

Chapter 11

Banking Problems in California

Introduction

California recorded major economic gains during the 1980s. In absolute terms, the state's growth during that decade was the most significant in its history, rivaled only—in percentage terms—by the economic expansion prompted by World War II. One of the main factors in the growth was an increase in funds flowing into the state's defense-related industries and real estate markets. The boom of the 1980s reinforced Californians' belief that the state and its economy were different from other regions of the nation, some of which were experiencing serious downturns during this period. This particular boom psychology led many to downplay the prospects of a serious recession, which in fact occurred during the early 1990s and was California's most severe since the 1930s.

Compared with the crises in the Southwest and the Northeast, California's deep recession of the early 1990s—despite the effect on earnings of the banking sector—was relatively mild in terms of bank failures. Only 47 banks failed during this period, all of them fairly small. Several factors contributed to this result, including the sharp decline in interest rates during the early 1990s, the localized nature of the recession, which was primarily concentrated in Southern California, and the dominance of the state's four largest banking organizations, whose geographically diversified portfolios were in a better position than other banks' portfolios to withstand the rigors of the recession. Most of the failures were banks chartered during the 1980s and/or community banks (those with less than \$300 million in assets) headquartered in Southern California. Failed banks had generally pursued aggressive real estate lending strategies, favoring higher-risk construction and commercial real estate loans over relatively more conservative residential real estate lending.

Residential has become extremely risky!

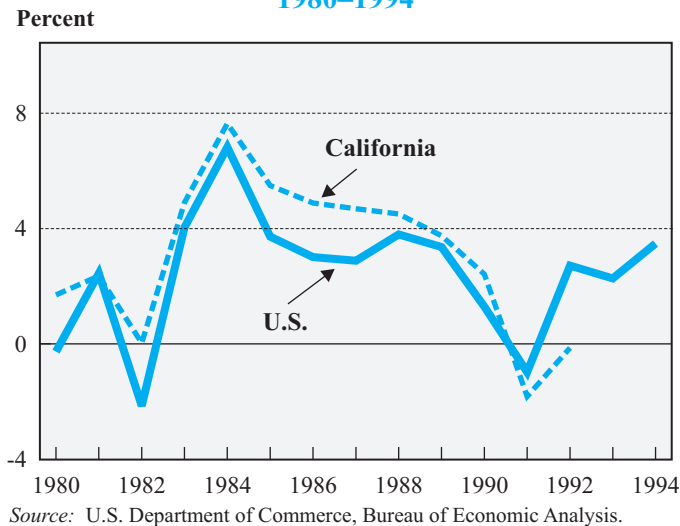
The first half of this chapter describes California's economy in the 1980s, particularly the defense-related industries and real estate markets; it also describes the lens through which Californians viewed their state's economy and its prospects. The second half of the chapter reviews the performance of the California banking industry before and during the

recession, with an emphasis on differences in the performance and failure experience of various groups of banks within the state's industry.

Economic Expansion, 1983–1989: Fundamentals

California outperformed the nation economically in the 1980s according to most measures, including output, income, population, and employment (see figure 11.1 and table 11.1). From 1983 to 1989, gross state product increased at an annual rate of 5.1 percent, far above the national rate of 3.6 percent. Personal income grew at an average annual rate of 8.1 percent, nearly triple the 2.7 percent national rate. California attracted 6 million new residents during the 1980s, accounting for nearly 25 percent of the national population increase. (Most of the new residents, drawn by employment opportunities, settled in Southern California. Los Angeles County attracted more than 1.2 million of the new residents, while neighboring counties also registered impressive gains.) Total employment advanced by 2.8 million, accounting for approximately 17 percent of all new jobs created nationally; and although California's labor force increased by 20 percent (150 percent of the national average), its jobless index was halved: by early 1989, the state's unemployment rate had declined to 5.0 percent, its lowest in 20 years.¹

Figure 11.1
Changes in California Gross State Product versus
Changes in U.S. Gross Domestic Product,
1980–1994



¹ *Economic Report of the Governor, The State of California* (1990), 49.

Table 11.1
Three Economic Growth Measures, California and U.S., 1980–1994
(Percent)

Year	Total Personal Income Growth		Population Growth		Non-Agricultural Employment Growth	
	CA	U.S.	CA	U.S.	CA	U.S.
1980	14.49	0.92	1.76	0.88	1.90	0.64
1981	8.82	2.74	2.61	1.28	1.38	0.82
1982	6.01	0.39	2.19	0.92	1.75	-1.76
1983	9.41	1.52	2.13	0.91	1.59	0.67
1984	10.39	5.99	1.94	0.86	6.10	4.72
1985	7.90	3.15	2.31	0.89	3.83	3.15
1986	6.66	2.94	2.49	0.92	2.54	2.0
1987	7.99	1.68	2.49	0.89	3.73	2.63
1988	7.95	2.84	2.47	0.91	1.99	3.18
1989	6.10	2.50	2.34	0.94	2.75	2.55
1990	7.74	1.47	2.35	1.24	5.80	1.41
1991	1.66	0.19	1.70	0.89	-4.56	-1.06
1992	6.59	2.80	1.62	1.14	-1.66	0.32
1993	1.34	1.74	0.99	1.08	-0.88	1.95
1994	4.15	3.86	0.68	0.99	0.75	2.98

Sources: U.S. Census Bureau, U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Bureau of Labor Statistics.

In fact, since World War II the state had almost always performed relatively well. In the years between the end of World War II and 1989, all eight national recessions had triggered a corresponding downturn in California, but in only one case—the 1970 recession—had California fared worse than the nation.² In two national recessions in the early 1980s (the first from January to July 1980, the second from July 1981 to November 1982), just before the expansion of the 1980s, the downturns in California were milder than those in the nation as a whole when measured by duration and employment losses. There were several reasons that California’s economy fared better at those times than the national economy. First, the state was strengthened by continued rapid population growth, expanding at twice the national rate in the early 1980s.³ A second factor was a booming semiconductor industry headquartered in Silicon Valley. Finally, California’s employment distribution in the early 1980s offered some protection in recessionary periods: the predominant industries

² David Hensley, “Recovery Pushed Back to ’92,” *UCLA Business Forecasting Project* (September 1991), 1.

³ The state added 525,000 new residents in 1980, 496,000 in 1981, and 527,000 in 1982 (for the years ending July 30). Approximately 55 percent of these population gains were attributable to migration (*California Statistical Abstract* [1995], 10, 12). This created a boom in the housing and construction industry during this period.

were the less-cyclical ones, including finance, services, trade, and aerospace, whereas the industries whose fortunes were closely tied to fluctuations of the national economy—construction, non-aerospace manufacturing, and transportation—were somewhat underrepresented.⁴

Initially, California's economic expansion was led by the defense-related manufacturing and construction industries, both of which more than counterbalanced agriculture and consumer electronics, which were having problems. Then by 1986, as growth in defense and construction decelerated, agriculture, commercial aviation, and consumer-goods manufacturing took over as the engines of growth for the state.⁵ In addition, foreign trade, particularly commerce with Pacific Rim nations, provided the state economy with crucial support. During the 1980s, Los Angeles overtook New York as the nation's leading port.

California is commonly referred to as the nation's largest economy, accounting for approximately 13 percent of national output. But its economy is not monolithic and comprises three distinct economies, one in each of the state's three key areas.⁶ The first is the San Francisco Bay area, with a mature, diversified economy that is home to Silicon Valley, the world leader in high-tech manufacturing. The second is the Central Valley, which specializes in agriculture and food processing and lies between the coastal mountains and the Sierra Nevada, stretching south from Sacramento to Bakersfield. Finally, there is the Los Angeles Basin, which is the dominant region economically and accounts for 50 percent of the state's population. Its most important economic sectors include defense-related manufacturing (aircraft related, missiles, space vehicles, naval equipment), high-tech manufacturing (computer, office, communications equipment, electronic components), advanced services (business, financial, health, tourism, and entertainment), construction, and consumer-goods manufacturing (furniture, apparel, and plastics).⁷ While all of California benefited from the economic expansion of the 1980s, the largest gains occurred in Southern California, particularly Los Angeles County.

Defense-Related Manufacturing: Southern California

World War II transformed the state's economy, particularly that of Southern California: manufacturing replaced agriculture as the dominant economic sector. With the Cold War, a new emphasis was put on high technology in arms production, an activity California had mastered during the war and one in which its dominance has never been challenged. Then in 1980, the election of Ronald Reagan to the presidency signaled the beginning of a

⁴ *Economic Report of the Governor, The State of California* (1983), 1.

⁵ Bank of America Corporation, *Economic and Business Outlook* (January 1989), 2.

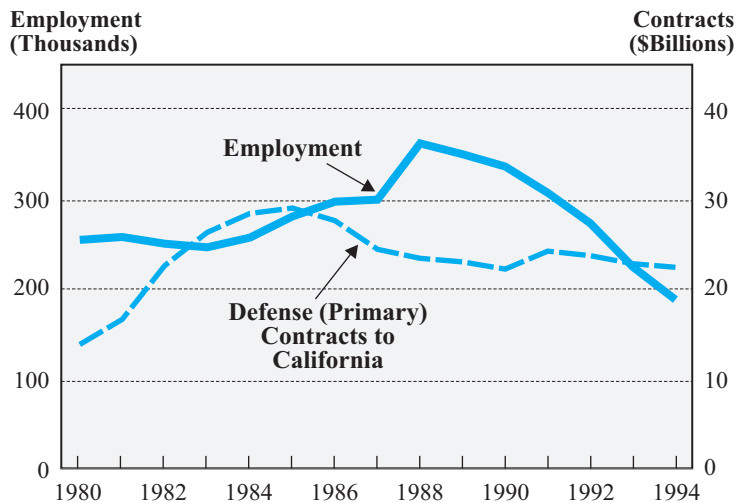
⁶ A discussion of the three Californias is provided in Pacific Gas and Electric, *Economic Outlook* (May 1993).

⁷ SRI International, *Understanding Changes in the Southern California Economy* (1991), 1-2.

major arms buildup during which large amounts of federal funds flowed into California's economy. The state's share of primary defense contracts averaged 20 percent during the 1980s, a percentage share it has maintained since the mid-1950s.⁸ (The state's share of National Aeronautics and Space Administration [NASA] expenditures was even greater.) In Fiscal Year 1984, federal primary defense contracts in California were valued at \$28.5 billion, more than double the volume just four years earlier (see figure 11.2).⁹

Defense-related manufacturing jobs are some of the most highly sought-after positions in the manufacturing industry. Employees generally possess high skill levels and are well compensated. One study estimates that defense-related employees create 30 percent more gross state product per worker than employees engaged in manufacturing, and nearly double the per capita level of service jobs.¹⁰ Defense-related employment peaked in 1988 at

Figure 11.2
Defense-Related Manufacturing Sector, FY 1980–1994



Source: *California Statistical Abstract* (1995).

⁸ *California Statistical Abstract*, table H-8, 120.

⁹ The defense establishment in California was dominated by several large firms—for example, Northrop, Hughes, Lockheed, TRW, Rockwell, McDonnell-Douglas, and General Dynamics—with the resources to compete for such projects as the Strategic Defense Initiative, the B-1 bomber, and the Trident missile. These organizations and their networks of smaller subcontractors are concentrated in the Los Angeles area, which absorbs more than half of statewide defense spending. The Commission on State Finance estimated that the top 20 defense-related contractors held 75 percent of the dollar value of primary defense contracts (Commission on State Finance, *Impact of Defense Cuts on California* [1992], 15–16).

¹⁰ James Dertouzos and Michael Dardia, *Defense Spending, Aerospace and the California Economy* (1993), 15–16.

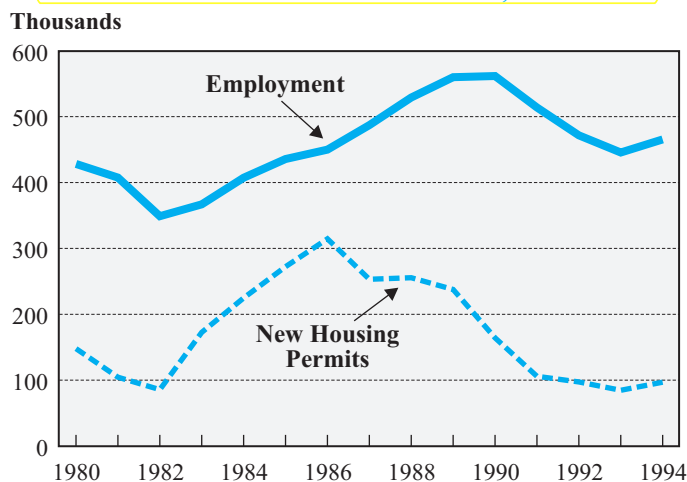
approximately 363,000 jobs, up 42 percent from 1980, with approximately 107,000 new jobs created. At year-end 1988, defense-related manufacturing accounted for approximately 3 percent of the state's total non-agricultural employment and approximately 17 percent of its manufacturing employment. In Los Angeles County, defense-related manufacturing accounted for 7.5 percent of nonfarm employment and 33.4 percent of all manufacturing employment. The peak in defense expenditures was reached in Fiscal Year 1985: \$29.1 billion. By FY 1989, the amount had fallen to \$23.1 billion—a 21 percent decline (before inflation is taken into account). However, the falloff in defense spending did not have an immediate and substantial effect upon California's economy, for two reasons. First, there is a substantial lag between the initial funding authorization and the actual disbursement of funds over the life of a multiyear project. Second, strength in commercial aviation and increased NASA expenditures also helped cushion the blow. Nevertheless, by the end of the decade defense-related employment had declined 7.1 percent from the 1988 peak (figure 11.2).

The Construction Industry and Real Estate Markets

The 1983–89 expansion was also sparked by the revival of the construction industry. In the early 1980s, California's building industry had been hit hard by recession, high interest rates, and high rates of inflation. In 1982, only 85,700 new housing units were authorized (see figure 11.3), marking the fifth consecutive year of declining housing starts and

Figure 11.3

The California Construction Sector, 1980–1994



Sources: *California Statistical Abstract* (1995) and Construction Industry Research Board.

the lowest level of activity since 1954.¹¹ In 1983, the construction industry started to rebound, responding to a declining interest-rate environment and a renewal of confidence in the economy. The number of new housing permits issued doubled in 1983, rising to 172,600, and construction employment increased by 5 percent, reversing a three-year trend of job losses. With further declines in interest rates and the apparent containment of inflation, the construction recovery gained momentum in 1984 and 1985, yielding substantial gains in employment through the end of the decade.

Much of the surge in construction activity in 1984 and 1985 was channeled into multifamily units, an unsurprising result in view of the shortages created by the decline in construction activity in the late 1970s and early 1980s and this activity's sensitivity to interest costs and credit availability. Beyond cyclical considerations, the industry was anticipating possible changes in the tax law that would reduce depreciation allowances and restrict real estate tax shelters. According to the Construction Industry Research Board, permit authorizations for multifamily construction peaked in 1986 at 168,000 and then declined throughout the rest of the decade and beyond, falling to 75,096 in 1989 (see figure 11.4). The Tax Reform Act of 1986 eliminated many of the incentives for multifamily construction.¹² Whereas multifamily building activity declined sharply after 1986, authorizations for construction of single-family homes continued strong, peaking at 162,651 permits in 1989 (figure 11.4).¹³ Although an average of nearly 250,000 housing units were authorized annually during the last seven years of the 1980s,¹⁴ supply failed to keep pace with growth in employment, population, and household formation.¹⁵

The shortage of dwellings exerted upward pressure on housing prices. At the beginning of the 1980s, the median California home price (\$99,550) was 60 percent above the national median (\$62,600). (See figure 11.5.) In contrast, before 1970 the differential between the median California and national home prices had been less than \$2,000. The 1980 price differential reflected substantial appreciation in California housing markets during the second half of the 1970s. Between 1982 and 1985 home prices in the state rose moderately, in 1986 they accelerated, and from 1987 to 1989 they increased at an unsustainable rate of 20

¹¹ *Economic Report of the Governor* (1983), 43.

¹² For a more detailed examination of the tax issues, see Chapter 3.

¹³ Construction Industry Research Board, *New Housing Units and Residential, Nonresidential, and Total Building Permit Valuations* (November 13, 1995), 1.

¹⁴ *Ibid.*

¹⁵ Center for Real Estate and Urban Economics, University of California at Berkeley, *California Real Estate Opportunities in the 1990s* (1991), 34.

Figure 11.4
New Housing Permits, Multifamily versus Single Family, California, 1978–1994

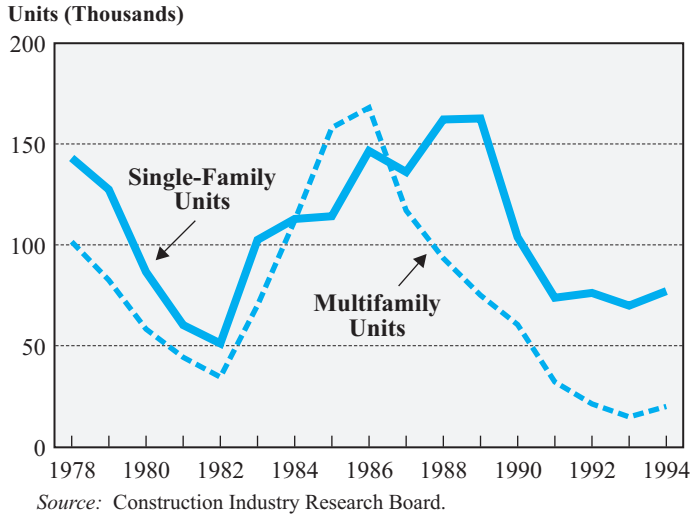
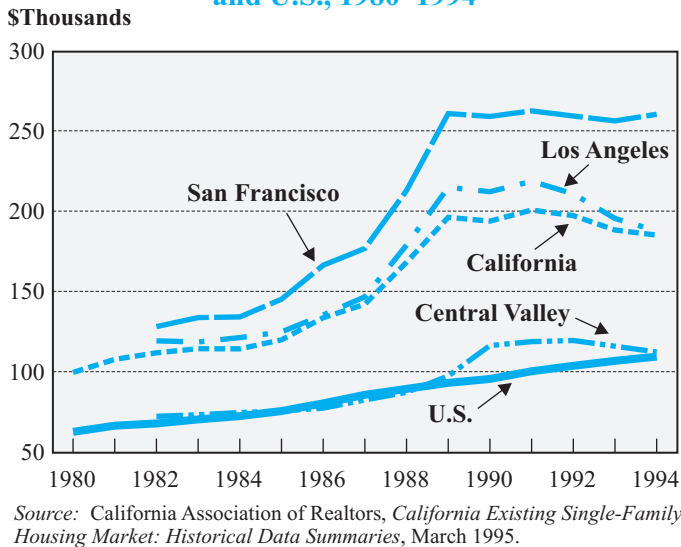


Figure 11.5
Median Home Prices, California (Selected Markets) and U.S., 1980–1994



to 25 percent. At the end of the decade, the median home price in California was more than double the national average: \$196,120 versus \$93,100.¹⁶

The substantial appreciation in home prices was not evenly distributed throughout the state. The greatest appreciation occurred in coastal areas—the San Francisco Bay area and Southern California from Santa Barbara to San Diego. In 1989, median home prices peaked in San Francisco (\$260,722) and Los Angeles (\$214,831). While the disparity between housing demand and supply was most acute in California’s coastal areas, supply and demand factors alone do not explain the surge in home prices at the end of the 1980s, which was heavily influenced by speculation. For many Californians, private residences had become a preferred investment vehicle offering little perceived risk, easily available credit, interest costs subsidized by the federal tax code, and the opportunity to make only modest down payments, thereby providing excellent leverage opportunities and producing large profits. In the late 1980s in San Francisco and Los Angeles, speculation was rampant.¹⁷ Homes sold quickly and there were occasional bidding wars, as prospective buyers bid above asking prices so as not to lose an opportunity for what appeared to be certain capital gains.

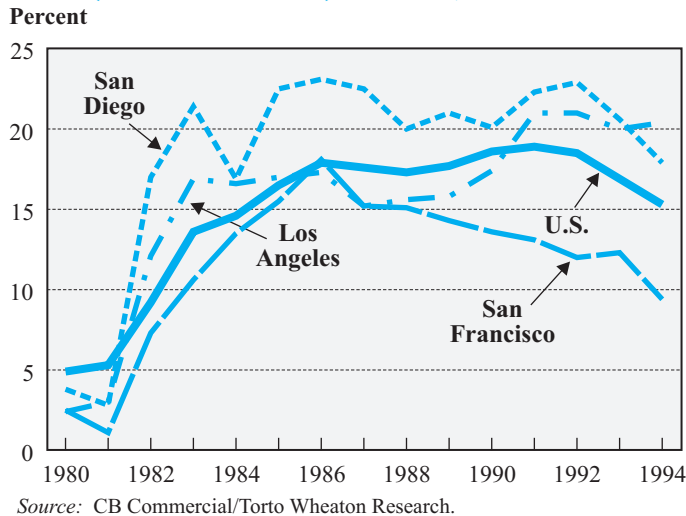
The construction surge also encompassed office space, as California participated in the office-building boom of the 1980s and mirrored developments in Texas, Boston, and New York. At the beginning of the 1980s there was a significant shortage of office space, as indicated by low vacancy rates in the state’s three largest office markets—Los Angeles (2.4 percent), San Francisco (2.5 percent), and San Diego (3.8 percent). (See figure 11.6.) Office-space inventories grew rapidly in the remainder of the decade, as nearly 300 million square feet of office space were added. In Los Angeles alone, between year-end 1979 and year-end 1989, office-space inventories jumped from 61.8 million square feet to 139.4 million square feet. In San Francisco, office-space inventories increased by nearly 75 percent, rising to 65.3 million square feet (see table 11.2). Significant development also occurred in San Diego, Santa Clara County (Silicon Valley), and Sacramento.¹⁸ And even though vacancy rates peaked in 1986, the building continued. The rules of development were turned upside down in the 1980s. As one commentator noted, “Developers did not borrow to build; all too often they built in order to borrow and borrow some more.” Under the old rules, developers acquired a site, completed construction plans, secured a major tenant, and then sought financing. In the 1980s, the financing was often secured first and then

¹⁶ California Association of Realtors, *California Existing Single-Family Housing Markets: Historical Data Summaries* (1995), 2.

¹⁷ George Salem and Donald Wang, *California Banking: Industry Outlook* (October 15, 1990), 12.

¹⁸ Center for Real Estate and Urban Economics, *Real Estate Opportunities*.

Figure 11.6
Commercial Office Vacancy Rates, California
(Selected Markets) and U.S., 1980–1994



the other parts of the package were brought together. Furthermore, lenders often offered 100 percent financing.¹⁹

The most explosive growth in office space occurred in Los Angeles. Although savings and loans and institutional investors provided some funding, Japanese banks and Japanese investors became a major force in development. Using the wealth created by booming domestic real estate and equities markets, the Japanese moved aggressively overseas, acquiring premium properties and financing construction projects at prices that seemed modest in comparison with prevailing real estate prices in Japan. Acquisitions were further facilitated by easily available credit and the impressive purchasing power of the Japanese yen. Between 1985 and 1993, the Japanese invested \$73.1 billion in U.S. real estate (see figure 11.7). Nearly 80 percent of the funds were invested during the four-year period 1987–90, the peak coming in 1988 (\$16.5 billion). Approximately one-third of the total investment from 1985 to 1993 was concentrated in California (\$25 billion).²⁰ Japanese ownership of California real estate increased rapidly: \$5 billion in 1987, \$6.5 billion in 1988, \$10 billion

¹⁹ Maggie Mahar, “The Great Collapse, Commercial Real Estate Is on the Skids across the Nation,” *Barron's* (July 22, 1991): 11.

²⁰ E & Y Kenneth Leventhal Real Estate Group, “1993 Japanese Disinvestment in U.S. Real Estate” (1994), 7.

Table 11.2
Office Real Estate Market Trends,
Los Angeles County and San Francisco, 1980–1994
(Thousands of Square Feet)

Year	Completions		Stock	
	Los Angeles	San Francisco*	Los Angeles	San Francisco*
1980	5,875	3,838	67,663	40,656
1981	6,786	1,492	74,449	42,148
1982	11,620	3,353	86,069	45,501
1983	7,233	4,238	93,302	49,739
1984	6,956	2,439	100,258	52,178
1985	9,901	2,739	110,159	54,917
1986	9,793	4,675	119,952	59,592
1987	6,246	1,820	126,198	61,412
1988	7,133	2,412	133,331	63,824
1989	6,054	1,487	139,385	65,311
1990	8,516	2,380	147,901	67,691
1991	7,711	428	155,612	68,119
1992	2,482	41	158,094	68,160
1993	257	0	158,351	68,160
1994	51	0	158,402	68,160

Source: *The Office Outlook*, vol. 2. CB Commercial/Torto Wheaton Research.

*Three-county total for Marin, San Francisco, and San Mateo Counties.

in 1989, \$13 billion in 1990, and \$18 billion in 1991.²¹ In addition, analysts estimated that in Los Angeles, Japanese commercial banks provided more than half of the commercial real estate loans.²² By 1991, the Japanese investors owned approximately 45 percent of premium downtown Los Angeles office space.²³ Japanese purchasers focused primarily on trophy properties: in 1989, Dai-ichi Mutual Life Insurance paid \$530 per square foot for a quarter-interest in First Interstate World Center, Los Angeles's tallest building.²⁴ In 1989, a Japanese developer paid \$850 million for the Pebble Beach resort near Monterey in Northern California (sold in 1992 for \$500 million). The property was financed by Japanese financial institutions.²⁵

America is not immune from the lost decade that Japan has experienced.

²¹ Ibid., 10.

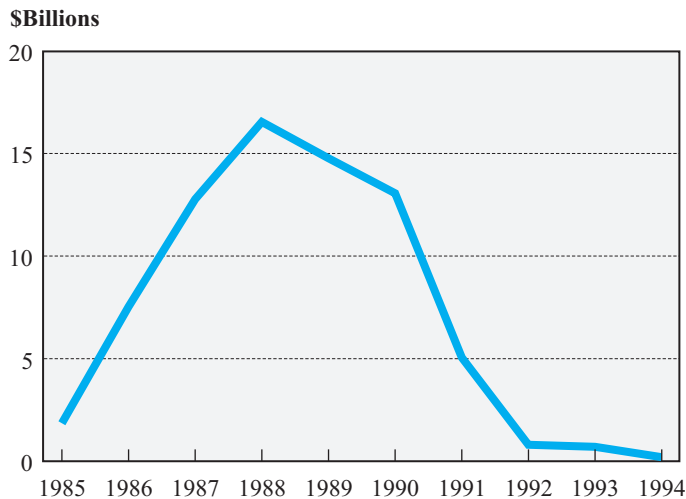
²² Stephen S. Cohen, Clara Eugenia Garcia, and Oscar Loureiro, "From Boom to Bust in the Golden State: The Structural Dimension of California's Prolonged Recession," working paper 64, Berkeley Roundtable on the International Economy, University of California at Berkeley, September 1993, 9.

²³ James Bates, "Japan's New Investment in U.S. Real Estate Down 61%," *Los Angeles Times* (February 21, 1992), A1.

²⁴ Ralph T. King, Jr., "Another Houston: Real-Estate Developers See the Next Disaster in Central Los Angeles," *The Wall Street Journal* (August 27, 1991), 1.

²⁵ James S. Granelli, "Japan's Banks Shaken by Fall in California Values," *Los Angeles Times* (March 18, 1993), A1.

Figure 11.7

Japanese Investment in U.S. Real Estate, 1985–1994

Source: E & Y Kenneth Leventhal Real Estate Group, “1994 Japanese Investment in U.S. Real Estate,” exhibit 1 (1995).

The overbuilding that occurred in the late 1980s had a strong speculative element. Despite high vacancy rates, building continued unabated. Investors, lenders, and developers assumed that demand for office space would continue to increase and that real estate values would likewise continue to increase. An additional indicator of the speculative nature of the market was the price paid for office space: in Los Angeles and Orange Counties between 1985 and 1990, despite high vacancy rates and a substantial volume of office construction nearing completion, sale prices rose from \$234 to \$303 per square foot.²⁶

From Boom to Bust: “But California Is Different”

California’s economic gains in the 1980s reinforced a belief long held in the state that California was different. The Golden State, it appeared, had always been rich. California’s most famous boom, the first of many, was the Gold Rush of 1849. During the remainder of the 19th century, agriculture and the railroads fostered substantial growth and created wealth. During the 20th century, the most prominent sources of wealth were, in turn, the oil industry, the entertainment industry, construction, defense/aerospace, and the computer chip. If California had been a separate nation, its 1989 gross product of \$703 billion²⁷ would

²⁶ Cohen et al., “Boom to Bust,” 10.

²⁷ U.S. Department of Commerce, Bureau of Economic Analysis, cited in *California Statistical Abstract* (1996), table D-1, 48.

have been surpassed by only six countries: the United States, Japan, Germany, France, Italy, and the United Kingdom. And even by historical standards, the growth in the 1980s was impressive—the most significant the state had ever experienced. Only the economic expansion during World War II rivaled this growth (in percentage terms). What made California's economic achievement in the 1980s particularly striking was the national context. The Midwest, Texas and the Southwest, and the Northeast endured a series of recessions during the 1980s and early 1990s.

The underlying psychology of the boom—that California was different—made it more difficult for those inside the state to perceive on the horizon the early-warning signs of a serious recession.²⁸ The relevance of the recent major downturns experienced by Texas and the Northeast was often denied. The boom and then bust in Texas were viewed as having been based essentially on a single commodity (oil), whereas California had a large, diverse economy, accounting for approximately one-eighth of national output. In the Northeast, the boom of the 1980s (followed by the bust of the early 1990s) was seen as representing a recapture of economic ground lost in the 1970s when the economy was undermined by high energy prices and a rapidly declining manufacturing sector. For these reasons, the parallels between these areas and California were not taken seriously by many observers. For decades California had been “the very model of a successful and dynamic regional economy,” continually growing, adapting, and overcoming obstacles to growth, generating new ideas and converting them to sources of wealth.²⁹ The boom in California in the 1980s had been preceded by the booms of the 1970s, the 1960s, and the 1950s. To many inside the state, just as previous booms had not been followed by a bust, this one would not be, either.

By 1989, the California economy slowed and began showing signs of distress. The initial problems emerged in precisely the sectors that had led the economic boom of the 1980s: defense-related manufacturing, construction, and commercial and residential real estate markets. But these early-warning signs were interpreted very differently depending on whether the analyst was based in California or elsewhere. In-state analysts, buoyed by the achievements of the 1980s, generally anticipated continued growth.³⁰ They minimized the threat posed by declining defense expenditures, and provided justifications for current real estate valuations. Analysts from outside were more circumspect in assessing the state's economy and prospects, particularly the price of residential real estate in coastal areas.³¹ These analysts, sensitive to what had happened in Texas and New England, questioned whether California's would be the next regional economy to face a serious downturn.

²⁸ David Hensley, “Where Concerns Mount, Growth Continues,” *UCLA Business Forecasting Project* (March 1990), 1.

²⁹ Cohen et al., “Boom to Bust,” 4.

³⁰ Hensley, “Growth Continues,” 1.

³¹ Salem and Wang, *California Banking*, 1–2.

The debate among analysts is illustrated by contrasting statements on the effect of declining defense expenditures. Defense spending peaked in California in Fiscal Year 1985 but, as noted above, the delay between appropriations and actual spending, strength in commercial aviation, and increased NASA expenditures all kept the state's economy from feeling the effect of the reduction in such spending. According to an analysis undertaken by the Bank of America, there was no question that defense spending would continue to decline—nevertheless, only a “modest” effect upon the state economy was anticipated.³² California had experienced a serious recession in the early 1970s, when real military spending fell by more than 10 percent in 1970 and 1971 as the Vietnam War moved toward a conclusion, but some analysts based in the state argued that during the two decades since that time, the structure of the state's economy had been transformed and was now large and diverse enough to offer insulation from problems in specific sectors.³³ In addition, defense-related manufacturing accounted for an increasingly smaller share of the state economy (between 1970 and 1990 it dropped from approximately 15 percent of the gross state product to approximately 8 percent). Thus, future cutbacks in that sector (in-state analysts maintained) would have less of an effect on the state's economy than cutbacks in the same sector had had 20 years earlier. In contrast, analysts who were more cautious about the potential implications of reduced defense expenditures pointed to New York State, which had been forced into a recessionary phase by problems in the securities industry after the October 1987 stock market crash even though, at the time, securities activities accounted for only between 4 and 5 percent of state output.³⁴

A second important issue in the debate over California's near-term economic performance was current valuations of real estate assets. The future was most clearly seen by two Prudential-Bache analysts, George Salem and Donald Wang.³⁵ Their October 1990 report, because it was so clearly at odds with the conventional wisdom, was both highly publicized and highly controversial; they concluded that residential markets in California were substantially overvalued and that a price correction was under way. In the previous year, prices in California's coastal markets had fallen by 10 to 20 percent from mid-1989 peaks, and Salem and Wang anticipated a total correction of 25 percent or more by year-end 1991. They characterized commercial real estate markets, particularly Los Angeles, as overbuilt, commanding declining rents, and failing to provide a sufficient return to satisfy institutional investors. It followed, according to the two analysts, that major price revisions would ensue. Finally, Salem and Wang viewed real estate in California as analogous to oil in Texas, in the sense that—because so much of household net worth in California was based on

³² Bank of America Corporation, “The California Economy in 1990: Surmounting the Challenges,” *Economic and Business Outlook* (January 1990), 1.

³³ *Ibid.*

³⁴ “Golden State Worriers,” *Business Week* (May 14, 1990): 35.

³⁵ Salem and Wang, *California Banking*.

home ownership—a drop in prices would have a major effect on consumption patterns, job creation, and unemployment.

An analysis produced at the Bank of America responded that nonresidents, unable to grasp the historical context, failed to understand the state’s real estate markets. California home prices as a percentage of national home prices had increased at a faster rate between 1974 and 1981 than in the recent 1987 to mid-1989 boom. Prices had stalled during the 1981–82 recession, but there had been no significant deterioration.³⁶ In addition, the authors of the analysis claimed that California’s residential real estate markets were not overbuilt: despite the authorization of nearly 250,000 housing permits annually during the expansion, a significant shortfall in housing supply allegedly remained, resulting from employment and population growth during the 1980s.³⁷

An economist at the Federal Reserve Bank of San Francisco also took issue with Salem and Wang, arguing that “relatively high home prices in California are easily explained by the comparative productivity of sites.” Rejecting Salem and Wang’s metaphor of California real estate as an overvalued stock vulnerable to correction, the Federal Reserve economist viewed the underlying land as a scarce production factor that was in limited supply and was given value by the high productivity of the area and competing uses. In fact, “the bulk of the sixfold increase in home prices” in the prior 20 years could be explained by movement in the gross state product.³⁸ Finally, the historical movement of home prices during both the Great Depression and the more recent recession in Texas indicated significant barriers to price rollbacks; these barriers included transactions costs and tax considerations.³⁹

In summary, because of California’s economic successes in the 1980s and its history of prosperity, few anticipated the depth of the coming recession, which would be the state’s worst economic downturn since the Great Depression. After all, in the early 1980s, amid a serious national recession, California had experienced only minor problems (except in the building industry): was that not additional evidence of the state’s continuing strength? In fact, however, the events of the 1980s may have made the state economy more vulnerable to an economic correction. First, the influx of dollars increased the importance of construction—a highly cyclical industry. Second, the size of the defense establishment in California made the state somewhat more vulnerable to events such as the end of the Cold War and the consequent reduction in defense spending. Third, Japanese acquisitions and financing of California real estate development, especially with respect to commercial real estate mar-

³⁶ Bank of America Corporation, “The California Economy in 1990,” 3.

³⁷ *Ibid.*

³⁸ Randall Johnston Pozdena, “Why Home Prices Don’t Fall (Much),” *FRBSF Weekly Letter* (January 4, 1991): 1–2.

³⁹ *Ibid.*, 3.

kets, made California more dependent on Japanese investments, so that the continued health of the Japanese economy became a major factor in California's economic future.

Recession, 1990–1994

California's economy followed the nation's into recession in December 1990 and was seriously hurt. Employment peaked at the end of 1990, but for the last six months of that year employment growth had been essentially flat, and some observers argued that the recession probably began in mid-year. Between December 1990 and January 1994, employment in the state declined by approximately 752,000, or nearly 6 percent of the total non-agricultural employment base. The most substantial employment losses occurred in the manufacturing sector (290,300, or 14 percent of total manufacturing employment—the defense-related manufacturing sector declined 126,000, or approximately 39 percent), trade (287,700, or 9 percent), and construction (116,000, or 21 percent). (See table 11.3.) The unemployment rate peaked in September 1992 at 9.5 percent, up from 5.0 percent in January 1990.

Table 11.3
Recession-Related Employment Losses in California and Los Angeles County

	Employment (Thousands)		Change (Percent)
	December 1990	January 1994	
California			
Total non-agricultural	12,634	11,882	-6.0
Construction	540	424	-21.0
Manufacturing	2,028	1,738	-14.0
Defense-related	327	201	-39.0
Trade	3,069	2,782	-9.0
Financial services	812	795	-2.0
Services	3,416	3,421	0.0
Government	2,107	2,083	-1.0
Los Angeles County			
Total non-agricultural	4,125	3,636	-11.9
Construction	130	94	-27.2
Manufacturing	811	633	-22.0
Defense-related	191	114	-40.3
Trade	958	806	-15.9
Financial services	276	246	-10.9
Services	1,188	1,119	-5.8
Government	543	534	-1.6

Source: California Employment Development Department.

The recession in California had at least three principal causes: the 1990–91 national recession, which reduced the demand for California’s goods and services; the substantial decline in national defense spending, which affected California defense contractors, particularly those headquartered in Southern California; and the collapse of residential real estate markets and overbuilt commercial markets, which had a major effect on the state’s construction industry.⁴⁰

The effects of the recession were unevenly distributed. The Central Valley region was affected only marginally. The effect on the San Francisco Bay area was greater, but was still cushioned somewhat by the diversified structure of the regional economy.⁴¹ The effect on the Los Angeles metropolitan area, in contrast, was severe. Between December 1990 and January 1994, Los Angeles County lost 489,600 jobs, representing nearly 12 percent of its total nonfarm employment base and 65 percent of the jobs lost in the whole state. Most seriously injured was the manufacturing sector, including defense-related manufacturing; also deeply affected were trade, services, financial services, and construction (table 11.3).

A 1993 study posits specific structural problems within the local economy as the reason the California recession was longer and more severe than the national downturn.⁴² For example, Southern California was particularly vulnerable to cutbacks in defense spending because of the way the defense-related manufacturing industry was structured. Large bureaucratic organizations had been created to serve the unique needs of the industry’s sole client, the Department of Defense. Competition was limited, incentives to control costs were lacking, and the emphasis was on accommodating the specifications of the buyer. When defense spending was reduced, secondary markets for these products were difficult to find. In contrast, the defense-related sector in Northern California was dominated by much smaller, entrepreneurial firms that were forced to contain costs to a greater extent in order to compete in the global marketplace.⁴³

Southern California’s commercial and residential real estate markets were also vulnerable to correction because the former were substantially overbuilt and the latter eventually became overpriced. Commercial developers, investors, and lenders counted on inflation and continued strong growth in office employment to make their projects viable. During the 1990s, with real estate inflation subsiding and office employment declining, commercial real estate markets were destabilized. In addition, Japan’s economy went into

⁴⁰ Center for the Continuing Study of the California Economy, *California Economic Growth* (1994), 3-3.

⁴¹ Pacific Gas and Electric, *Economic Outlook* (January 1995), 9.

⁴² Cohen et al., “Boom to Bust,” 3.

⁴³ *Ibid.*, 8–9.

recession in 1990, with investors suffering major losses in equities and real estate; Japanese lenders were forced to reassess the real estate strategy they had aggressively pursued in the 1980s. Japan's marginally capitalized banks—confronted by major losses, that country's worst post-war recession, a rising interest-rate environment, a large portfolio of nonperforming assets, and pressure from financial markets and Japanese regulators to deal with these issues—significantly cut their lending and investments in U.S. real estate markets.⁴⁴

The office market in Los Angeles County was undercut further when the completion of substantial amounts of new office space (16.2 million square feet in 1990 and 1991—table 11.2) coincided with a wave of corporate restructurings that significantly reduced the demand for office space. The result was declining rents, falling purchase prices, and higher vacancy rates. (In San Francisco, local ordinances that restricted annual expansion of downtown office space to 475,000 square feet—essentially, one building—had been in place since 1986, saving developers from themselves.)⁴⁵

In the residential sector, the substantial appreciation in California home prices during the 1980s created a problem of affordability. Median home prices in the state peaked in 1991 at \$200,660, approximately six times the nation's average household income. As prices increased, the market of potential buyers became narrower. According to the California Association of Realtors, only 14 percent of Los Angeles households in 1989 could afford to purchase a local median-price home.⁴⁶ Because the decline in home prices in the early 1990s was largely unanticipated, it was particularly worrisome to existing homeowners. The number of California home sales peaked in 1988 at 562,240, but uncertainty about future real estate values reduced sales activity in 1991 to 425,420 homes.⁴⁷ The Real Estate Research Councils of Southern and Northern California estimated that between March 1990 and October 1995, average home prices declined by 21.1 percent in Southern California and 9.6 percent in Northern California.⁴⁸

⁴⁴ Japanese investment in U.S. real estate declined to \$13 billion in 1990 and to \$5 billion in 1991. New investment was nonexistent in 1992 and 1993, with only limited funds disbursed to complete projects under construction. The Japanese destabilized markets further by becoming sellers in 1993 and continuing to sell in 1994. E & Y Kenneth Leventhal Real Estate Group estimated disinvestment and restructurings by Japanese interests of \$4.5 billion in California in 1993 and sales of \$3.14 billion in 1994, representing a liquidation of 30 percent of the \$25 billion the Japanese had invested in California real estate since 1985.

⁴⁵ "California Dreaming, on a Rainy Day," *The Economist* (June 23, 1990): 78.

⁴⁶ California Association of Realtors, *Historical Data Summaries*, 18.

⁴⁷ *Ibid.*, 7.

⁴⁸ Estimates provided by Michael Carney, Real Estate Research Council of Southern California, in a presentation at the UCLA Business Forecast Meeting, December 13, 1995.

The Banking Industry: Profitability, Structure, and Competition, 1980–1989

Because the recession primarily affected Southern California, most bank failures during the 1990–94 period occurred in this region.⁴⁹ However, although the recession was the state’s most severe since the 1930s, the banking crisis as measured by both the number of bank failures and losses to the Bank Insurance Fund was relatively minor in comparison with the crises in the Southwest and the Northeast. To this extent the California banking crisis was “different” from those in the other regions. Contributing to this result were the sharp decline in interest rates during the early 1990s; the localized nature of the recession, which was concentrated in Southern California; and the dominant presence in the state of four of the largest banking organizations in the nation, whose geographic diversification both inside and outside the state mitigated the recession’s effect on their overall operations.

Although California’s economic growth was strong during the 1980s, the overall performance of the state’s banking industry was relatively mediocre going into the recession of the early 1990s. The weighted average median return on assets (ROA) for all California banks over the 1980–89 period was 0.63 percent, which was substantially below the median return for the U.S. banking industry (0.94 percent).⁵⁰ (See table 11.4.) These subpar returns were heavily influenced by the poor earnings record of the Bank of America (BoA) during most of the decade, which averaged only 22 basis points over this period. However, from 1988 to 1990 the overall performance of the California banking industry improved significantly, and the industry’s ROA matched or exceeded the returns for the U.S. banking industry.

Table 11.4 also identifies the profitability of the various banking groups that played roles in the provision of banking services within the state: established community banks (those with less than \$300 million in assets), banks chartered during the 1980s, and the four statewide organizations. Community bank operations are generally restricted to localized banking markets; because these institutions have limited geographic scope in comparison with larger organizations, they have fewer opportunities to diversify their lending. Commercial “banks chartered in the 1980s” were also small, locally oriented organizations. What distinguished them from community banks was their large number, which made them a competitive force in the state banking industry. Finally, the four statewide organizations dominated the California banking structure, their large branch networks operating within all major markets as well as competing on an interstate basis (in three of the four cases).⁵¹

⁴⁹ For convenience in analyzing the effects of the recession on the state banking industry, five complete years of data—1990–94—are discussed to approximate the duration of the recession.

⁵⁰ All ROAs for the different banking groups discussed in this section for the 1980–89 and 1990–94 periods refer to weighted average medians unless otherwise noted.

⁵¹ The Bank of America, First Interstate Bank, and, to a more limited extent, Security Pacific Bank all had a presence outside of California.

Table 11.4
Median Return on Assets for U.S. and California Banking Industries, 1980–1994
(Percent)

	Yearly Medians														Weighted Medians [‡]		
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1980–1989	1990–1994
U.S. Banking Industry	1.12	1.09	1.04	0.98	0.90	0.90	0.80	0.81	0.87	0.92	0.86	0.89	1.07	1.14	1.09	0.94	1.00
California Banking Industry	0.79	0.83	0.37	0.24	0.44	0.49	0.51	0.73	0.87	1.04	0.93	0.56	0.48	0.46	0.73	0.63	0.63
Established California Community Banks*	0.95	0.94	0.47	0.38	0.59	0.64	0.73	0.85	0.98	1.16	1.02	0.74	0.67	0.49	0.76	0.76	0.75
California Banks Chartered in the 1980s	-0.53	0.45	0.10	0.06	0.23	0.27	0.35	0.64	0.82	1.00	0.92	0.55	0.38	0.32	0.62	0.44	0.57
California "Big Four" Banks	0.60	0.49	0.35	0.41	0.48	0.35	0.55	-0.55	1.14	1.28	1.11	-0.10	0.60	1.14	1.15	0.51	0.78
Bank of America	0.54	0.36	0.34	0.30	0.34	-0.41	-0.48	-0.96	0.91	1.21	0.91	0.98	1.00	1.14	1.15	0.22	1.04
First Interstate	0.65	0.61	0.36	0.52	0.62	0.67	0.77	-1.69	1.33	1.28	1.32	-0.24	0.07	0.96	0.97	0.51	0.62
Security Pacific [†]	0.70	0.69	0.68	0.67	0.65	0.56	0.63	-0.15	1.12	1.31	0.80	-1.04	—	—	—	0.69	-0.12
Wells Fargo	0.55	0.29	0.25	-0.07	-1.59	0.13	0.47	0.16	1.17	1.27	1.41	0.04	0.60	1.36	1.63	0.26	1.01

*California community banks are defined as institutions with less than \$300 million in total assets.

[†]Acquired by Bank of America in 1992.

[‡]Medians are weighted by number of banking organizations.

The ROA of the different banking groups in the state varied widely over the 1980–89 period. Community banks recorded an ROA of 0.76 percent, which exceeded the ROA for all California institutions but fell short of the 0.94 return for the U.S. banking industry. In contrast, the performance of banks that were chartered during the decade was relatively poor. Over the entire 1980–89 period, this group recorded a median return on assets of only 44 basis points, below that of all the other groups within the state as well as the U.S. banking industry (table 11.4).

The dominant banking group in the state consisted of the statewide banking organizations, known collectively as “the Big Four”: Bank of America, First Interstate Bank, Security Pacific Bank, and Wells Fargo Bank. At the beginning of the decade they accounted for approximately 72 percent of statewide assets and 70 percent of total income of all California banking organizations. Any discussion of the performance of the California banking industry during the 1980–89 period is therefore heavily weighted by the performance of these organizations. Their median ROA from 1980 to 1989 was 51 basis points, substantially below the 94 basis point return for the U.S. banking industry. In 1987 this group actually experienced a net loss on assets of 55 basis points, as most of these firms charged earnings to set aside reserves for potential losses on loans to less-developed countries. From 1988 to 1990, however, their returns rebounded strongly, with gains that substantially exceeded those for the U.S. banking industry (table 11.4).

The below-average performance of the California banking industry from 1980 to 1989 was influenced by the intense competitive climate within the state’s banking and financial sectors. First and most especially, the newly deregulated California thrift industry posed strong challenges for deposit and loan products. Second, as just mentioned, the vibrant economy produced a large number of new entrants in the form of newly chartered banks that began operations in the first half of the 1980s. Finally, the increased market share of the California subsidiaries of Japanese banks also enhanced competition.

California thrift institutions, which are among the largest in the nation, have traditionally posed substantial competitive challenges to California’s commercial banks. At the beginning of the 1980s, four of the state’s ten largest depository institutions were thrifts; at year-end 1984, thrift institutions controlled approximately 50 percent of the state’s total domestic deposits, while commercial banks held approximately 48 percent and credit unions another 2 percent (see tables 11.5 and 11.6). Commercial banks in California have traditionally played an important role in providing residential and commercial mortgage credit. For example, at year-end 1989 median real estate loans (not shown) represented approximately 33 percent of total assets at California banks, substantially above the 23 percent median total for the U.S. banking industry.

Table 11.5
Ten Largest Depository Institutions in California,
December 31, 1979

Rank	Name of Institution	Location	Total Domestic Deposits (\$Billions)
1	Bank of America	San Francisco	\$86.1
2	Security Pacific Bank	Los Angeles	18.5
3	Wells Fargo Bank	San Francisco	16.1
4	Crocker National Bank	San Francisco	12.5
5	United California Bank	Los Angeles	11.7
6	Home Savings of America	Los Angeles	9.4
7	Great Western Savings	Beverly Hills	7.4
8	American Savings & Loan	Beverly Hills	7.3
9	Union Bank	Los Angeles	4.5
10	California Federal Savings & Loan	Los Angeles	4.5

Source: *American Banker* (February 21 and 26, 1980).

Table 11.6
Market Share of Total Domestic Deposits, by Type of Depository Institution in California, 1984–1992

Year	Total Domestic Deposits					
	Commercial Banks (\$Billions)	(Percent)	Thrift Institutions (\$Billions)	(Percent)	Credit Unions (\$Billions)	(Percent)
1984	\$177.4	48.3%	\$181.6	49.5%	\$ 8.3	2.3%
1985	185.8	47.9	191.6	49.4	10.8	2.8
1986	192.5	45.8	215.0	51.1	13.3	3.2
1987	191.3	42.7	241.7	54.0	14.9	3.3
1988	201.9	41.5	268.2	55.2	16.2	3.3
1989	217.9	43.0	270.6	53.4	17.9	3.5
1990	235.9	45.8	260.2	50.5	19.4	3.8
1991	245.9	48.1	242.0	47.4	22.9	4.5
1992	240.5	48.6	227.0	45.8	27.8	5.6

Source: Federal Reserve Bank of San Francisco.

During the early 1980s, while Congress was partly deregulating the thrift industry, the California state assembly went much further by significantly expanding the powers of state-chartered thrifts. The Nolan bill, which became effective on January 1, 1983, authorized state-chartered thrifts to invest directly in real estate *without limitation*; previously, direct

real estate investments had been limited to 12 percent of total assets.⁵² The legislation also eliminated a 5-percent-of-total-assets ceiling on loans secured by commercial real estate. In 1982, when the Nolan bill was passed, seven of the state's ten largest thrifts were state-chartered.⁵³

The attractiveness of the new powers was reflected in chartering patterns. The broad discretion granted to state-chartered thrifts, coupled with access to federally insured deposits, attracted new investors to the California thrift industry.⁵⁴ In the five years after the effective date of the Nolan bill, more than two-thirds of new thrifts (48 of 67) elected to be state chartered. Partly as a result of the new entrants and expanded powers, thrift institutions' share of statewide domestic deposits increased to 55 percent by year-end 1988, up almost 6 percentage points since 1984, while commercial banks' market share dwindled to 42 percent (down approximately 7 points) (table 11.6). Yet despite the new thrift powers granted at federal and state levels, the profit performance of California thrifts was relatively poor during the 1980s. Their ROA averaged only 11 basis points from 1984 through 1989; during the best year—1985—it was 46 basis points.⁵⁵

The second factor affecting the competitive environment was trends in the number of commercial banks. California began the decade of the 1980s with 240 commercial banks. During the next ten years (1980–89) that number more than doubled, with a total of 299 new banks being chartered—about 87 percent of them (260) during the first six years of the decade. More than half of the new banks were federally chartered (the remainder were state chartered [see figure 11.8]) and most of the new banks were headquartered in Southern California (not shown). The large number of new entrants enhanced competition within the state, but as a group, these newly chartered banks were outperformed by all other California banking groups (table 11.4).

The third factor that intensified competition in the state's banking industry was the significantly increased presence of Japanese banks in the state's banking markets. Between 1985 and 1990, assets of the nine California subsidiary banks owned by Japanese interests rose from \$11.8 billion to \$37.8 billion. This substantial growth was accomplished primarily by acquisitions; and by 1989, Japanese interests owned four of California's ten largest commercial banks. To gain market share, the Japanese banks were often willing to sacrifice

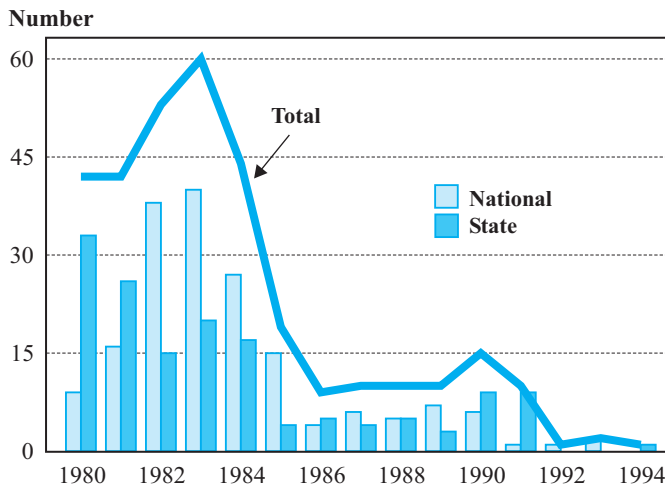
⁵² "California S&L Powers Bill to Governor," *American Banker* (June 15, 1982), 2.

⁵³ Norman Strunk and Fred Case, *Where Deregulation Went Wrong: A Look at the Causes behind Savings and Loan Failures in the 1980s* (1989), 57. In 1983 the California state legislature also expanded the power of state-chartered banks to make direct investments in real estate, adding a provision to the state banking code to allow state banks to invest up to 100 percent of total equity and/or 10 percent of total assets directly into real estate. More than 100 state banks took advantage of this provision, often with the encouragement of state officials.

⁵⁴ *Ibid.*, 58.

⁵⁵ Office of Thrift Supervision.

Figure 11.8
Newly Chartered Banks in California, 1980–1994



short-term profits, by pricing loans at 25 to 50 basis points below rates charged by their competitors.⁵⁶ In 1989, after five years of losses or marginal results, Japanese banks' ROA reached a high of 0.80 percent.⁵⁷

Effects of the Recession on California Banking (I): Troubled Banks

The condition of the California banking industry closely tracked changing economic circumstances within the state. In 1985–86 only 72 (approximately 17 percent) of the state's banks received problem-bank ratings (CAMEL 4 and 5) (see table 11.7a). These institutions accounted for less than 6 percent of the total number of problem banks nationally at that time. As the state economy gained momentum during the second half of the decade, the number of problem banks declined. In 1989, the industry registered a record income level of \$3.7 billion, while the number of problem institutions was half what it had been four years earlier. With the California recession of the early 1990s, however, the number of problem institutions jumped dramatically, reaching a peak of 118 in 1992, or approximately 26 percent of the total number of California banks. In 1993 and 1994, as the state was recov-

⁵⁶ Robert Luke, "Japanese Banks Tackle California Middle Market," *American Banker* (September 10, 1988).

⁵⁷ For a discussion of the presence of Japanese banks in the California banking system, see Gary C. Zimmerman, "The Growing Presence of Japanese Banks," *FRBSF Weekly Letter* (October 28, 1988).

Table 11.7a
CAMEL Ratings for All California Banks, 1981–1994

Report Date (Year-end)	Number of California Problem Banks/Percentage of Total					Total
	CAMEL Rating					
	1	2	3	4	5	
1981	53 18.4	181 62.8	41 14.2	12 4.2	1 0.3	288 100%
1982	52 16.2	175 54.5	55 17.1	28 8.7	11 3.4	321 100
1983	53 14.6	195 53.9	63 17.4	40 11.0	11 3.0	362 100
1984	45 11.5	197 50.3	94 24.0	44 11.2	12 3.1	392 100
1985	44 10.2	234 54.3	81 18.8	51 11.8	21 4.9	431 100
1986	41 8.9	261 56.6	87 18.9	53 11.5	19 4.1	461 100
1987	38 8.2	276 59.6	94 20.3	43 9.3	12 2.6	463 100
1988	49 10.7	285 62.1	86 18.7	37 8.1	2 0.4	459 100
1989	56 12.2	300 65.2	68 14.8	31 6.7	5 1.1	460 100
1990	51 11.2	294 64.6	74 16.3	28 6.2	8 1.8	455 100
1991	36 7.8	245 53.4	100 21.8	68 14.8	10 2.2	459 100
1992	17 3.8	203 45.3	110 24.6	96 21.4	22 4.9	448 100
1993	26 6.1	189 44.6	110 25.9	77 18.2	22 5.2	424 100
1994	25 6.2	202 50.0	92 22.8	59 14.6	26 6.4	404 100

Note: Examination ratings were obtained from the FDIC's historical database. In some instances examination ratings were missing; however, from 92 to 99 percent of banks' ratings were in the database. As a result, the number of CAMEL-rated banks each year was slightly smaller than the total number of California banks in other tables.

ering from the recession, the number of problem banks was declining relatively slowly. In 1993 and 1994, problem banks still accounted for 23 and 21 percent, respectively, of all banks in the state.

In contrast to what happened in the recession in the Southwest, where commercial bank equity capital and reserves declined as the crisis intensified, in California the banks'

Table 11.7b
CAMEL 4- and 5-Rated Institutions, California Banks versus
Banks in Rest of U.S., 1981–1994

Report Date (Year-end)	Number of Problem Banks/Percentage of Total		
	California Banks	Other Banks	Total
1981	13	220	233
	5.6	94.4	100%
1982	39	436	475
	8.2	91.8	100
1983	51	611	662
	7.7	92.3	100
1984	56	836	892
	6.3	93.7	100
1985	72	1,151	1,223
	5.9	94.1	100
1986	72	1,388	1,460
	4.9	95.1	100
1987	55	1,245	1,300
	4.2	95.8	100
1988	39	1,085	1,124
	3.5	96.5	100
1989	36	1,001	1,037
	3.5	96.5	100
1990	36	1,019	1,055
	3.4	96.6	100
1991	78	993	1,071
	7.3	92.7	100
1992	118	614	732
	16.1	83.9	100
1993	99	292	391
	25.3	74.7	100
1994	85	138	223
	38.1	61.9	100

levels of capital and reserves increased significantly during the 1980s and throughout the recession years. These increases offered some support for the notion that the state's banking industry had been relatively undercapitalized in the 1980s. For example, in 1986, 36 percent of California's banks had equity capital and reserve ratios at or below 7 percent, whereas only 19 percent of the U.S. banking industry had similar ratios (see tables 11.8a and 11.8b).

Table 11.8a
Equity and Reserves to Assets, California Banks, 1980–1994

Report Date (Year-end)	Number of U.S. Banks/ Percentage of Total					Total
	Equity Capital and Reserves to Total Assets					
	<5.0	5.0–7.0	7.0–9.0	9.0–11.0	> 11.0	
1980	12	63	75	43	88	281
	4.3	22.4	26.7	15.3	31.3	100%
1981	9	65	70	38	130	312
	2.9	20.8	22.4	12.2	41.7	100
1982	17	63	76	40	165	361
	4.7	17.5	21.1	11.1	45.7	100
1983	21	92	84	59	152	408
	5.2	22.6	20.6	14.5	37.3	100
1984	17	89	117	79	150	452
	3.8	19.7	25.9	17.5	33.2	100
1985	22	106	143	86	124	481
	4.6	22.0	29.7	17.9	25.8	100
1986	30	145	146	74	89	484
	6.2	30.0	30.2	15.3	18.4	100
1987	13	79	201	88	102	483
	2.7	16.4	41.6	18.2	21.1	100
1988	14	80	198	88	93	473
	3.0	16.9	41.9	18.6	19.7	100
1989	10	81	188	98	102	479
	2.1	16.9	39.3	20.5	21.3	100
1990	8	46	198	119	111	482
	1.7	9.5	41.1	24.7	23.0	100
1991	16	47	178	108	131	480
	3.3	9.8	37.1	22.5	27.3	100
1992	13	31	137	142	132	455
	2.9	6.8	30.1	31.2	29.0	100
1993	7	22	119	141	136	425
	1.7	5.2	28.0	33.2	32.0	100
1994	5	21	104	125	149	404
	1.2	5.2	25.7	30.9	36.9	100

Note: Data exclude Bank of America, First Interstate, Security Pacific, and Wells Fargo banks.

Capital levels improved during the second half of the 1980s as California's banks moved closer to industry benchmarks. At year-end 1989, only 19 percent of California's commercial banks had equity and reserve positions at or below 7 percent; the percentage of banks

Table 11.8b
Equity and Reserves to Assets, U.S. Banks, 1980–1994

Report Date (Year-end)	Number of U.S. Banks/ Percentage of Total					Total
	Equity Capital and Reserves to Total Assets					
	<5.0	5.0–7.0	7.0–9.0	9.0–11.0	> 11.0	
1980	154	1,847	6,300	3,963	2,494	14,758
	1.0	12.5	42.7	26.9	16.9	100%
1981	212	1,872	6,223	3,857	2,581	14,745
	1.4	12.7	42.2	26.2	17.5	100
1982	257	1,953	5,972	3,821	2,765	14,768
	1.7	13.2	40.4	25.9	18.7	100
1983	243	2,341	5,688	3,583	2,892	14,747
	1.7	15.9	38.6	24.3	19.6	100
1984	230	2,249	5,801	3,530	2,964	14,774
	1.6	15.2	39.3	23.9	20.1	100
1985	211	2,084	5,842	3,641	3,018	14,796
	1.4	14.1	39.5	24.6	20.4	100
1986	324	2,402	5,609	3,466	2,867	14,668
	2.2	16.4	38.2	23.6	19.6	100
1987	381	1,749	5,494	3,463	3,099	14,186
	2.7	12.3	38.7	24.4	21.9	100
1988	409	1,517	5,214	3,412	3,061	13,613
	3.0	11.1	38.3	25.1	22.5	100
1989	310	1,390	4,939	3,426	3,131	13,196
	2.4	10.5	37.4	26.0	23.7	100
1990	266	1,278	5,005	3,263	3,003	12,815
	2.1	10.0	39.1	25.5	23.4	100
1991	181	1,066	4,705	3,405	3,013	12,370
	1.5	8.6	38.0	27.5	24.4	100
1992	88	717	4,150	3,781	3,245	11,981
	0.7	6.0	34.6	31.6	27.1	100
1993	27	404	3,416	4,034	3,671	11,552
	0.2	3.5	29.6	34.9	31.8	100
1994	38	545	3,232	3,573	3,674	11,062
	0.3	4.9	29.2	32.3	33.2	100

declined continuously until, at year-end 1994, approximately 6 percent of banks had positions at or below 7 percent.

The improvement in ratios of equity capital and reserves, especially after 1991, may be partly explained by the phase-in of risk-based capital standards and the passage of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). This legislation imposed severe restrictions on undercapitalized banks.⁵⁸ In addition, FDICIA-mandated risk-related deposit insurance premiums in the early 1990s also gave banks an incentive to improve their capital positions.

Effects of the Recession on California Banking (II): By Bank Group

The California recession affected the performance of individual banking groups differently. Community banks and banks chartered during the 1980s, especially those headquartered in Southern California, were most affected by the recession, as reflected in the number of bank failures. Most of the large statewide organizations, with more-diversified loan portfolios, came through in satisfactory condition.

During the 1990–94 period, commercial banks headquartered in Southern California were generally less successful than those headquartered elsewhere. Banks located outside of Southern California’s six counties recorded a median ROA of 0.83 percent, in comparison with only 0.45 percent for banks located in the six southern counties (see table 11.9).

Over the 1990–94 period, California community banks as a group earned a median return of 75 basis points on assets, significantly higher than the 63 basis points earned by the state banking industry during that same period (table 11.4). Performance varied, however, between the community banks inside and those outside Southern California. Those located within Southern California had a median ROA of only 0.58 percent, while those headquartered outside of Southern California recorded an ROA of 0.95 percent (table 11.9). Banks chartered during the 1980s, which were weakened by their poor earnings during most of the decade, were especially vulnerable to a downturn in the economy. This group averaged only 57 basis points on assets over the 1990–94 period (table 11.4). Those located in Southern California were particularly affected, earning only 25 basis points on assets—substantially lower than the 81 basis points earned by those located outside of Southern California (table 11.9). Given the relatively poor performance of this group and then the recession of the early 1990s, it is not surprising that California banks chartered during the 1980s accounted for 29 of the 47 bank failures in the state during this period.

The recession had only a relatively modest effect on the profitability of the Big Four, which outperformed all other groups during this period. The Big Four recorded a median re-

⁵⁸ See Chapters 2 and 12 .

Table 11.9
Median Return on Assets for California Banking Groups and U.S., 1990–1994

	1990	1991	1992	1993	1994	Weighted Medians* 1990–1994
Southern California Banks	0.92%	0.51%	0.17%	0.04%	0.56%	0.45%
Rest of California Banks	0.95	0.75	0.74	0.80	0.93	0.83
U.S. Banking Industry	0.86	0.89	1.07	1.14	1.09	1.00
California Community Banks						
Southern California	1.01	0.56	0.48	0.15	0.53	0.58
Rest of California	1.06	0.94	0.85	0.92	0.98	0.95
Banks Chartered in the 1980s						
Southern California	0.87	0.47	0.05	0.48	0.17	0.25
Rest of California	0.98	0.67	0.71	0.76	0.95	0.81

Note: “Southern California” includes Los Angeles, Orange, Riverside, San Bernadino, Ventura, and San Diego Counties. “Rest of California” includes all remaining counties.

*Medians are weighted by number of banking organizations.

turn on assets of 78 basis points from 1990 to 1994, above the ROA of the other groups in the state (table 11.4). The statewide operations of the Big Four provided a diversified earnings base that offered some protection from the recession. For some members of this group, especially the Bank of America, earnings gathered from multistate operations provided additional support.⁵⁹ Generally, loan losses recorded mostly from Southern California units were offset or reduced by gains obtained from units located in other regions of California as well as in other states.

However, performance varied significantly among the four organizations. The best-performing were the Bank of America and Wells Fargo, both headquartered in Northern California. These organizations coupled diversity of statewide operations with considerable skill in containing credit losses. The Bank of America was not seriously affected by the recession, with an ROA of more than 1.0 percent from 1990 to 1994.⁶⁰ Net income on California operations totaled \$1.33 billion in 1992, \$1.56 billion in 1993, and \$1.70 billion in

⁵⁹ Bank of America and First Interstate Bank were the most diversified of the four organizations. Security Pacific Bank had some limited out-of-state holdings, while Wells Fargo Bank was primarily concentrated in California.

⁶⁰ During the 1980s the Bank of America was, and in the 1990s continued to be, California’s dominant financial institution. At the end of 1984 the bank operated 1,070 branches in California, accounting for 37 percent of statewide deposits and 49 percent of the net income earned by banks in the state. But the 1980s were a difficult period for the Bank of America, which absorbed large losses in 1985 (\$431 million), 1986 (\$442 million), and 1987 (\$780 million). In 1988, after selling a number of subsidiaries, the Bank of America resumed profitable operations, which have continued through the 1990s.

1994. After experiencing massive losses in the mid-1980s, the Bank of America instituted a rigorous system of credit controls.⁶¹ An industry report prepared by Smith Barney stated: “Thanks to its ill-fated commercial real estate lending, [Bank of America] was too busy overhauling its systems to make many [commercial real estate] loans in the 1985–1987 period. And it returned to the market with a conservative attitude. Once bitten, twice shy, or so we hope.”⁶² For Wells Fargo Bank, the fact that it focused on the California market made it especially vulnerable to the 1990–94 recession, particularly given its extensive commercial real estate exposure. The recession’s effect upon Wells Fargo was felt principally in 1991, when net income was only \$23 million and ROA only 0.04 percent. The bank rebounded in 1992 (net income of \$306 million, an ROA of 0.60 percent) and in 1993 and 1994 was one of the nation’s most profitable banks.

First Interstate Bank and Security Pacific Bank, both headquartered in Los Angeles, were considerably more damaged by the recession than the two organizations based in San Francisco. Unlike Wells Fargo, First Interstate Bank was not focused entirely upon its California operations. It sought a national presence and was operating in 16 states in 1989. During the 1980s, it moved into new geographic markets by licensing its name and services to banks not owned by the holding company. To a certain extent, the earnings from its interstate operations helped cushion the effect of the recession on loan losses in its primary market—Southern California. Nevertheless, during the recession First Interstate incurred a loss in 1991 (-0.24 ROA) and resumed marginally profitable operations in 1992 (0.07 percent ROA). The bank made a full recovery in 1993 and 1994, with returns on assets of almost 1 percent. (In 1995 First Interstate was purchased by Wells Fargo.)

Security Pacific, the state’s fourth major organization, focused its strategy during the 1980s primarily on serving retail customers and middle-market business firms in California.⁶³ Despite the organization’s solid profit performance during the 1980s, the recession had a major effect on Security Pacific’s operations and its heavy concentration of loan exposures within the state. Security Pacific was the only major California bank that was threatened by failure during the early 1990s, registering a loss on assets of 1.04 percent (\$555 million) in 1991. In 1992, weakened by the recession, it was purchased by the Bank of America. Before the acquisition, which *The Wall Street Journal* characterized as “a salvage operation,” the Security Pacific holding company had posted total losses of \$1.41 billion in its three preceding quarters.⁶⁴ After the acquisition, as a result of the continuing recognition of loss in Security Pacific’s loan portfolio, the Bank of America eventually

⁶¹ See description of the credit process for commercial real estate in Bank of America Corporation, *Annual Report* (1992), 25.

⁶² Smith Barney, *California Banking Report* (October 18, 1990), 8.

⁶³ Janet Lewis, “The War for California,” *Institutional Investor* (July 1990): 90.

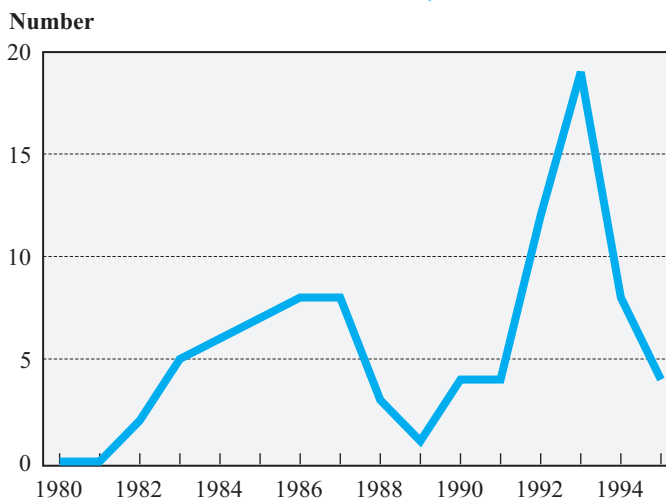
⁶⁴ Ralph T. King, Jr., “New Bank Behemoth Has Big Burdens, Rich Potential,” *The Wall Street Journal* (April 23, 1992), 1.

charged \$3.6 billion of the \$4.2 billion acquisition price to goodwill.⁶⁵ Nevertheless, the three large banks that then remained rebounded strongly during 1994, the final year of the recession. Wells Fargo, Bank of America, and First Interstate had ROAs of 1.63 percent, 1.15 percent, and 0.97 percent, respectively, while all U.S. banks earned 1.11 percent on assets (table 11.4).

Effects of the Recession on California Banking (III): Failed Banks

Given the severity of the California recession, the number and size of bank failures in California were relatively modest. Over the 1990–94 period, only 47 banks with total assets of \$3.5 billion failed (see figure 11.9 and table 11.10). Total resolution costs to the FDIC amounted to \$766 million. All failed institutions were relatively small—the largest had assets of only \$564 million; 10 banks had assets between \$100 million and \$200 million; the remaining 36 banks had assets under \$100 million. The sharp decline in interest rates in the early 1990s played a role in reducing the number of bank failures in California and else-

Figure 11.9
California Bank Failures, 1980–1995



⁶⁵ Bank of America Corporation, *Annual Report* (1992), 48.

Table 11.10
Bank Failures in California by Region, 1990–1994

Institution	Failure Date	Assets (\$Thousands)	Resolution Costs (\$Thousands)	County
Northern California				
1 Alvarado Bank*	01/25/91	\$ 30,499	\$ 4,323	Contra Costa
2 Financial Center Bank NA*	05/04/92	198,802	26,895	San Francisco
3 Statewide Thrift & Loan Co.*	11/13/92	10,335	2,341	Santa Clara
4 American Bank & Trust Co.	06/18/93	35,577	6,261	San Mateo
5 Regent Thrift & Loan Assn.*	09/17/93	7,383	1,429	San Francisco
6 Barbary Coast National Bank*	05/19/94	10,453	656	San Francisco
Total		\$ 293,049	\$ 41,905	
Central Valley				
1 Placer Bank of Commerce*	03/27/92	\$ 29,447	\$ 5,340	Placer
2 Valley Commercial Bank*	04/24/92	25,495	4,852	San Joaquin
Total		\$54,942	\$ 10,192	
Southern California				
1 Wilshire Bank National Assn.*	05/31/90	\$ 22,818	\$ 3,435	Los Angeles
2 Merchant Bank of California*	06/08/90	52,501	3,745	Los Angeles
3 First Pacific Bank	08/10/90	112,980	43,514	Los Angeles
4 Far Western Bank*	12/14/90	157,763	25,398	Orange
5 Manilabank California*	03/08/91	20,144	4,067	Los Angeles
6 Landmark Thrift & Loan Assn.	07/12/91	13,974	2,143	San Diego
7 Mission Valley Bank NA*	10/24/91	40,637	14,241	Orange
8 Assured Thrift & Loan Assn.	01/03/92	51,956	18,810	Orange
9 Independence Bank	01/30/92	564,201	139,551	Los Angeles
10 Mission Viejo National Bank*	02/28/92	98,283	29,957	Orange
11 United Mercantile B & T Co. NA*	03/20/92	30,218	9,893	Los Angeles
12 Bank of Beverly Hills	04/03/92	118,136	31,686	Los Angeles
13 North American Thrift & Loan	05/29/92	21,337	4,496	Orange
14 American Interstate Bank	06/12/92	40,943	7,239	Orange
15 Huntington Pacific Th&L Assn.	12/04/92	40,980	16,064	Orange
16 Columbia National Bank*	01/22/93	45,880	16,844	Los Angeles
17 First American Capital Bk. NA*	03/04/93	26,355	6,946	Orange
18 Olympic National Bank*	04/02/93	84,025	23,641	Los Angeles
19 Premier Bank*	04/08/93	51,174	9,219	Los Angeles
20 First Western Bank NA*	04/15/93	14,298	3,319	San Diego
21 American Commerce NB*	04/30/93	137,774	28,434	Orange
22 Wilshire Center Bank NA*	05/06/93	9,239	5,431	Los Angeles
23 Palos Verdes National Bank*	05/20/93	49,630	11,081	Los Angeles
24 Capital Bank of California*	06/18/93	200,138	62,163	Los Angeles
25 City Thrift & Loan Assn.	07/09/93	41,676	18,046	Los Angeles
26 First La Mesa Bank*	07/09/93	77,361	15,334	San Diego
27 Maritime Bank of California*	08/27/93	30,857	6,987	Los Angeles
28 Western United National Bank*	09/24/93	19,386	6,463	Los Angeles
29 Brentwood Thrift & Loan Assn.	10/15/93	12,972	3,271	Los Angeles
30 Mid City Bank National Assn.*	10/21/93	87,750	14,190	Los Angeles
31 Bank of San Diego	10/29/93	296,470	61,546	San Diego
32 Century Thrift & Loan	11/05/93	35,363	11,993	Los Angeles
33 Mechanics National Bank	04/01/94	149,643	41,279	Los Angeles
34 Pioneer Bank*	07/08/94	107,611	20,008	Orange
35 Bank of San Pedro	07/15/94	112,109	31,628	Los Angeles
36 Commercebank	07/29/94	119,785	14,732	Orange
37 Western Community Bank*	07/29/94	46,794	6,934	Riverside
38 Bank of Newport	08/12/94	151,026	28,212	Orange
39 Capital Bank	08/26/94	7,546	14,183	Los Angeles
Total		\$3,371,733	\$816,123	
Grand Total		\$3,719,724	\$868,220	

* Banks chartered between 1980 and 1990.

where.⁶⁶ The decline in interest rates produced a sharply upward-sloping yield curve, which increased the value of bank security portfolios and raised net interest margins on new loans. In California, the gains from lower interest rates absorbed losses caused by the recession and permitted some institutions to write off problem assets.

The recession had the greatest effect, in terms of failures, on banks chartered during the 1980s, especially those located in Southern California. Twenty-nine of the 47 failed banks (62 percent) had been chartered during the 1980s,⁶⁷ and 39 of the 47 were headquartered in Southern California—22 of the failures involved banks headquartered in Los Angeles County, nearly four times the number of failures that occurred in the nine-county San Francisco Bay area.⁶⁸ Only 8 failures occurred in Northern California: the 6 that occurred in the Bay Area, and 2 located in the Central Valley area (table 11.10).

Nationally, California led the nation in total number of bank failures in 1993 (19) and 1994 (8), replacing Texas, which had the lead from 1986 to 1992. But even so, during the first five years of the 1990s California bank failures accounted for only approximately 10 percent of the nation's failed banks, 2.6 percent of failed assets, and 5.7 percent of resolution costs.⁶⁹ Furthermore, the 47 California bank failures constituted only a fraction of the number of failures that had occurred in the Southwest and Northeast. In Texas, for example, 485 banks failed during the 1986–92 period. In addition, during the second half of the 1980s, nine of the ten largest Texas banking organizations had either been closed or required outside assistance, whereas only one of the four largest California organizations—Security Pacific Bank—was threatened by the recession. In the Northeast crisis, 111 banks failed during the three years 1990–92; in 1991 alone there were 52 failures, more than all of the failures in the California recession. In addition, the largest failure in California had total assets of only \$564 million, whereas in the Northeast much larger institutions were closed in the 1990–92 period. To this extent, the California banking crisis was indeed “different” from those in other regions of the nation.

⁶⁶ From 1990 to 1994 the federal funds rate declined from 8.1 to 4.2 percent. This decline significantly increased the U.S. banking industry's net income (which rose from \$16.6 billion to \$44.7 billion) and ROA (from 0.50 to 1.15 percent). In addition, over the same period, the number of bank failures declined from 168 to 13.

⁶⁷ Ten of the failed banks were chartered in 1983, four in 1982, five in 1981, four in 1980, two in 1984, and one each in 1985, 1986, 1987, and 1988.

⁶⁸ Independence Bank was headquartered in Los Angeles and had total assets of \$564 million at the time of failure. Thus, it was not counted as a “community bank.”

⁶⁹ During this period a total of 466 banks failed nationally, with total assets of approximately \$128 billion and resolution costs of \$13.5 billion.

California Bank Failures and Real Estate Investment

What made California banks particularly vulnerable to an economic slowdown were key investment choices made during the 1980s. In this period California banks' ratios of total loans and leases to assets substantially exceeded the national averages (and in 1990 went above 70 percent). (See figure 11.10.)

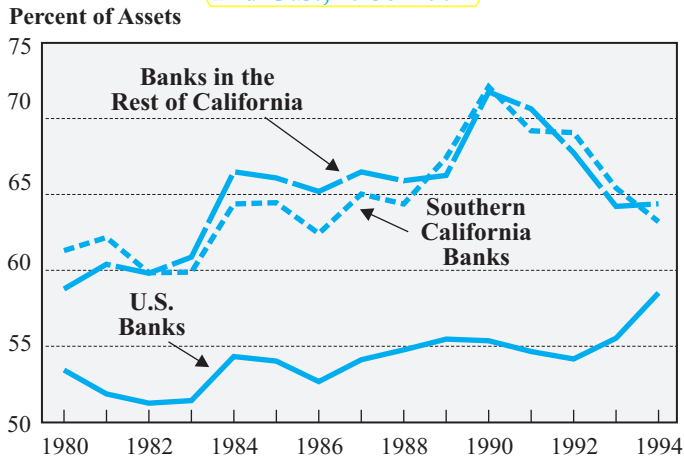
In addition to maintaining relatively high loans-to-assets levels, the California banks also altered the risk orientation of their lending programs by originating increasing proportions of real estate loans as a percentage of total assets. In 1989 these types of loans amounted to more than 30 percent, significantly above the level held at the end of 1980 (see figure 11.11). Exposure continued to increase through the early part of the recession before leveling off in 1991 at just above 40 percent of total assets. Although this trend toward greater real estate lending was occurring nationally, the proportion of real estate loans to total assets was significantly higher for California banks than for the U.S. banking industry. The higher levels of real estate lending for California banks were reflected primarily in the holdings of commercial real estate loans, which from 1980 to year-end 1989 increased from approximately 8 percent to almost 20 percent of total assets. This trend continued into the recession, with commercial real estate loans leveling off in 1991 at approximately 25 percent of total assets (see figure 11.12).

The switch to real estate lending was partly a function of the loss of market share of commercial and industrial loans to the capital markets and to other competitors, a trend that had been occurring nationally in the U.S. banking industry for some time (see figure 11.13). In California between 1984 and year-end 1989, the median commercial and industrial loans dropped from more than 20 percent of total bank assets to approximately 16 percent. These types of loans continued to decline in importance in California bank loan portfolios, averaging between 10 and 15 percent in 1994. Another reason for the switch to real estate lending was that the surge in population growth in the state during the 1980s created new investment opportunities for such activity. As mentioned above, California attracted 6 million new residents during the decade, accounting for nearly 25 percent of the national population increase. In dollar values, between 1980 and year-end 1989 annual real estate lending by California banks rose from only \$47 billion to approximately \$105 billion.

The high proportion of real estate loans in California bank loan portfolios during this period accounted for a substantial percentage of nonperforming assets as the recession hit in the early 1990s. This fact was reflected in the rising median volume of nonperforming assets and median net charge-offs on loans and leases (see figures 11.14 and 11.15). The high levels of nonperforming loans and charge-offs significantly affected the earnings performance of California banks during these same years (table 11.9).

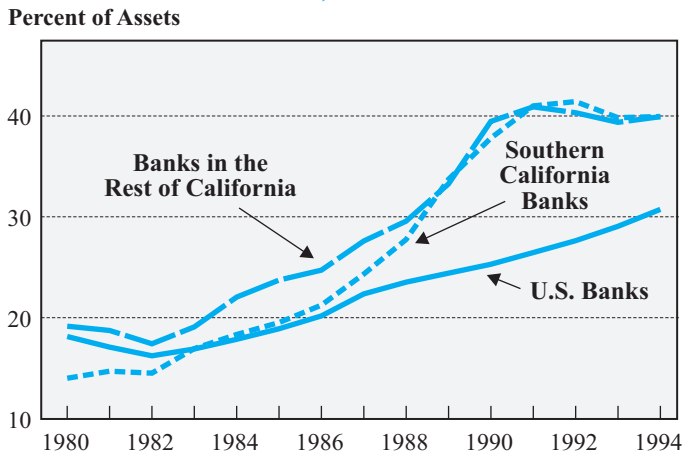
Similar trends existed with Wall Street switching from Dot.com to RMBS

Figure 11.10
Median Total Loans and Leases,
Southern California versus the Rest of California
and U.S., 1980–1994



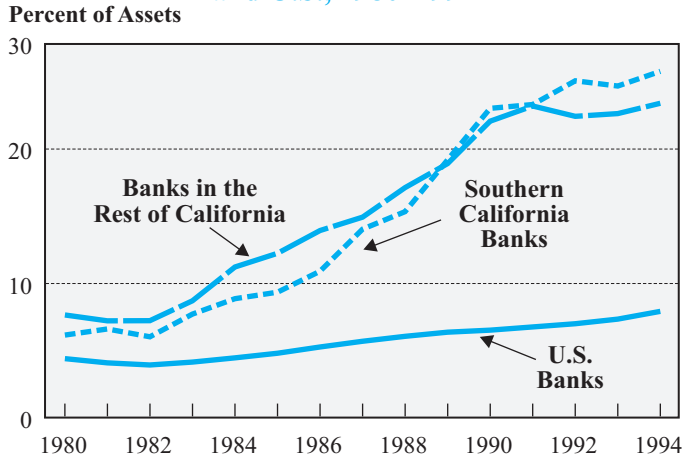
Note: Southern California consists of Los Angeles, Orange, Riverside, San Bernardino, San Diego, and Ventura Counties.

Figure 11.11
Median Total Real Estate Loans,
Southern California versus the Rest of California
and U.S., 1980–1994



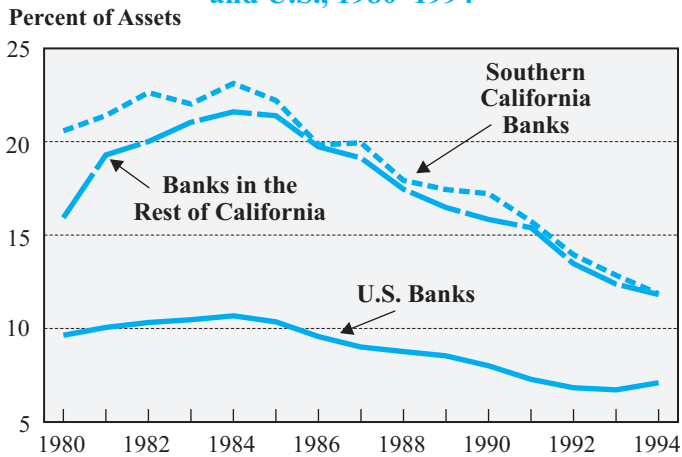
Note: Southern California consists of Los Angeles, Orange, Riverside, San Bernardino, San Diego, and Ventura Counties.

Figure 11.12
Median Total Commercial Real Estate Loans,
Southern California versus the Rest of California
and U.S., 1980–1994



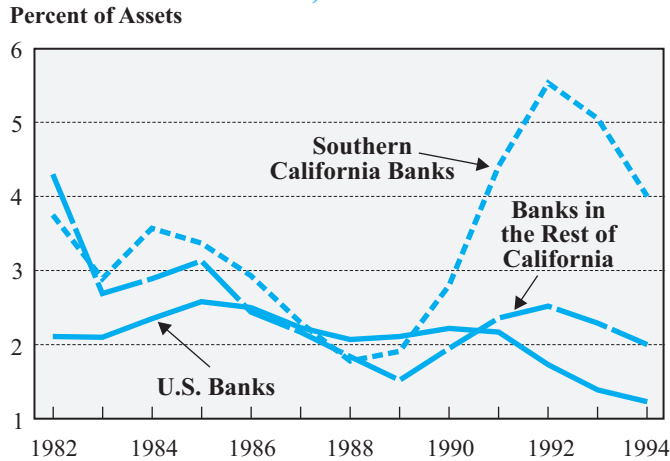
Note: Southern California consists of Los Angeles, Orange, Riverside, San Bernardino, San Diego, and Ventura Counties.

Figure 11.13
Median Total Commercial and Industrial Loans,
Southern California versus the Rest of California
and U.S., 1980–1994



Note: Southern California consists of Los Angeles, Orange, Riverside, San Bernardino, San Diego, and Ventura Counties.

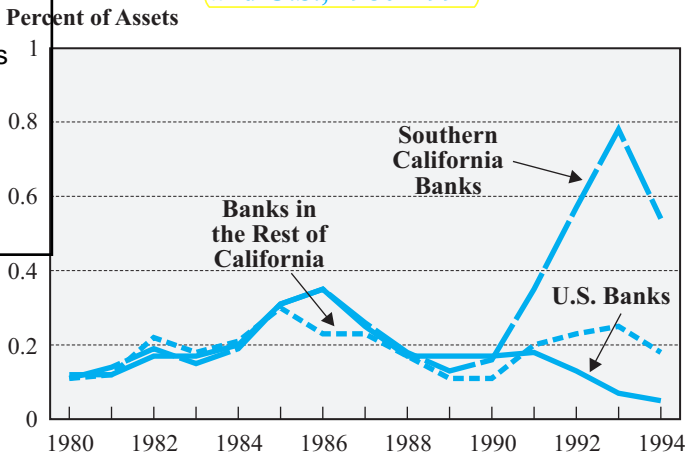
Figure 11.14
Median Nonperforming Assets,
Southern California versus the Rest of California
and U.S., 1982–1994



Note: Southern California consists of Los Angeles, Orange, Riverside, San Bernardino, San Diego, and Ventura Counties.

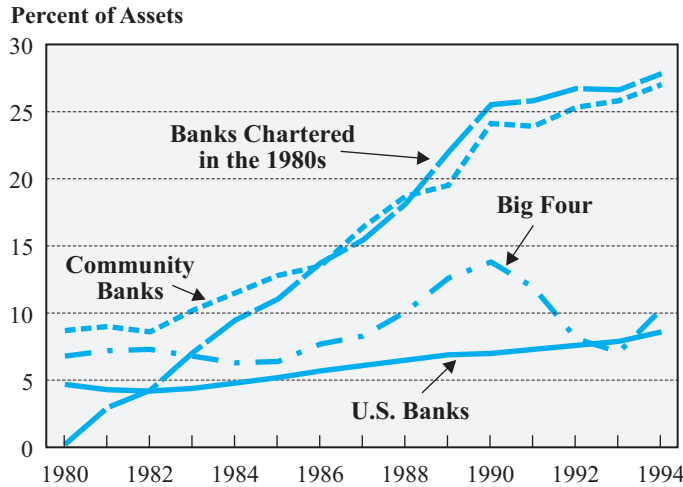
Figure 11.15
Median Net Charge-Offs on Loans and Leases,
Southern California versus the Rest of California
and U.S., 1980–1994

An overwhelming percentage of the most risky and leveraged loans are located within CA



Note: Southern California consists of Los Angeles, Orange, Riverside, San Bernardino, San Diego, and Ventura Counties.

Figure 11.16
**Median Commercial Real Estate Loans,
 California Banking Groups versus the U.S.,
 1980–1994**



Within the individual banking groups, although all three groups increased their real estate lending during the 1980–89 period, their portfolio choices and risk strategies differed. The Big Four organizations were less aggressive lenders in commercial real estate than community banks and banks chartered in the 1980s. (Commercial real estate lending includes construction and land development loans, loans secured by multifamily residential properties, and loans secured by nonfarm nonresidential properties.) Median commercial real estate loans as a percentage of total assets at the Big Four amounted to approximately 13 percent at the end of 1989, up from only approximately 7 percent in 1980 (see figure 11.16). For California community banks, however, median commercial real estate loans increased significantly between 1980 and year-end 1989, rising from only approximately 9 percent of total assets to approximately 20 percent. A similar pattern was observed for banks chartered during the 1980s: between 1980 and 1989, median commercial real estate loans as a percentage of total assets increased by almost 21 points, going from less than 1 percent to approximately 22 percent. For community banks and banks chartered during the 1980s, this type of lending continued to increase during the recession years of the early 1990s (figure 11.16). When the recession was at its fullest, the relatively high proportion of

commercial real estate lending played a leading role in the majority of failures of both community banks and banks chartered in the 1980s.⁷⁰

Conclusion

The series of regional recessions during the 1980s and early 1990s reached California last. However, in sharp contrast to the recessions in the Southwest and Northeast, where large numbers of banks failed and huge insurance losses were recorded, California experienced relatively few bank failures and relatively low losses. This was the situation despite the recession that was the deepest the state had experienced since the 1930s. Some reasons for this comparative mildness include, first, the fact that short-term interest rates declined during the early 1990s, allowing banking industry profits to increase. Second, the most serious consequences of the recession were localized in Southern California, so that bank failures were primarily restricted to banks in this geographic area. Most banks headquartered outside of Southern California were not seriously challenged by the recession. Third, most failures occurred among relatively smaller community banks and/or banks that had been chartered in the 1980s, so that losses to the insurer were limited. Fourth, primarily because of the geographic portfolio diversification (both inside and outside California) of the four statewide organizations, the loan losses these organizations experienced in Southern California were mostly offset or reduced by gains from units in other regions. Thus, the effect of the recession was not as pronounced on the large organizations as on banks whose loan portfolios were restricted to local markets. This result also differentiates the California bank crisis from the other regional crises: in California no large banking organization failed.⁷¹

However, although there were several differences between the California recession and the other regional recessions, there were also certain shared elements. These included a boom psychology that spurred development and inflated real estate prices; a shift by commercial banks into real estate lending, particularly high-risk commercial and construction lending; and the vulnerability of banks chartered during the 1980s. At least in these three respects, the California experience essentially paralleled the experiences in the Southwest and the Northeast.

Nontraditional lending products, NIV guidelines and 100% financing were almost non-existent during the S&L crisis within CA.

⁷⁰ The correlation between commercial real estate lending and deterioration in the asset quality of California community bank portfolios between 1990 and 1994 has been documented. See two articles by Gary C. Zimmerman: “California’s Community Banks in the 1990s,” *FRBSF Weekly Letter* (January 26, 1996), and “Factors Influencing Community Bank Performance in California,” Federal Reserve Bank of San Francisco *Economic Review*, no. 1 (1996): 34–36. For a more general discussion of the issue, see Lynn E. Brown and Karl E. Case, “How the Commercial Real Estate Boom Undid the Banks,” in *Real Estate and the Credit Crunch*, ed. Lynn E. Brown and Eric Rosengren (1992), 57–97.

⁷¹ Because Security Pacific Bank was purchased by Bank of America without any assistance from the FDIC, it was not counted as a bank failure.