FRBSF Weekly Letter

October 27, 1989

# Bank Earnings and LDC Loss Reserves

U.S. commercial bank earnings over the first half of the year hit an all time high of $14.3 billion, smashing the year-earlier record of $10.4 billion. In the aggregate, the return on bank assets nationally rose to 0.91 percent, the highest of the decade, and approaching the one percent mark that is generally considered excellent for the industry. In the West, bank earnings also hit a record, $2.4 billion, and the return on assets climbed to 1.12 percent.

Nationally, performance was strong across all size groups and across most regions, with the exception of the Southwest, which is still suffering the after-effects of the energy-related downturn. Strong earnings reflect a favorable widening of net interest margins (the difference between a bank's yield on assets and its cost of funds), increases in fee income, and asset growth.

Matching their first-half performance may prove difficult for banks in the second half, however. Asset quality considerations will dominate the industry's earnings picture, especially for the nation's largest banks. Even without any dramatic changes in overall economic conditions, a number of factors could substantially weaken industry performance through the end of 1989. At the top of the list are concerns about the quality of banks' loans to finance leveraged buyouts (LBOs), real estate loans, and loans to less developed countries (LDCs). In this *Letter* banks' LDC debt exposure will be examined.

**LDC loan concerns**

In recent months, concerns about the value of banks' LDC loans have resurfaced. There has been continued deterioration in the secondary market values of LDC loans. Bankers also have expressed concerns about the current Mexican debt restructuring. And Treasury Secretary Brady's plan to reduce the debts of LDCs likely will result in increased loan writeoffs. These forces have all served to heighten concern about LDC loan quality and the need to hold adequate reserves against expected losses.

The largest, and most imminent threat to bank portfolios is the status of loans to Mexico, Brazil, and Argentina. Loans to these nations have been a major concern to the industry since repayment difficulties came to light in the early 1980s. Seven years later, these LDCs continue to struggle to make payments on their existing debts. Negotiations for the repayment and rescheduling of these loans continue to be arduous and time consuming, and prospects remain uncertain. Meanwhile, new financing virtually has dried up, making these countries' cashflow problems even more acute.

Secondary market values reflect the concern about many LDC loans. For example, in 1986 the secondary market bid price for loans to Argentina, Mexico, and Brazil was at or above $60 per $100 in face value. Those prices fell sharply in 1987, and have continued to deteriorate since then. In September 1989, the bid price for $100 of Argentine loans was around $17, the price of Brazilian loans was about $30, and the price of Mexican loans was about $43.

**1987**

In 1987, the nine U.S. "money center" banks took a major step in dealing with troubled LDC credits. All told, they increased their loan loss reserves against LDC loans by more than $15 billion. This raised the level of most banks' reserves to 25 to 35 percent of their total LDC loans outstanding. Industry earnings fell from over $17 billion in 1986 to less than $4 billion in 1987, as most of the nation's largest banks reported actual losses associated with the expenses incurred in building their reserves.

WESTERN BANKING *Western Banking* is a quarterly review of banking developments in the Twelfth Federal Reserve District. It is published in the *Weekly Letter* on the fourth Friday of January, April, July, and October.

By building their reserves in 1987, U.S. banks were able to cushion future earnings against the possibility that these LDC loans would have to be "charged off" or marked down in value. In fact, this increase in reserves has given U.S. banks the flexibility to reduce their LDC loan exposure by selling these loans at a discount, swapping them, or writing them off.

Although increased chargeoffs have reduced reserves somewhat, LDC debt exposure has declined significantly. Compared to its peak in 1983 of almost $94 billion, exposure to troubled nations has been reduced by about $30 billion. Most of the reductions have come about as a result of loan sales and loan swaps.

Nonetheless, as of March 1989, U.S. banks still held $63.6 billion in troubled LDC debt. When compared to capital, which for large banks totaled $137.4 billion, risk still is high, particularly since most of this debt is owed by the large Latin American nations. Moreover, more than seventy percent of this debt is held by the nine U.S. money center banks, making their aggregate troubled LDC debt-to-capital ratio nearly 80 percent.

**How much is needed?**
Faced with such high exposure and the continued decline in the secondary market values of these loans, three of the nation's largest banks took dramatic action in the third quarter of this year. Chase Manhattan, Manufacturers Hanover, and Morgan Guaranty made substantial increases in their reserves against LDC loans. These three institutions alone raised their loan loss reserves by about $5 billion. More recently, Chemical Bank and Bank of New York added a total of $1.4 billion to their reserves as well.

As in 1987, the large expense necessary to build loan loss reserves likely will result in actual losses for the year at these banks. At the same time, it also will substantially strengthen their future earnings cushions. The stock market's initial reaction to these actions was positive, suggesting that investors applaud banks' efforts to address asset quality problems.

These actions raise questions about how large reserves need to be. At the major U.S. banks, loss reserves against medium- and long-term LDC loans now range from a low of about 27 percent to a high of 100 percent. Most of the large U.S. banks currently fall in the 30-46 percent range. In contrast, earlier in the year the major British banks increased their reserves against LDC loans to about 50 percent. And the generally conservative German and Swiss banks are reported to hold reserves of about 80 percent, although European banks have the added inducement of tax incentives to hold larger reserves.

Efforts by the industry to boost loss reserves to the 40-45 percent range thought necessary by some bank analysts likely would have a major impact on industry earnings for 1989. However, the impact would not be as large as that of the 1987 increase in reserves. In any event, because of the actions that already have been taken, industry earnings will be reduced substantially in the second half of 1989, even if other large U.S. banks do not follow suit and add reserves.

Whether more banks decide to add reserves will depend on other considerations as well. Concerns about exposure to highly leveraged merger and acquisition deals and to troubled real estate markets are high on the list of these considerations. Industry watchers are concerned about exposure in these areas on account of recent deterioration in the financial conditions of some of the large firms that have been financed by junk bonds and bank loans, and because of regional weakness in real estate markets.

**More capital**
Following their actions to boost loss reserves, three of the large banks also announced their intention to sell new stock to boost their equity capital positions. Equity capital also provides a cushion in the event of asset quality problems or earnings difficulties. The money center banks are not alone in their desire to maintain adequate capital in the face of tightening regulatory standards and concerns about asset quality. Salomon Brothers recently estimated that the nation's banks might issue more than $5 billion in new stock by the end of this year. That equity could prove a most timely boost to capital.

Asset quality problems could have a dramatic impact on earnings through the remainder of 1989. However, if the economy remains healthy, the regional and small banks generally should remain strong performers.

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**Economist**

# REGIONAL BANKING DATA

JUNE 30, 1989

(Not Seasonally Adjusted, Preliminary Data)

| | | DISTRICT | ALASKA | ARIZ. | CALIF. | HAWAII | IDAHO | NEVADA | OREGON | UTAH | WASH. |
|---|---|---|---|---|---|---|---|---|---|---|---|
| ASSETS AND LIABILITIES -- $ MILLION (ALL COMMERCIAL BANKS) | | | | | | | | | | | |
| ASSETS | TOTAL | 446,718 | 4,413 | 27,815 | 312,496 | 13,685 | 7,618 | 13,978 | 20,694 | 10,694 | 35,324 |
| | FOREIGN | 42,706 | 1 | N/A | 40,815 | 1,297 | N/A | N/A | N/A | 74 | 519 |
| | DOMESTIC | 404,011 | 4,413 | 27,815 | 271,681 | 12,388 | 7,618 | 13,978 | 20,694 | 10,620 | 34,805 |
| LOANS | TOTAL | 309,937 | 1,850 | 19,935 | 217,277 | 8,127 | 5,113 | 10,917 | 13,589 | 6,855 | 26,274 |
| | FOREIGN | 31,202 | 1 | N/A | 30,231 | 772 | N/A | N/A | N/A | N/A | 199 |
| | DOMESTIC | 278,734 | 1,849 | 19,935 | 187,046 | 7,356 | 5,113 | 10,917 | 13,589 | 6,855 | 26,075 |
| | REAL ESTATE | 121,734 | 693 | 8,594 | 88,382 | 3,483 | 1,304 | 1,955 | 4,343 | 2,842 | 10,139 |
| | COMMERCIAL | 75,518 | 720 | 4,817 | 51,199 | 2,117 | 1,354 | 1,517 | 5,012 | 1,791 | 6,992 |
| | CONSUMER | 55,828 | 223 | 4,711 | 30,638 | 1,213 | 1,361 | 7,136 | 2,993 | 1,635 | 5,918 |
| | AGRICULTURE | 5,249 | 8 | 463 | 2,619 | 28 | 629 | 19 | 345 | 123 | 1,015 |
| | INTERNATIONAL | 96 | N/A | 10 | 84 | 0 | N/A | N/A | 0 | 2 | 0 |
| SECURITIES | TOTAL | 44,204 | 1,628 | 3,590 | 24,135 | 2,610 | 1,456 | 1,951 | 3,580 | 1,750 | 3,503 |
| | U.S.T.S. | 13,869 | 1,155 | 1,410 | 6,672 | 840 | 419 | 602 | 1,141 | 346 | 1,284 |
| | SECONDARY MARKET | 17,268 | 194 | 580 | 12,010 | 718 | 608 | 458 | 856 | 850 | 994 |
| | OTHER SECURITIES | 13,067 | 279 | 1,600 | 5,453 | 1,052 | 430 | 892 | 1,582 | 553 | 1,225 |
| LIABILITIES | TOTAL | 419,968 | 4,000 | 26,153 | 294,587 | 12,842 | 7,076 | 13,092 | 19,293 | 9,988 | 32,937 |
| | DOMESTIC | 377,262 | 3,999 | 26,153 | 253,772 | 11,545 | 7,076 | 13,092 | 19,293 | 9,914 | 32,418 |
| DEPOSITS | TOTAL | 347,726 | 3,483 | 22,375 | 243,590 | 12,134 | 6,129 | 6,717 | 15,891 | 8,646 | 28,762 |
| | FOREIGN | 34,992 | 1 | N/A | 33,308 | 1,114 | N/A | N/A | N/A | 74 | 495 |
| | DOMESTIC | 312,733 | 3,483 | 22,375 | 210,282 | 11,019 | 6,129 | 6,717 | 15,891 | 8,572 | 28,266 |
| | DEMAND | 79,005 | 990 | 4,698 | 57,040 | 2,031 | 995 | 1,852 | 3,349 | 1,600 | 6,451 |
| | TIME AND SAVINGS | 233,728 | 2,493 | 17,677 | 153,242 | 8,988 | 5,134 | 4,865 | 12,542 | 6,972 | 21,816 |
| OTHER BORROWINGS | | 48,035 | 460 | 3,390 | 30,600 | 248 | 859 | 5,766 | 2,548 | 1,146 | 3,019 |
| EQUITY CAPITAL | | 26,750 | 414 | 1,662 | 17,908 | 843 | 541 | 886 | 1,401 | 706 | 2,388 |
| LOAN LOSS RESERVE | | 7,953 | 40 | 565 | 6,222 | 128 | 89 | 195 | 185 | 134 | 396 |
| STANDBY LETTERS OF CREDIT | | 33,540 | 22 | 685 | 29,429 | 453 | 115 | 166 | 566 | 279 | 1,826 |
| LOAN COMMITMENTS | | 136,949 | 261 | 3,434 | 109,920 | 3,657 | 1,095 | 1,609 | 4,867 | 1,604 | 10,502 |
| LOANS SOLD | | 116,703 | 10 | 232 | 115,833 | 66 | 55 | 62 | 235 | 14 | 196 |
| ASSET QUALITY -- PERCENT OF LOANS (LARGE COMMERCIAL BANKS) | | | | | | | | | | | |
| LOAN LOSS RESERVE (ALL BANKS) | | 2.57 | 2.16 | 2.83 | 2.86 | 1.58 | 1.74 | 1.78 | 1.36 | 1.96 | 1.51 |
| NET CHARGEOFFS, TOTAL | | 0.95 | 0.86 | 2.41 | 0.88 | 0.08 | 0.27 | 2.31 | 0.69 | 0.84 | 0.38 |
| | REAL ESTATE | 0.40 | 1.19 | 3.43 | 0.08 | 0.02 | 0.05 | 1.05 | 0.63 | 0.63 | 0.34 |
| | COMMERCIAL | 0.37 | 0.84 | 1.94 | 0.30 | -0.08 | 0.02 | 0.39 | 0.66 | 1.04 | -0.14 |
| | CONSUMER | 1.86 | 0.41 | 1.72 | 1.95 | 0.35 | 0.77 | 3.09 | 0.98 | 1.23 | 1.18 |
| | AGRICULTURE | 0.42 | N/A | 1.28 | 0.22 | -1.20 | 0.42 | -0.01 | 1.06 | 0.17 | 0.43 |
| PAST DUE & NON-ACCRUAL, TOTAL | | 5.01 | 9.53 | 10.20 | 5.29 | 1.29 | 1.91 | 1.80 | 2.30 | 4.10 | 3.14 |
| | REAL ESTATE | 5.01 | 14.50 | 17.40 | 4.01 | 1.08 | 2.41 | 4.51 | 3.70 | 5.53 | 4.34 |
| | COMMERCIAL | 5.94 | 8.77 | 7.52 | 6.80 | 1.43 | 2.17 | 3.02 | 1.84 | 3.82 | 2.41 |
| | CONSUMER | 2.16 | 2.43 | 1.98 | 2.55 | 2.00 | 1.83 | 0.95 | 1.72 | 2.98 | 1.95 |
| | AGRICULTURE | 10.10 | N/A | 5.06 | 15.40 | 8.87 | 2.02 | 0.54 | 2.69 | 3.30 | 5.40 |
| EARNINGS AND RETURNS -- $ MILLION (ALL COMMERCIAL BANKS) | | | | | | | | | | | |
| INCOME | TOTAL | 25,338 | 204 | 1,498 | 17,875 | 689 | 414 | 1,035 | 1,073 | 581 | 1,969 |
| | INTEREST | 21,299 | 173 | 1,307 | 14,800 | 609 | 373 | 930 | 932 | 513 | 1,662 |
| | FEES & CHARGES | 1,015 | 9 | 74 | 681 | 17 | 20 | 25 | 58 | 29 | 102 |
| EXPENSES | TOTAL | 21,840 | 179 | 1,749 | 15,046 | 570 | 349 | 838 | 907 | 535 | 1,667 |
| | INTEREST | 11,503 | 96 | 752 | 8,046 | 339 | 212 | 410 | 495 | 297 | 856 |
| | SALARIES | 4,024 | 36 | 280 | 2,844 | 115 | 55 | 89 | 179 | 78 | 346 |
| | LOAN LOSS PROVISION | 1,521 | 10 | 397 | 813 | 16 | 9 | 94 | 59 | 38 | 85 |
| | OTHER | 4,792 | 37 | 320 | 3,342 | 100 | 72 | 245 | 174 | 122 | 380 |
| INCOME BEFORE TAXES | | 3,469 | 25 | -251 | 2,807 | 117 | 64 | 196 | 166 | 43 | 302 |
| TAXES | | 1,259 | 3 | -119 | 1,066 | 41 | 21 | 94 | 50 | 12 | 92 |
| NET INCOME | | 2,416 | 22 | -132 | 1,902 | 76 | 43 | 127 | 116 | 33 | 228 |
| ROA (%) | | 1.12 | 1.06 | -0.96 | 1.26 | 1.17 | 1.16 | 1.86 | 1.18 | 0.63 | 1.34 |
| ROE (%) | | 18.10 | 10.90 | -16.00 | 21.20 | 18.10 | 15.90 | 28.70 | 16.60 | 9.27 | 19.10 |
| NET INTEREST MARGIN (%) | | 4.53 | 3.65 | 4.03 | 4.47 | 4.14 | 4.32 | 7.62 | 4.41 | 4.13 | 4.74 |

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## MARKET SHARE STATISTICS

PERCENT OF COMBINED MARKET TOTAL FOR AUGUST 1989, BY REGION

| | DISTRICT | | | ALASKA | | | ARIZONA | | | CALIF | | | HAWAII | | | IDAHO | | | NEVADA | | | OREGON | | | UTAH | | | WASH | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| DEPOSIT TYPE | CB | SL | CU | CB | SL | CU | CB | SL | CU | CB | SL | CU | CB | SL | CU | CB | SL | CU | CB | SL | CU | CB | SL | CU | CB | SL | CU | CB | SL | CU |
| TOTAL DEPOSITS | 46 | 50 | 4 | 71 | 9 | 20 | 60 | 36 | 5 | 43 | 54 | 3 | 65 | 30 | 5 | 86 | 11 | 3 | 67 | 30 | 3 | 66 | 29 | 5 | 68 | 22 | 10 | 55 | 39 | 7 |
| DEMAND | 94 | 4 | 2 | 98 | 1 | 1 | 93 | 4 | 3 | 94 | 4 | 2 | 94 | 3 | 3 | 93 | 2 | 5 | 100 | 0 | 0 | 96 | 2 | 3 | 92 | 5 | 4 | 95 | 4 | 1 |
| NOW | 61 | 32 | 7 | 51 | 14 | 35 | 75 | 16 | 9 | 58 | 35 | 6 | 72 | 25 | 3 | 87 | 9 | 4 | 78 | 16 | 7 | 76 | 18 | 6 | 75 | 14 | 11 | 65 | 23 | 12 |
| SAVINGS & MMDA | 59 | 33 | 8 | 52 | 8 | 40 | 73 | 19 | 9 | 58 | 35 | 7 | 61 | 28 | 11 | 87 | 9 | 4 | 74 | 20 | 5 | 68 | 23 | 9 | 69 | 10 | 21 | 57 | 28 | 15 |
| SMALL TIME | 27 | 70 | 3 | 64 | 22 | 14 | 46 | 51 | 3 | 22 | 76 | 3 | 40 | 57 | 3 | 82 | 16 | 2 | 41 | 57 | 2 | 52 | 44 | 4 | 56 | 37 | 7 | 42 | 54 | 4 |
| LARGE TIME | 34 | 65 | 1 | 94 | 4 | 2 | 45 | 54 | 2 | 31 | 67 | 1 | 78 | 20 | 2 | 86 | 10 | 3 | 60 | 40 | 0 | 67 | 31 | 2 | 77 | 20 | 3 | 45 | 55 | 1 |

CB = COMMERCIAL BANKS; SL = SAVINGS & LOANS AND SAVINGS BANKS; CU = CREDIT UNIONS; MAY NOT SUM TO 100% DUE TO ROUNDING

## INTEREST RATES ON DEPOSITS AND LOANS (%)

| TYPE OF ACCOUNT OR LOAN | DATE | US | DISTRICT | ARIZONA | CALIF | HAWAII | IDAHO | OREGON | UTAH | WASH |
|---|---|---|---|---|---|---|---|---|---|---|
| MONEY MARKET DEPOSIT ACCOUNTS | JUL89 | 6.56 | 6.29 | 5.95 | 6.51 | 6.33 | 6.26 | 6.10 | 6.48 | 5.34 |
| | AUG89 | 6.54 | 6.25 | 6.01 | 6.48 | 6.33 | 6.12 | 6.01 | 6.46 | 5.34 |
| | SEP89 | N/A | 6.28 | 5.95 | 6.58 | 6.33 | 6.12 | 5.85 | 6.46 | 5.67 |
| 6-MONTH CERTIFICATES | JUL89 | 8.24 | 7.77 | 7.81 | 8.31 | 7.21 | 8.26 | 8.04 | 7.82 | 7.12 |
| | AUG89 | 8.12 | 7.69 | 7.62 | 8.18 | 7.15 | 8.08 | 7.96 | 7.88 | 7.06 |
| | SEP89 | N/A | 7.73 | 7.58 | 8.09 | 7.15 | 8.05 | 8.04 | 7.77 | 7.17 |
| 2-1/2 YEAR CERTIFICATES | JUL89 | 8.21 | 8.07 | 8.02 | 8.28 | 8.22 | 8.23 | 7.92 | 7.94 | 7.93 |
| | AUG89 | 8.10 | 7.98 | 7.83 | 8.17 | 8.01 | 8.08 | 7.69 | 8.00 | 7.80 |
| | SEP89 | N/A | 7.95 | 7.83 | 8.22 | 8.07 | 8.09 | 7.73 | 8.02 | 7.80 |

Loan rate data is not available.