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Western Banking in 1986

Banks in the West have not fared particularly well over the past five years despite the significant expansion of western economic activity. Aggregate bank earnings have not reached the levels of the late 1970s, and loan losses generally have followed a stubborn upward trend. Since 1980, failures of western banks have hit post-war highs, and the number of banks requiring special supervisory oversight has climbed more or less continuously.

However, 1986 provided some hope that the worst is behind western banks. Although data are not yet final, aggregate earnings appear to have broken a five-year downtrend by rising over their year-earlier level. Core deposit growth remained strong and exceeded the growth in loans during the year. Importantly, the steady decline in asset quality showed signs of abating, and western banks improved their capital positions significantly.

Last year may prove to be the long-awaited turning point for the western banking industry, although the turnaround was expected to have come several years earlier. Ordinarily, banks can count on improvement by the end of the second year of an economic expansion, as the financial conditions of their borrowers strengthen. In the 1980s, however, western banks had to adjust to wrenching structural shifts in the economy as well as cyclical influences which, together, caused uneven performance across various sectors of the western economy. Moreover, banks had to react to a number of structural changes in the competitive environment of their own industry.

Uneven economy

Like the national pattern, the western economy has posted very uneven growth across industries over the last five years, and the results have been reflected in the condition of bank portfolios. The service-related sectors of the economy have fared remarkably well, while other sectors, including agriculture, forest products, energy and mining, have languished. As a result, banks in western agricultural areas, for example, have tended to suffer serious asset quality and earnings problems much like their counterparts in the Midwest. Banks in areas that are more dependent on military contracts, tourism, and trade, by contrast, generally have enjoyed strong loan and earnings growth.

Disinflation

Another major influence on western bank portfolios has been the surprisingly rapid decline in the rate of inflation over the last few years. As inflation has subsided, so has the rate of increase in the value of the real assets, such as buildings, equipment, and land, that typically collateralize bank loans. The unexpected slowdown and, in some cases, decline, in the rate of growth in collateral value has, in turn, reduced the value of banks' loan portfolios by increasing the risk of loss.

Loans secured by real estate were prime "victims" of this development. Because the value of real estate rose rapidly throughout the late 1970s and early 1980s, and was expected to continue rising more-or-less indefinitely, the default rate on real estate loans was low. Only a hundredth of one percent, for example, was unrecoverable by western banks in 1980. When default did occur, banks usually recouped their losses through the sale of the foreclosed property. As the value of real estate dipped in the early and mid-1980s, the loss rate skyrocketed — rising to almost four-tenths of one percent in 1986.

Moreover, falling real asset prices affected commercial real estate and agricultural loans much more than they did home mortgage loans. Loan loss rates on agricultural loans, for example, now hover around a staggering four percent.

The deterioration in bank earnings over the past few years is a consequence mostly of this unexpected increase in loan losses and in the proportion of nonperforming loans (i.e., those on which payments are not being made). Moreover, western banks have had to contend with a significant increase in administrative costs associated with problem loan workouts and renegotiations.

Deregulation and disintermediation

Western banks, like their counterparts

elsewhere, also have had to adjust to basic structural changes in the way they conduct business. These changes include the elimination of interest rate ceilings on almost all deposits, the substantial deregulation of the powers of thrift institutions, and the decline in banks' role as funding intermediaries.

Deregulation of deposit rates and of the powers of thrift institutions over the past five or so years has dramatically raised the level of competition in the provision of consumer banking services. Moreover, deregulation has changed the way banks raise funds and offer services, rendering extensive "brick-and-mortar" branch networks less valuable. Banks have responded to these changes by attempting to trim their networks, but this process is taking time and has entailed significant costs, particularly for western banks, which have relied more heavily than banks elsewhere on branches as a way of delivering services.

In addition to the changes brought about by deregulation, banks also have experienced a diminution in their roles as funding intermediaries. Western banks increasingly are selling or securitizing the loans they originate because it often is more profitable to generate fee income from servicing loans than from holding the loans in portfolio. At the same time, corporate borrowers are placing debt directly in national markets and relying less on banks as sources of funds. While this shift has affected the larger banks most, the loss of this corporate business has induced larger banks to pursue the middle market customers of smaller banks, increasing the level of competition in that market.

1986: A turning point?

These strains on western banks were evident in major problems with asset quality as well as continuing struggles with high overhead costs in 1986. For example, noninterest expense relative to total income rose to an estimated 35 percent, which is higher than the estimated national average of 32 percent. Moreover, western banks wrote off an estimated $4 billion in bad loans (net of recoveries) last year — a near-record high and well above the average rate for the nation. To compensate for this drain on reserves and to bolster reserves for future write-offs, western banks took an estimated $7 billion in provisions for loan losses from current earnings. Despite these measures, the level of so-called "nonperforming" loans remained high throughout 1986.

At the same time, however, there were a number of encouraging signs as well. Adjustments made in previous years began to pay off. Many western banks experienced strong improvements in capital positions, earnings, returns on assets, and equity during the year. In the aggregate, net income after taxes easily surpassed 1985 earnings despite the well-publicized problems at one of the West's largest banks. This improvement in earnings helped to bolster aggregate capital-to-asset ratios from 6.8 percent in 1985 to 7.1 percent in 1986. In addition, only 62 banks in the nine-state region reported capital ratios below the regulatory minimum, down from 66 banks in 1985.

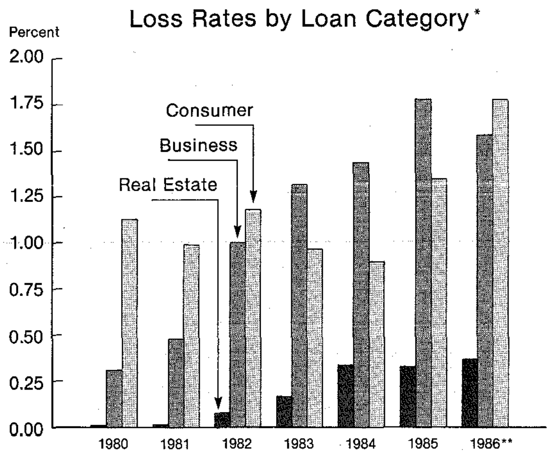
Even the downtrend in asset quality showed signs of turning around at most western banks. The rapid rate of deterioration apparently was arrested in most major loan categories by the end of the year, while the loss rate on business loans actually dropped. (See chart.)

As a group, large banks (assets of $300 million or more) showed generally strong improvement, with a number of these institutions reporting large increases in earnings. Indeed, many of the major banks' returns on assets and equities are comparable with or above the national averages for their size group.

Surprisingly, the average rate of return on assets and equity for small banks (assets under $300 million) in the West lagged behind those of most of the larger institutions and of their own peer group nationally. The rapid growth in the number of newly chartered banks over the last few years tended to depress the average return for this group as a whole, despite the solid performance of many smaller, established institutions. In fact, the growth in the number of new banks is a sign of the generally optimistic outlook for banks in this region.

Modest growth

Domestic asset expansion among western banks continued at a modest pace last year, enabling western banks to bolster capital ratios. Weakness in nonmortgage loan demand, in addition to banks' deliberate efforts to strengthen underwriting standards, played an important part in slowing overall loan growth. The slow growth of business lending reflected the continuing difficulty large banks have had in competing with the commercial paper market and long-term debt financing. Even many smaller institutions,



* Banks with $300 million or more in total assets. Loss rate is defined as loan charge-offs less recoveries as a percent of loans outstanding.
** Based on ratios for first nine months of 1986.

which lend primarily to small or middle market businesses, also reported weakness in commercial lending.

Consumer loan demand, which paced loan growth for the last two years, dropped off dramatically in 1986. Rising consumer debt, the slowdown in the economy, relatively high interest rates on credit cards, cut-rate financing on automobiles, and concern over the future deductibility of interest payments on consumer loans all appear to have taken their toll on consumer lending. Moreover, while most banks continued aggressively to market consumer loan products, the significant rise in consumer loan losses during the year also induced them to tighten underwriting standards.

Agricultural lending also declined dramatically at western banks. High levels of nonperforming loans and charge-offs against farm loans combined with continued distress in portions of the agricultural industry made agricultural lending unattractive in 1986.

Real estate loan originations were the only really strong component of loan demand in 1986 as mortgage rates declined steeply over the course of the year. Lower rates caused a resurgence of the single family housing market, and also spurred a large volume of refinancing. However, the growth of outstanding loans lagged behind loan origination activity as many institutions preferred to generate fee income from originating and packaging loans for resale.

Western banks were able to rely on retail core deposits to fund asset expansion in 1986. Savings and transactions deposits grew at 30 and 20 percent rates respectively over the year — far exceeding the rates of growth in money market deposit accounts (MMDAs) and small denomination (under $100,000) time certificates of deposit, which grew less than three percent. In the past, MMDAs and small time certificates accounted for the major share of retail deposit growth. However, shares in total retail deposit growth shifted in 1986 as ceilings on NOW accounts and savings deposits were removed, effective January 1 and April 1 respectively, thereby minimizing the rate differentials among these different types of retail deposit products.

Healthy retail deposit growth also enabled western banks to pay down borrowings of higher cost, large denomination ($100,000 and over) certificates of deposit, and other purchased funds. Reduced reliance on such volatile sources of funds also helped banks improve their financial positions in 1986.

In summary, western banks have had to make significant adjustments to changes in the economy and their competitive environment. These adjustments have been costly but are now largely behind the industry. The very real improvements in earnings and in capital-to-asset ratios during 1986 provide a strong base for the industry in coming years. Assuming further progress in the control of asset quality, western banks can look forward to strong performance in 1987.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 2/25/87	Change from 2/18/87	Change from 2/26/86 Dollar	Percent[7]
Loans, Leases and Investments[1] [2]	204,853	− 320	2,374	1.1
Loans and Leases[1] [6]	184,011	− 512	819	0.4
Commercial and Industrial	53,690	− 932	395	0.7
Real estate	67,517	− 332	1,334	2.0
Loans to Individuals	37,670	− 82	− 2,689	− 6.6
Leases	5,454	5	− 223	− 3.9
U.S. Treasury and Agency Securities[2]	13,761	182	2,721	24.6
Other Securities[2]	7,080	9	− 1,168	− 14.1
Total Deposits	205,014	− 3,184	5,360	2.6
Demand Deposits	50,443	− 2,428	4,077	8.7
Demand Deposits Adjusted[3]	34,410	799	3,177	10.1
Other Transaction Balances[4]	19,038	− 199	4,266	28.8
Total Non-Transaction Balances[6]	135,533	− 557	− 2,983	− 2.1
Money Market Deposit Accounts—Total	46,459	− 589	781	1.7
Time Deposits in Amounts of $100,000 or more	32,584	223	− 6,083	− 15.7
Other Liabilities for Borrowed Money[5]	24,467	− 6	− 2,208	− 8.2

Two Week Averages of Daily Figures	Period ended 2/23/87	Period ended 2/9/87
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	45	111
Borrowings	7	6
Net free reserves (+)/Net borrowed(−)	38	106

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