FRBSF Weekly Letter

April 5, 1985

Western Banking Turnaround

As a group, western banks posted their first year-over-year increase in aggregate earnings since 1980. Nevertheless, just as in the last few years, their profitability remained well below that of the national banking industry because of large loan losses suffered by a few large banks. Moreover, the unevenness of economic expansion, which has characterized the current national and regional recoveries, resulted in mixed performances across western banks in 1984.

The major drag on earnings for the banking industry, both nationally and in the West, continued to be related to asset quality. A business expansion normally brings an improvement in bank loan quality by the end of its second year as it boosts the financial positions of bank borrowers. But despite an economic expansion that is strong by historical standards and which has now entered its third year, a significant improvement in the quality of bank assets does not seem imminent. One of the key reasons for this is the unevenness of the economic recovery in the District, a phenomenon shared with the national economy and shaped by some of the same developments — a reduction in inflation, a persistence of high real interest rates and a strong dollar.

High interest rates and a strong dollar

The current expansion's high level of real interest rates has increased the real debt burden of many U.S. firms and raised the likelihood of defaults. It also has complicated the international debt repayment situation both directly by adding to the interest cost of financing debts and indirectly by being one factor that has driven up the foreign exchange value of the dollar.

Because much of international debt is denominated in dollars, a stronger U.S. dollar means a higher debt repayment burden to a borrowing country in terms of its own currency.

This problem is particularly acute for lesser developed countries (LDCs) with substantial amounts of international debt. Because a solution to the economic problems of LDCs seems unlikely in the near future, large banks probably will be plagued for some time by their outstanding loans to these nations.

The strong dollar also has contributed to weakness in several important segments of the domestic economy and thereby affected bank loan quality. It has curbed the overseas sales of many domestic firms while creating stiff competition for domestic industries competing against imported products. Reductions in international competitiveness, attributable in part to the strong dollar, have weakened many export and import-competing industries in the West as elsewhere in the nation.

The strong dollar and high real interest rates have contributed to the unusually high default rates on bank loans to the troubled steel, mining and manufacturing industries, as well as to the agricultural and forest products industries. In a similar way, persistent weakness in the markets for petroleum products will continue to produce problems with loans to the energy industry. Furthermore, in many of the areas dominated by these depressed industries, both consumers and smaller businesses have suffered as well. Even a robust economy is not likely to improve the prospects of repayment by some firms in these industries unless the dollar loses some of its strength in international markets.

Problems with loan quality varied widely across banks in the West. For many, increases in provisions for loan losses due to bad loans resulted in weakened earnings, while for some, they resulted in actual losses. Size, composition of loan portfolios, and location each played an important role in determining banks' loan quality. Multinationals were hurt by their problem LDC loans, while energy lenders continued to suffer from over-investment in the domestic petroleum industry. In California, some larger banks were also hurt by heavy losses on real estate and agricultural lending. In Oregon, the smaller banks, lending in local markets, were hardest hit by the extended weakness in the forest products industry. Also, loan losses related to real estate were instrumental in the failure of several small western banks.

Deregulation

This recovery is the first in 50 years to occur during a period in which depository institutions have been free from interest ceilings on most deposit accounts. Deposit-rate deregulation has come essentially in two stages — first, on large-size business deposits in the late 1960s and early 1970s, and second, on retail consumer deposits in the late 1970s and early 1980s. This deregulation has altered the way the financial and real sectors are affected by the business cycle. For example, deregulation of deposit rates means that regulated depository institutions are no longer vulnerable to financial disintermediation when market rates rise above ceiling levels. Thus, deregulation has eliminated the periodic shortages of loanable funds that used to occur when rates rose above ceiling levels, and thereby has ensured a good availability of bank loans and credit despite high interest rates. Not only has the economy benefited from the increased availability of bank credit during these episodes, but banks themselves are now able to compete much more effectively with financial institutions not subject to interest ceilings, such as money market funds, insurance companies, and the U.S. Treasury.

Under deposit-rate ceilings on retail accounts, banks and thrifts attracted core deposits, such as passbook savings, checking, and NOW accounts, by paying both explicit interest at the ceiling rate and by offering depositors a multitude of added conveniences and free or underpriced services, such as free checking privileges and extensive branch office networks. In theory, this sort of noninterest or nonprice competition would be less efficient than direct competition using interest rates because depositors on average would value these additional services at less than their cost. Thus, under deposit deregulation, the explicit interest cost of attracting retail deposits would rise while the noninterest cost would decline as banks and thrifts cut back on some underpriced services and high-cost branches and begin charging explicitly for other services.

Particularly in the competitive bank and thrift markets that prevail in the West, it is likely that the rise in explicit interest costs actually would be less than the decline in noninterest costs. The total combined interest and noninterest costs might actually decline with deposit deregulation, although there could be a costly adjustment period. Therefore, a subtle but very important impact of deposit-rate deregulation is that it has offered the prospect of lowering the total cost of attracting retail deposits, particularly in competitive markets.

Deposit deregulation has had still another important impact. Under the previous system of ceiling rates on retail deposits, large banks with access to national or international financial markets had substituted wholesale deposits, such as unregulated large certificates of deposit (CDs of $100,000 or more), for retail deposits. This response also was not as cost-effective in attracting deposits as direct price competition for retail deposits would have been. The shift from wholesale CDs to retail Money Market Deposit Accounts (MMDAs) that followed deposit deregulation appears to have had a beneficial impact on the earnings of large banks. It improved their competitive position for retail deposits in relation to their unregulated competitors, such as the money market funds, and allowed them to compete more efficiently against other banks for deposits.

The forces of deregulation were most evident in the pricing of MMDAs — ceiling-free, insured, short-term retail accounts offering limited check-writing privileges, and not subject to a reserve requirement on personal accounts. With the MMDA, institutions were able to attract large quantities of funds (at year-end, over $415 billion nationally), thus allowing large banks in particular to reduce their need for more expensive wholesale liabilities, such as large CDs. During 1984, rates paid on MMDAs, which total over twenty percent of western banks' domestic deposits, were well below those paid on large CDs and rates paid by competing money market funds (Chart 1). While this pricing strategy for MMDAs tended to limit the total quantity of MMDA balances, it also resulted in a significant cost savings for many banks. Thus, banks' overall deposit versus lending interest margins widened as they took advantage of the lower costs of deposits.

With the ability to engage in direct price competition, banks reduced nonprice forms of attracting deposits. They began to raise explicit fees for some previously underpriced banking services and to eliminate or cut back on others. The decline in some nonpriced services resulted in cost savings that were supplemented by increased fee income from the explicit pricing of other services. Both changes contributed to lowering the noninterest costs of attracting deposits.

One negative effect of deregulation on bank earnings has been the adjustments some banks have had to make in shifting from nonprice to price competition. For example, deregulation reduced the value of branches in attracting retail deposits and therefore imposed additional costs associated with reducing the number of such offices on banks, especially those with large branch networks. These losses associated with adjusting to a deregulated environment may have had short-run negative effects on some banks' earnings, but there is little evidence that the costs of deregulation have substantially offset deregulation's positive effects on lowering total deposit costs and increasing fee income. The upturn in bank earnings and the rate at which new banks formed in the Twelfth District last year suggest that deregulation has not had a widespread or lasting adverse impact on the industry. On the contrary, the impact appears to have been positive.

Performance

Much of the improvement in aggregate western bank earnings resulted from a slight improvement in net interest margins — the difference between interest earned on assets and interest paid on liabilities. Moreover, many banks' earnings also benefited from a moderate expansion in assets.

Because of the unevenness of the current economic expansion, asset growth varied considerably across banks. The most rapid expansions were in some smaller institutions that chose to increase their real estate and consumer lending. Consumers were eager to borrow, even at historically high real rates, to finance acquisitions of autos, other consumer durable goods and housing that had been postponed over the last several years. Weak loan demand from the corporate sector during much of the second half of 1984 slowed loan growth at the larger banks and led them to place more emphasis on their lending to the household sector.

In addition, declining interest rates during the second half of 1984 had a positive impact on bank earnings because loan rates temporarily lagged behind the decline in funding costs and because some banks still held substantial amounts of long-term fixed rate loans.

Together, these positive factors offset the continued need to build up loan loss reserves, and resulted in an increase of nearly $400 million in western banks' aggregate net income for 1984 (net of extraordinary gains or loses). While earnings were well above 1983's depressed $1.1 billion level, they were still far below the record $2.0 billion earned in 1980. For western banks in the aggregate, and for many individual institutions in the West as well, returns on equity and assets still are below the national averages. However, the turnaround in profitability in 1984 as shown on Chart 2, is important considering that banks probably will continue to face credit quality problems despite the advanced stage of the recovery. Improved earnings are essential if western banks are to generate much needed additions to their capital, and to continue to build cushions against potential losses.

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Chart 1
Interest Rates

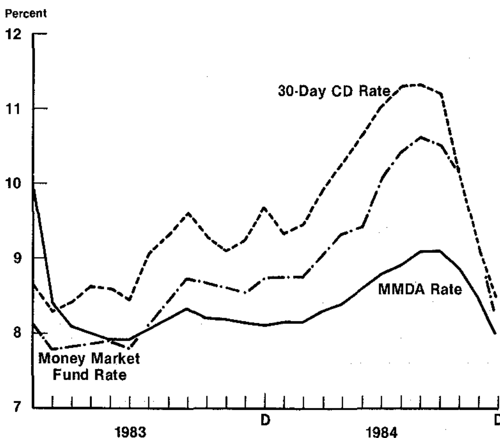
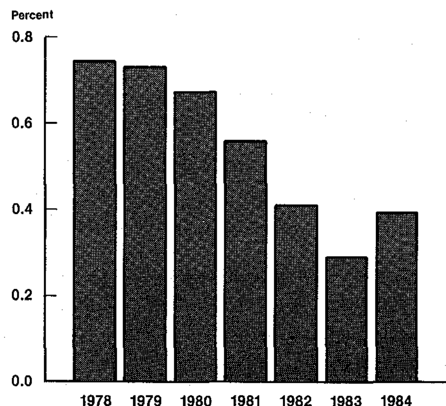


Chart 2
Aggregate Return on Assets
(Twelfth District Banks)



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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 03/20/85	Change from 03/13/85	Change from 03/21/84 Dollar	Change from 03/21/84 Percent[7]
Loans, Leases and Investments[1] [2]	189,496	621	12,495	7.1
Loans and Leases[1] [6]	171,992	697	14,843	9.4
Commercial and Industrial	53,139	294	5,755	12.1
Real estate	62,454	137	2,585	4.3
Loans to Individuals	32,986	81	5,892	21.7
Leases	5,320	− 8	324	6.4
U.S. Treasury and Agency Securities[2]	10,603	− 59	− 1,680	− 13.7
Other Securities[2]	6,901	− 17	− 663	− 8.7
Total Deposits	193,086	− 302	8,225	4.4
Demand Deposits	43,955	− 152	1,280	2.9
Demand Deposits Adjusted[3]	29,230	− 541	182	.6
Other Transaction Balances[4]	13,200	− 66	1,010	8.2
Total Non-Transaction Balances[6]	135,931	− 85	5,939	4.5
Money Market Deposit Accounts—Total	43,861	− 91	3,350	8.2
Time Deposits in Amounts of $100,000 or more	38,970	− 9	924	2.4
Other Liabilities for Borrowed Money[5]	18,501	−1,266	263	1.4

Two Week Averages of Daily Figures	Period ended 03/11/85	Period ended 02/25/85
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	63	111
Borrowings	32	84
Net free reserves (+)/Net borrowed(−)	30	27

[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