Financial Industry ISSUES

FEDERAL RESERVE BANK OF DALLAS FIRST QUARTER 1991

Eleventh District Banks Secure a Net Gain in 1990

"Last year marks the first time since 1985 that the District's banks, as a group, earned positive net income."

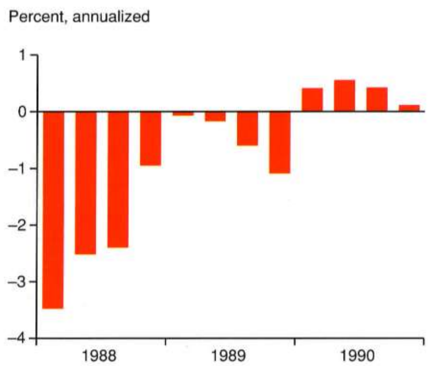
Banks in the Eleventh District returned to profitability last year, reversing a four-year trend of losses. Preliminary year-end income statements indicate that the District's banks earned $784 million in profits during 1990. The recovery in net income resulted in a return on District banking assets of 0.45 percent, just under the 0.5-percent return on assets for banks elsewhere in the nation. With the higher District earnings came a reduction in troubled assets and an increase in equity capital. The number of District bank failures declined from 144 in 1989 to 105 in 1990. While the number of District bank failures remained high, financial conditions improved at both large and small banks in the region.

Industry Performance

Last year marks the first time since 1985 that the District's banks, as a group, earned positive net income. As shown in Chart 1, the industry reported profits in every quarter of 1990. The higher earnings represented a sharp contrast to the losses of the preceding four years.

Table 1 shows the major components of the return on District banking assets. The increase in 1990 earnings can be traced to lower loan loss provisions, reduced noninterest expenses and higher net interest margins. The reduced loss provisions were a direct result of fewer nonperforming loans, against which banks hold reserves. A decline in total troubled assets and their associated management costs helped lower noninterest expenses, and a continued movement away from purchased funds toward less expensive core deposits pushed up net interest margins. At year-end 1989, District banks funded 16 percent of assets with large certificates of deposit, compared with 13 percent in the fourth quarter of 1990.

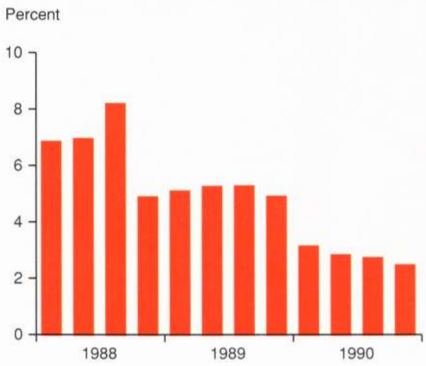
Chart 1
Return on Assets*
Eleventh District Banks



*Ratio of quarterly net income to average assets adjusted for mergers and acquisitions.
NOTE: The Eleventh District comprises the state of Texas, northern Louisiana and southern New Mexico. Fourth-quarter 1990 figure is preliminary.
DATA SOURCE: Report of Condition and Income.

"As with District banks overall, the increase in profitability among the small banks resulted from lower levels of nonperforming assets."

Chart 2
Troubled Asset Ratio*
Eleventh District Banks



*Ratio of loans past due 90 days or more, nonaccrual loans and other real estate owned to end-of-period gross assets.
NOTE: Fourth-quarter 1990 figure is preliminary.
DATA SOURCE: Report of Condition and Income.

Overall, return on assets in 1990 improved by 77 basis points.

Much of the turnaround in District earnings was either directly or indirectly associated with a reduction in troubled assets. Nonperforming loans at District banks fell from $5.4 billion in 1989 to $2.5 billion in 1990, which represented a decline of more than 50 percent. As shown in Chart 2, the troubled asset ratio has dropped sharply since its peak of 8.3 percent in the third quarter of 1988. At year-end 1990, 2.5 percent of District banking assets were nonperforming, which compared favorably with the 2.9 percent reported by banks elsewhere in the nation. Last year was the first time since 1984 that the District's troubled asset ratio was lower than the ratio for the rest of the U.S. banking industry. Also, District banks now hold 89 cents in loan loss reserves for every $1 of nonperforming loans, compared with roughly 55 cents per $1 of troubled loans during 1988 and 1989.

The decline in nonperforming loans and foreclosed real estate lowers the threat of further capital reductions at District banks. In addition, the equity-to-asset ratio itself has increased, providing a greater buffer against future losses. As Chart 3 shows, the equity-to-asset ratio rose from 4.5 percent in 1988 to 6.1 percent at year-end 1990. This improvement moved District banks closer to the 6.5-percent equity-to-asset ratio reported last year by banks elsewhere in the nation.

Small Bank Performance

Despite the overall improvement in District banking conditions, analysts have questioned the breadth of the region's financial recovery. Improvements in the industry figures result in part from the federal assistance provided in the resolution of bank failures. Hence, movements in the aggregate data may not be indicative of changes in the condition of unassisted District banks, most of which are relatively small.

Disaggregated data indicate that financial conditions have improved even among the District's small banks. Although the improvement among the small banks has been less dramatic than that for the industry as a whole, the problems at smaller District banks were less severe during the height of the region's banking difficulties.

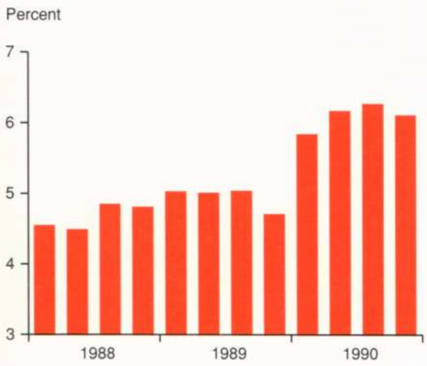
Chart 4 shows profitability figures for District banks with assets under $100 million. To ensure that any improvement in performance does not merely reflect the resolution of failed institutions, calculations included only those small banks that operated throughout the 1988–90

Table 1
Major Profitability Components
Eleventh District Banks

	1989 (Percent)	1990[1] (Percent)	Effect on Profitability (Basis Points)
Net Interest Margin	2.75	3.05	+30
Noninterest Income	2.05	1.40	–65
Loss Provision	1.45	.53	+92
Other Noninterest Expense	3.70	3.40	+30
Gains on Securities	.05	.01	–4
Taxes	.04	.11	–7
Extraordinary Items	.02	.03	+1
Return on Assets	–.32	.45	+77
Taxable Equivalent Net Interest Margin[2]	2.82	3.13	+31

[1] Preliminary.
[2] For each bank with profits before tax greater than zero, tax-exempt income was increased by the product of $[t/(1-t)]$ and the lesser of profits before tax or tax-exempt income, where t is the marginal tax rate.
NOTE: Data are adjusted for mergers and acquisitions.
DATA SOURCE: Report of Condition and Income.

Chart 3
Equity-to-Asset Ratio*
Eleventh District Banks



*Ratio of equity capital to end-of-period net assets.
NOTE: Fourth-quarter 1990 figure is preliminary.
DATA SOURCE: Report of Condition and Income.

period. Overall, 79 percent of the small banks in the sample were profitable in 1990, compared with 71 percent in 1988. Of the Dallas banks included in the sample, only 51 percent were profitable in 1989, but that figure improved to 66 percent in 1990. In Houston, the improvement was even more significant, with 84 percent of the banks included in the sample reporting positive net income in 1990, compared with 58 percent in 1988. The profitability of small banks in all other metropolitan areas also improved slightly, and the proportion of rural banks that were profitable remained fairly stable at about 80 percent.

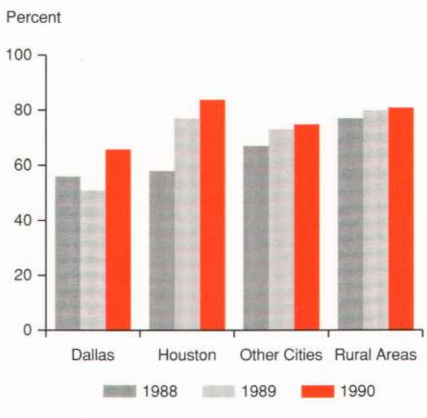
As with District banks overall, the increase in profitability among the small banks resulted from lower levels of nonperforming assets. Chart 5 shows the median troubled asset ratio for the sample of small District banks. The ratio for the group of Dallas banks declined from 1989 to 1990 but remained above its 1988 level. The small Houston banks showed substantial improvement in both 1989 and 1990. Asset quality problems remained relatively low and stable in all other cities and rural areas.

Bank Credit

While District banking conditions generally have improved, concerns persist about the availability of bank credit. Reductions in bank lending have been cited as a factor contributing to slow regional growth. To the extent that earlier declines in bank credit were caused by deterioration in bank performance, the recent improvement in District banking conditions might suggest a turnaround in bank lending. Chart 6 shows, however, that the District loan-to-asset ratio declined in both 1988 and 1989 before stabilizing at about 45 percent in 1990. And the dollar value of bank loans declined over the entire three-year period.

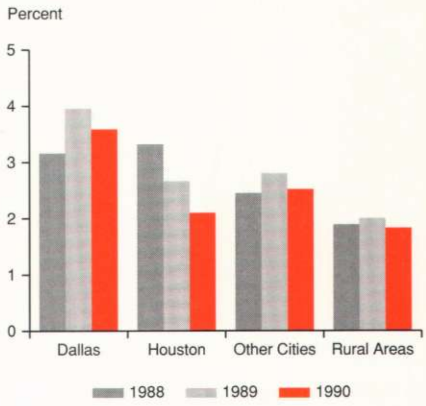
The District's banks, as a group, have increased liquidity by investing a higher share of assets in securities. The proportion of District banking assets invested in securities was 27 percent at the end of last year, compared with 17 percent at year-end 1987. A rise in U.S. government agency securities, such as certificates of participation in residential mortgage pools and collateralized mortgage obligations, accounted for most of the overall increase. As a share of assets, U.S. government agency securities rose about 10 percentage points over the 1988–90 period. In dollar terms, these relatively liquid investments rose from about $13 billion at year-end 1987 to just under $30 billion at the end of last year.

Chart 4
Percent of Small Eleventh District Banks
with Positive Net Income*



*Based on a panel of small banks (those with assets under $100 million) that operated throughout the three-year period from 1988 to 1990.
NOTE: 1990 figures are preliminary.
DATA SOURCE: Report of Condition and Income.

Chart 5
Median Troubled Asset Ratio*
Small Eleventh District Banks

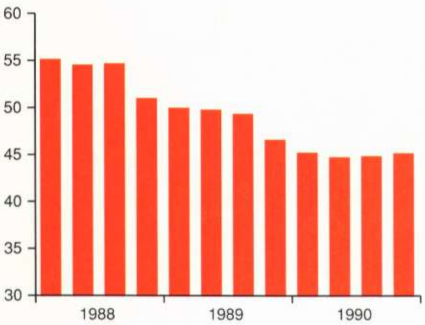


*Based on a panel of small banks (those with assets under $100 million) that operated throughout the three-year period from 1988 to 1990.
NOTE: 1990 figures are preliminary.
DATA SOURCE: Report of Condition and Income.

The causes and consequences of the movement away from loans toward securities cannot be determined through an examination of the banking data alone. District banks may have adopted a more cautious lending strategy following the financial difficulties that occurred during the past several years. The current loan-to-asset ratio at District banks stands well below the levels of the mid-1980s but corresponds more closely to the levels reported before the region's energy and real estate expansions. From this perspective, the recent retrenchment in District lending can be viewed partly as a return to historical standards.

Table 2 shows average lending concentrations at year-end 1990 for the District and the rest of the nation. The figures include only those banks located in metropolitan areas. On average, loans represented about 46 percent of assets at the District banks, compared with 59 percent for banks elsewhere in the nation. However, most of the gap in total loan exposure simply reflected a higher average concentration of residential real estate

Chart 6
Loan-to-Asset Ratio*
Eleventh District Banks



*Ratio of total loans and leases to end-of-period gross assets.
NOTE: Fourth-quarter 1990 figure is preliminary.
DATA SOURCE: Report of Condition and Income.

loans at banks outside the District. Differences in the other major lending categories were relatively minor. In contrast, at year-end 1984, the average concentration of commercial and industrial loans for District banks located in metropolitan areas was 21 percent, compared with 15 percent for metropolitan banks outside the District. Hence, regional comparisons of loan concentrations indicate that a portion of the decline in District lending represents a return to more normal lending levels.

Additional factors may lie behind the decline in District lending. Potential regulatory factors, including the new risk-based capital requirements and tighter supervisory standards, may have contributed to the reduced loan volume. Moreover, the low loan-to-asset ratio at District banks partly reflects the long period of depressed earnings at Southwest financial institutions. Furthermore, sluggish loan demand from qualified borrowers could explain why District lending levels have not followed the turnaround in general banking conditions. The regional recession that occurred in 1986 had a severe, prolonged effect on the collateral values and financial statements of local borrowers. As a result, continued growth in the regional economy may be a necessary condition for increased lending at District banks.

Concluding Remarks

Banking conditions in the Eleventh District continued to improve in 1990. The District's banks secured a net gain for the first time since 1985 and, by some measures, outperformed their national counterparts. In addition to the recovery evident for District banks as a group, the District's small banks also made substantial progress in reducing troubled assets and generating profits. While a rebound in bank lending has yet to materialize, the recent improvement in financial conditions suggests that most District banks are now positioned to meet the funding needs of regional businesses and individuals in the years to come.

— Jeffery W. Gunther
Kelly Klemme

Table 2
Average Lending Concentrations for Banks in Metropolitan Areas, 1990 (Percent)*

Loan Category	Eleventh District	Rest of Nation
Commercial and Industrial	11.61	13.29
Residential Real Estate	9.28	16.54
Commercial Real Estate	9.46	10.60
Construction	2.10	3.41
Consumer	11.99	11.32
Other	1.44	3.34
Total Loans	45.88	58.50

* Mean ratio of loans, by category, to end-of-period gross assets.
NOTE: Data are preliminary.
DATA SOURCE: Report of Condition and Income.

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