Financial Industry ISSUES

FEDERAL RESERVE BANK OF DALLAS FIRST QUARTER 1992

Credit Crunch Concerns Linger As Banking Industry Improves

"The aggregate national data mask the severity of difficulties experienced in certain regions."

Banks in the Eleventh District improved performance in 1991 relative to 1990. For the second year in a row, the District's banks earned positive net income while reducing troubled assets and increasing capital.

Growth in net income from $780 million in 1990 to $1.2 billion in 1991 led to a return on assets of 0.68 percent, up from 0.45 percent in 1990. The higher net income in 1991 also raised the proportion of District banks that were profitable, with both small and large banks sharing in the profitability gains.

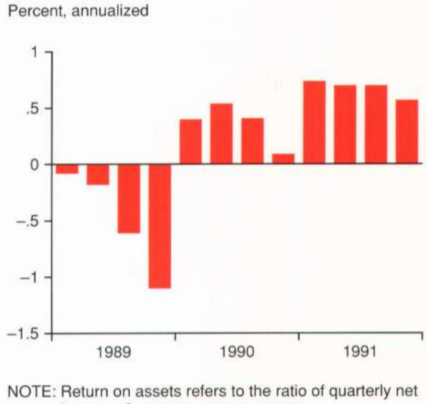
The banking industry showed some signs of improvement at the national level as well. The profitability of U.S. banks increased modestly, and asset quality problems began to diminish in late 1991. Despite some overall improvement in the banking industry, severe difficulties persisted in certain regions throughout 1991. As a result, concerns linger about the availability of credit, particularly for small businesses.

Industry Performance

Profitability. Eleventh District banks improved their return on assets in 1991 relative to 1990, as shown in Chart 1. This performance is particularly noteworthy because it occurred during a year of national recession. The 1990–91 period also marks the first time since 1984–85 that District banks earned profits in two consecutive years.

The sources of the increased profitability are shown in Table 1, which lists the major components of the return on assets for banks both in the Eleventh District and in the rest of the nation. The return on assets for District banks was lower than the return on assets for the rest of the nation in 1990, but the District surpassed the rest of the nation in 1991. From 1990 to 1991, the return on assets for District banks grew 23 basis points, while the

Chart 1
Return on Assets for Eleventh District Insured Commercial Banks



NOTE: Return on assets refers to the ratio of quarterly net income after tax to average assets.
DATA SOURCE: Report of Condition and Income.

return on assets for banks in the rest of the nation increased 5 basis points. The modest growth in the rest of the nation relative to the Eleventh District reflects both continued recovery in District banking conditions and emerging stress in the West Coast banking sector.

The growth in profitability in 1991 both for District banks and banks in the rest of the nation resulted from higher net interest margins, increased noninterest income and additional gains on securities sold. Eleventh District banks also benefited from reduced loan loss provisions, whereas banks in the rest of the nation increased their loan loss provisions. An increase in noninterest expenses moderated the growth in profitability for banks both in the District and in the rest of the nation.

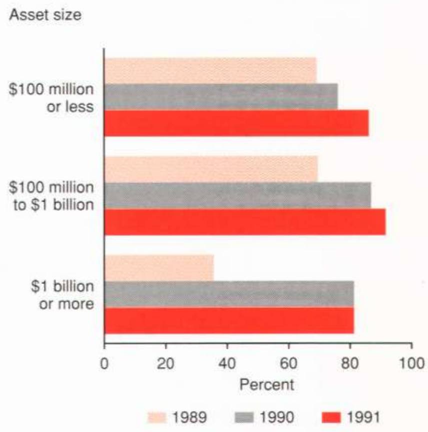
The rise in net interest margins that fueled the growth in bank profitability mirrors the recent decline in short-term interest rates. Because some banks' deposit liabilities are of shorter duration than their assets, quicker adjustment in deposit expenses has helped to lower banks' deposit costs relative to their asset returns. Also, interest expense has been reduced by a decreased reliance on high-cost deposits, such as large certificates of deposit.

The improvements in District profitability benefited banks of all sizes, suggesting breadth in the District banking industry's improved performance. As Chart 2 shows, 86 percent of District banks with total assets of $100 million or less had positive net income in 1991, compared with 76 percent a year earlier and 69 percent in 1989. The percentage of medium-sized banks that had positive net incomes rose to 92 percent in 1991, up from 87 percent in 1990 and 70 percent in 1989. Among banks with total assets of $1 billion or more, the percentage with positive net incomes remained steady at 81 percent for 1990 and 1991, compared with only 36 percent in 1989.

Asset Quality. Chart 3 shows the improvement that has occurred in the District banks' troubled asset ratio, both over time and relative to the rest of the nation's banks. The decline in the District's troubled asset ratio through 1990 and 1991 shows that the District's banks are recovering from the difficulties that emerged following the downturn in the regional economy that began in 1986. The recovery of the District's banks also bodes well for the future performance of the District's economy.

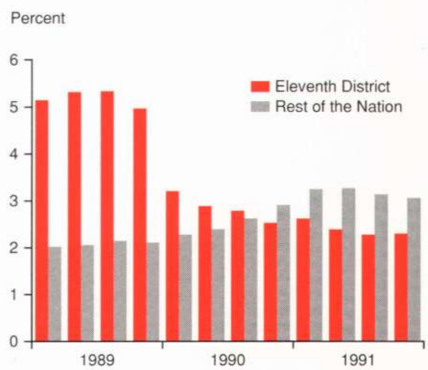
The recession in the West Coast real estate market contributed to the rise in the troubled asset ratio in the rest of the nation. By late 1991, however, the troubled asset ratio for banks outside the District

Chart 2
Percentage of Eleventh District Banks with Positive Net Income



DATA SOURCE: Report of Condition and Income.

Chart 3
Troubled Asset Ratio for the Eleventh District and the Rest of the Nation



NOTE: Troubled asset ratio is the ratio of the sum of loans past due 90 days or more, nonaccrual loans and other real estate owned to end-of-period gross assets.

DATA SOURCE: Report of Condition and Income.

Table 1
Major Profitability Components for Insured Commercial Banks

Eleventh District

	1990 (Percent)	1991 (Percent)	Effect on Profitability (Basis Points)
Net Interest Margin	3.06	3.35	29
Noninterest Income	1.40	1.61	21
Loss Provision	.53	.46	7
Other Noninterest Expense	3.42	3.82	–40
Gains on Securities	.01	.19	18
Taxes	.11	.22	–11
Extraordinary Items	.04	.03	–1
Return on Assets	.45	.68	23

Rest of the Nation

	1990 (Percent)	1991 (Percent)	Effect on Profitability (Basis Points)
Net Interest Margin	3.51	3.69	18
Noninterest Income	1.68	1.81	13
Loss Provision	.99	1.06	–7
Other Noninterest Expense	3.50	3.76	–26
Gains on Securities	.01	.08	7
Taxes	.24	.25	–1
Extraordinary Items	.03	.04	1
Return on Assets	.50	.55	5

NOTE: 1991 data are preliminary. Eleventh District data are adjusted for mergers and acquisitions.

DATA SOURCE: Report of Condition and Income.

had begun to decline, indicating a potential recovery from the recent slide in asset quality.

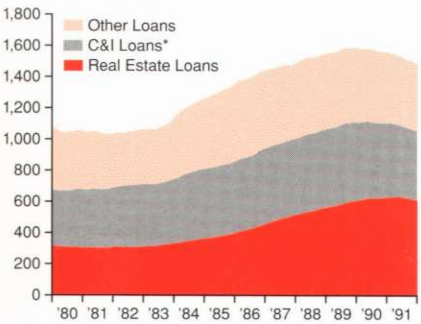
Bank Credit Availability

While overall banking conditions have improved somewhat, concerns over the availability of credit persist. Analysts have suggested that recent declines in bank lending activity have contributed to sluggish economic growth. In the nation, total bank loans (adjusted for inflation) fell slightly between 1990 and 1991, as shown in Chart 4. During 1991, the volume of real estate loans stabilized near 1990 levels, but commercial loans experienced a modest decline. In the Eleventh District, total inflation-adjusted bank loans declined by 6.9 percent during 1991.

The decline in bank loans nationwide may be explained either by banks' more cautious lending strategies or by a decrease in potential borrowers' desire for credit. In general, it is difficult to distinguish the effects of supply and demand shocks on aggregate bank lending.

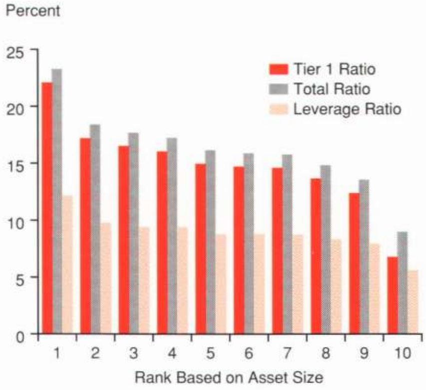
Capital. One supply-related factor that could be contributing to the decline in bank lending is the implementation of risk-weighted capital requirements. The new requirements call for more capital for loans thought to have high credit risk, such as commercial and industrial loans, and less capital for investments thought to have low risk, such as U.S. Treasury bonds. In effect, therefore, the new risk-based capital requirements potentially impose a tax on certain types of bank lending.

Chart 4
Composition of Lending at U.S. Insured Commercial Banks



*Commercial and Industrial Loans.
DATA SOURCE: CITIBASE, Citibank Economic Database.

Chart 5
Risk-Based Capital Ratios, 1990



NOTE: Rank 1 represents the smallest banks.
DATA SOURCE: Report of Condition and Income.

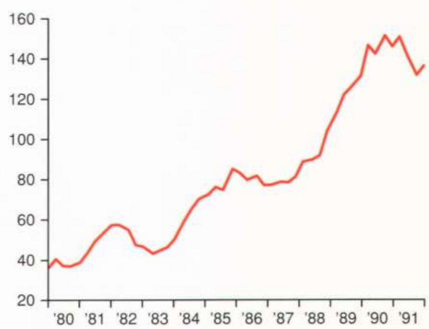
The new risk-based capital requirements may have had substantial effects on lending activity only at the largest U.S. banking organizations, however. Data in Chart 5 show that larger banks generally have relatively low risk-weighted capital ratios, suggesting that the move to risk-based capital requirements may have imposed some constraints on this group of banks. Smaller banks generally have risk-weighted capital ratios well above the 4-percent minimum requirement for the Tier 1 ratio and 8-percent minimum requirement for the total risk-weighted capital ratio, so that the transition to the new capital requirements may have been less difficult for the smaller institutions. The leverage capital ratio, which is not a risk-weighted measure, shows smaller differences across bank sizes. All in all, the new capital requirements have affected aggregate bank lending to some degree by constraining lending activity at the nation's large banks, but the new capital requirements probably did not impact the lending relationships between smaller banks and their borrowers.

Commercial Paper. Several factors may have relieved some of the possible stress associated with the recent national decline in bank loans. Commercial paper issued by nonfinancial firms more than tripled between 1980 and 1991, as shown in Chart 6, while bank credit doubled. During 1991, commercial paper declined, which may reflect a weakening of demand for credit among the class of borrowers with access to the commercial paper market, or a reluctance to purchase commercial paper by investors.

The long-term growth in the commercial paper market reflects the increasing importance of nonbank sources of credit. Large borrowers increasingly have turned to commercial paper, which is often less costly than bank credit. Commercial paper as a source of credit, however, is relatively inaccessible for small firms, and they continue to rely upon bank credit.

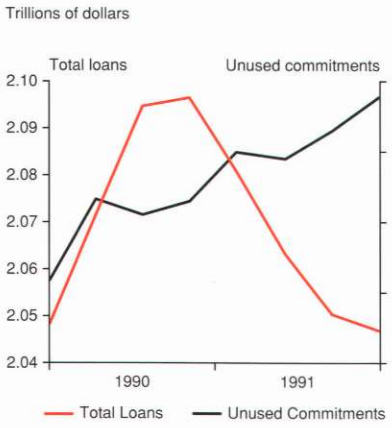
Credit Commitments. An additional factor that may help offset reduced bank lending is unused credit commitments extended by commercial banks. Credit commitments provide a potential source of liquidity for borrowers. By arranging for a credit commitment before credit is needed, borrowers are able to insure themselves against the risk of an unforeseen need for liquidity emerging when banks are reluctant

Chart 6
Commercial Paper Issued by Nonfinancial Firms



DATA SOURCE: CITIBASE, Citibank Economic Database.

Chart 7
Loans and Commitments at U.S. Banks

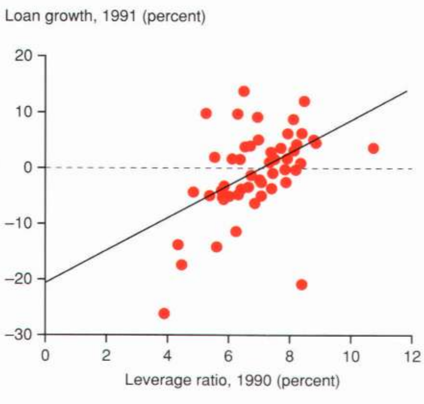


DATA SOURCE: Report of Condition and Income.

to lend. Fees paid for unused credit commitments also offer a source of income to banks.

Chart 7 shows the patterns in unused credit commitments. While total bank loans have declined, unused credit commitments have risen in the nation as a whole and have fallen only slightly in the Eleventh District. The increase in unused credit commitments indicates that some borrowers still have access to credit that they have not yet used. Furthermore, the sum of bank loans and unused credit commitments shows that the total presence of the banking industry in the lending process actually increased during the recent period in which bank loans were declining.

Chart 8
Loan Growth and the Leverage Ratio by State



NOTE: The leverage ratio is the ratio of Tier 1 capital to tangible assets.

DATA SOURCE: Report of Condition and Income.

Pockets of Distress. Although modest improvements are noticeable in the nation's banking industry, some regions' banks continue to experience distress, particularly those on the East and West coasts. The heterogeneity in banking markets across states is revealed by Chart 8, which shows capital levels and loan growth for each state. The solid line shows the general trend; growth in loans has been lower in states with relatively low leverage ratios. Declines in lending exceeding 10 percent occurred in six states, most of which had relatively low capital ratios. One interpretation of these data is that a negative shock to bank capital in a region can reduce the lending capacity of the region's banks, thereby potentially harming small business borrowers in the region. Hence, the aggregate national data mask the severity of difficulties experienced in certain regions.

Concluding Remarks

The Eleventh District's banking industry performed well in 1991. Total profits, return on assets and asset quality each improved during the year. Banking conditions also improved somewhat nationwide, particularly in the latter part of 1991, but total bank loans declined both in the Eleventh District and in the rest of the nation. Analysts have viewed this decline in bank lending as a possible indication of a general shortage of credit availability.

Although bank lending has declined, unused credit commitments and commercial paper may have lessened the difficulties associated with this decline on a national basis. The substantial dispersion of capital levels and loan growth rates across states, however, suggests that credit availability may be restricted for small business borrowers in some areas of the country.

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