11	7	79	8	14	56	36	8
DEMAND	92	4	5	99	0	1	95	0	5	91	4	5	91	3	6	91	1	8	99	1	0	94	1	5	89	3	8	91	5	3
NOW	65	28	7	60	6	35	91	0	9	59	35	6	72	26	2	89	8	3	77	15	8	85	8	7	84	3	12	66	23	11
SAVINGS	50	33	17	38	3	59	73	1	26	48	39	12	53	37	9	80	9	10	66	17	17	61	19	20	59	5	36	44	20	36
MMDA	65	33	2	89	8	3	98	0	2	59	39	2	78	21	0	95	5	0	82	16	2	91	5	4	82	6	12	68	29	3
SMALL TIME	35	62	3	77	8	15	95	1	4	25	72	3	44	54	2	86	13	2	49	48	3	77	18	5	77	13	9	43	53	4
LARGE TIME	48	48	4	93	4	3	92	1	7	43	52	4	83	16	1	87	9	5	66	34	0	87	9	4	80	9	11	47	51	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 1991 (%)

TYPE OF ACCOUNT OR LOAN	DATE	US	DISTRICT	ARIZ	CALIF	HAWAII	IDAHO	OREGON	UTAH	WASH
MONEY MARKET DEPOSIT ACCOUNTS	JUN91	5.29	5.31	5.04	5.31	5.20	5.56	5.18	5.50	5.30
	JUL91	5.24	5.31	5.02	5.30	5.14	5.53	5.16	5.74	5.30
	AUG91	5.16	5.25	4.98	5.27	5.11	5.40	5.01	5.64	5.28
92 TO 182 DAYS CERTIFICATES	JUN91	5.86	5.78	5.45	5.76	5.62	5.89	5.84	5.80	5.97
	JUL91	5.82	5.80	5.45	5.80	5.64	5.89	5.75	5.74	6.14
	AUG91	5.61	5.57	5.43	5.56	5.44	5.63	5.41	5.52	5.88
2-1/2 YEARS AND OVER CERTIFICATES	JUN91	6.96	6.66	6.30	6.84	7.12	7.13	6.93	6.63	6.78
	JUL91	6.96	6.68	6.30	6.90	7.12	7.22	6.87	6.62	6.77
	AUG91	6.79	6.53	6.28	6.75	6.76	6.84	6.54	6.57	6.54
COMMERCIAL, SHORT-TERM*	AVE. RATE	7.82	8.21	8.03	8.02	8.18	10.52	9.18	7.39	8.37
	AVE. MAT. (DAYS)	61	212	45	265	55	118	88	79	143
COMMERCIAL, LONG-TERM*	AVE. RATE	9.13	9.66	10.63	9.53	10.99	N/A	N/A	9.22	N/A
	AVE. MAT. (MONTHS)	40	44	32	44	46	N/A	N/A	53	N/A
LOANS TO FARMERS*	AVE. RATE	10.16	9.09	9.15	8.96	N/A	10.38	9.15	11.47	9.60
	AVE. MAT. (MONTHS)	9	16	6	11	N/A	13	33	17	5
CONSUMER, AUTOMOBILE	AVE. RATE	11.06	11.36	13.00	11.47	N/A	11.50	10.69	10.63	11.08
CONSUMER, PERSONAL	AVE. RATE	15.24	14.79	17.99	17.90	N/A	11.50	13.13	15.50	11.93
CONSUMER, CREDIT CARDS	AVE. RATE	18.24	18.40	18.00	18.82	N/A	N/A	19.20	21.00	17.93

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