Statement of Robert T. Parry

President, Federal Reserve Bank of San Francisco

on Current Developments in Western Banking

before the

Committee on Banking, Finance and Urban Affairs

House of Representatives

San Francisco

January 12, 1989

Mr. Chairman:

I am Robert Parry, President of the Federal Reserve Bank of San Francisco, a position I have held since early 1986. The San Francisco Bank and its four branches in Los Angeles, Portland, Salt Lake City, and Seattle serve the Twelfth Federal Reserve District, which comprises the nine westernmost states. In addition to its large geographic size, the District represents almost one-fifth of the nation's population and personal income.

I am pleased to speak on western banking developments. The business of banking has changed significantly in the last decade as a result of increased domestic and international competition, volatile economic and financial conditions, and changes in the creditworthiness of some major types of borrowers.

These changes have important implications for the financial condition of the banking industry in our District, as well as for national banking policy. I plan to address both of these topics briefly.

The Western Regional Economy and Banking

The health of our District's economy has a major bearing on the condition of western banks. Over the past three years, the performance of this District's economy has been somewhat stronger than that of the nation as a whole. Manufacturing, construction, services, trade, and tourism all have contributed to this strength. Moreover, agriculture has seen recovery in the last several years. Land prices finally appear to be rising, and the drought last year actually boosted the region's agricultural sector because of the availability of irrigation water.

Weaknesses in the District have been concentrated in a few states' economies, particularly that of Alaska, which has been weak as a result of soft world oil markets.

On the whole, I expect to see moderate growth at a high level of employment in the District. This outlook suggests that there will be few major new sources of stress for bank portfolios arising from their domestic loan assets.

Continued income and employment growth should support the servicing requirements of corporate and consumer debt, which together comprise about 50 percent of bank loans in our District. Likewise, continued recovery in agricultural incomes and land values should buoy the agricultural loan market. In fact, the percentage of agricultural loans that were non-performing has fallen in the District from about 17 percent to a bit less than 12 percent over the past 2 quarters. Finally, real estate markets in most areas of the District are in sound condition and should remain so. The only exceptions are Alaska, where the economy has been weak, and to a lesser extent, Arizona, where there has been overbuilding in some areas.

Overall, then, banking in our District is entering 1989 in good shape. Loan performance problems remain above desirable levels, but have generally declined since 1983. In addition, preliminary data show bank profits are up in every state in our District except Alaska.

The Need for Banking Reform

This good news should not be allowed to mask the seriousness of the challenges facing bank policy makers. The portfolios of depository institutions in some parts of our nation have deteriorated sharply in recent years as a result of number of factors, including the rise in interest rates in the 1970s and early 1980s, regional downturns, and/or weaknesses in important regional industries.

But at the heart of this deterioration in portfolios, I believe, is the present structure of the deposit insurance system. Under weakened capital conditions, the present system provides an incentive for insured institutions to take on more risk. And the problem most likely will get worse with the passage of time, making immediate reform critical.

Geographic diversification through interstate banking and product diversification through expanded powers would have cushioned these institutions from the most severe shocks and, so, are desirable directions for reform. For institutions in a weakened capital position, however, opportunities to expand must be restricted, as these opportunities may also provide a means of taking on still further risk.

Thank you, Mr. Chairman, for the opportunity to offer my comments today.