Financial Industry ISSUES

FEDERAL RESERVE BANK OF DALLAS SECOND QUARTER 1992

The Transition to Healthier Banks and Thrifts: Has Money Growth Been Affected?

After several years of difficulties, the financial industry is now showing a clear trend toward stronger performance. Banks and thrifts in the Eleventh Federal Reserve District, which consists of Texas, northern Louisiana and southern New Mexico, continue to improve and outperform their counterparts across the nation. Evidence also suggests that financial institutions outside the District are in the early stages of a turnaround. Yet, despite the improvement in bank and thrift performance, some analysts worry that recent weakness in the growth of the monetary aggregate M2 appears related to the capital levels of banks and thrifts.

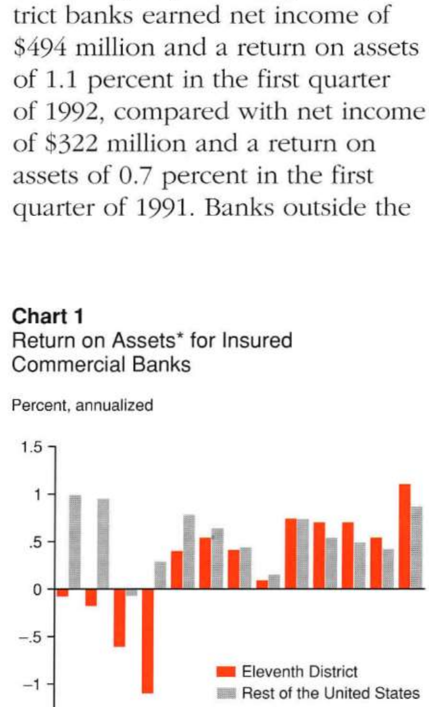
Industry Performance

Profitability. As Chart 1 shows, the profitability of banks in the Eleventh District and elsewhere improved during the first quarter of 1992. According to preliminary data, District banks earned net income of $494 million and a return on assets of 1.1 percent in the first quarter of 1992, compared with net income of $322 million and a return on assets of 0.7 percent in the first quarter of 1991. Banks outside the District earned a return on assets of 0.9 percent during the first quarter of this year, compared with 0.7 percent during the first quarter of 1991. While earnings at banks in both the Eleventh District and elsewhere enjoyed a considerable boost from gains on securities sold, a larger part of the increased profitability can be attributed to higher net interest margins.

Government resolution programs and favorable interest-rate spreads resulted in a profitable 1991 for the nation's thrifts. Private-sector thrifts in the Eleventh District earned $219 million in net income and a return on assets of 0.4 percent during 1991, compared with a loss of $300 million in 1990. Last year marks the first year since 1985 that Eleventh District private-sector thrifts earned a profit. Private-sector thrifts outside the District earned net income in 1991 of $1.7 billion and a return on assets of 0.2 percent, compared with a loss of $2.6 billion in 1990.

Asset Quality. Asset-quality problems have continued to subside in the Eleventh District. Table 1 shows the most recent statistical breakdown of troubled assets at District banks and thrifts. The ratio of troubled assets to total assets for District banks was 2.2 percent during the first quarter of 1992, compared with 2.6 percent for the same period last year. While

Chart 1
Return on Assets* for Insured Commercial Banks



*Ratio of quarterly net income after tax to average assets.

DATA SOURCE: Federal Financial Institutions Examination Council, Reports of Condition and Income.

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Table 1
Asset Quality at Eleventh District Financial Institutions (in Millions of Dollars)

	Banks (1992:1)	Thrifts (1991:4)
Problem Loans	$2,211.6	$ 279.9
Real Estate	920.4	259.8
Other	1,291.2	20.1
Repossessed Assets	1,785.9	4,006.1
Troubled Assets	3,997.5	4,286.0
Troubled Assets as a Percentage of Total Assets	2.2	8.6

*Loans past due 90 days or more and nonaccrual loans.

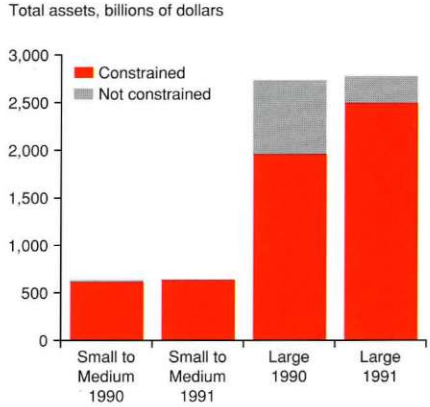
DATA SOURCES: Federal Financial Institutions Examination Council, Reports of Condition and Income; Office of Thrift Supervision, Thrift Financial Reports.

this ratio remains relatively high at 8.6 percent for District private-sector thrifts, it has declined considerably since its peak of almost 26 percent in 1987.

Banks outside the Eleventh District also have been successful in reducing their troubled assets. These banks reported a troubled asset ratio of 3 percent in the first quarter of this year, compared with 3.2 percent for the first quarter of 1991. Private-sector thrifts outside the District, on the other hand, reported an increase in their troubled asset ratio to 3.5 percent in 1991 from 3 percent in 1990.

Capital Adequacy. With the implementation of risk-based capital standards and deposit insurance premiums tied, in part, to capital positions, the importance of maintaining adequate capital levels has increased for U.S.

Chart 2
Bank Capital Constraints*



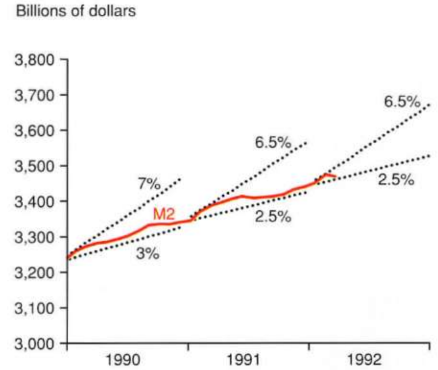
*Bank is constrained or not constrained by any one of the tier 1, total, or leverage ratios.

DATA SOURCE: Federal Financial Institutions Examination Council, Reports of Condition and Income.

financial institutions. Over the past year, banks have been successful in their efforts to raise their capital ratios. By the end of 1991 only 3 percent of U.S. banks failed to meet the minimum capital requirements of 4 percent tier 1 capital to risk-weighted assets, 8 percent total capital to risk-weighted assets, and 3 percent tier 1 capital to unweighted assets (the leverage ratio). As Chart 2 shows, large banks, defined as the top 10 percent of banks in terms of total assets, have been particularly successful at improving their capital ratios. At the end of 1990, more than 140 of these banks, holding approximately $780 billion in total assets, failed to meet the minimum requirements. By the end of 1991, only 70 large banks holding about $290 billion in total assets failed to meet the new requirements.

The financial health of banks and thrifts appears to be on the upturn both in the Eleventh District and across the nation. The transition to a healthier financial environment has not been without cost, however. The credit crunch has received much attention. Many observers are also now concerned about the effect of financial recoveries and resolutions on the Federal Reserve's monetary policy objectives. Chart 3 shows recent growth in M2, which consists of currency, checkable deposits, savings deposits, small time deposits and general purpose money market mutual funds, compared with its target growth ranges. Over the past several years, growth in the money supply has been near the

Chart 3
M2 Growth and Target Cones



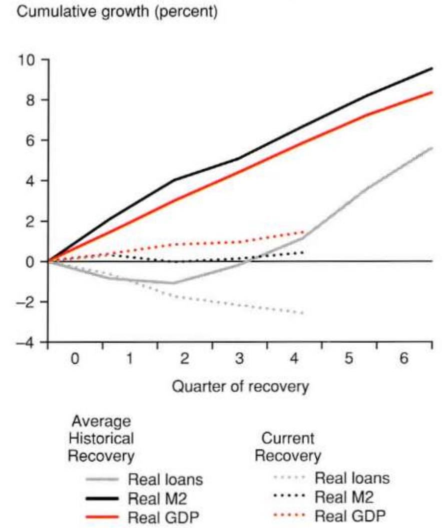
DATA SOURCE: CITIBASE, Citibank Economic Database.

bottom of the target range established by the Federal Reserve. Consequently, many analysts are concerned about the sources of weak growth in the money supply and the adverse effects slow money growth may be having on economic activity.

Bank and Thrift Difficulties and Monetary Policy

A Historical Perspective. By most measures, economic activity bottomed out in the spring of 1991, and the economy has been experiencing a mild recovery since then. But, in

Chart 4
Growth in Output, Money and Bank Credit

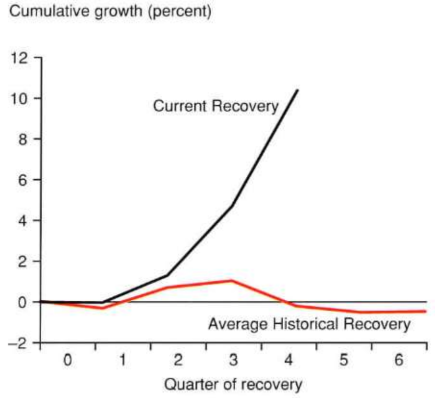


DATA SOURCE: CITIBASE, Citibank Economic Database.

many ways, the current environment is unique. Chart 4 compares the cumulative growth in Gross Domestic Product (GDP), M2 and bank loans (all adjusted for inflation) in the current recovery with the average growth of these same variables during previous periods of prolonged economic recovery since 1959. The anemic pace of GDP growth in the current recovery, compared with its average growth in previous recoveries, stands out. Chart 4 also shows that, historically, bank lending does not exceed its initial level until the fourth quarter of an upturn. The continued decline in loan volume in the current period of recovery is somewhat unusual. Equally apparent is the weakness of current M2 growth compared with average growth in the money supply during previous recovery periods.

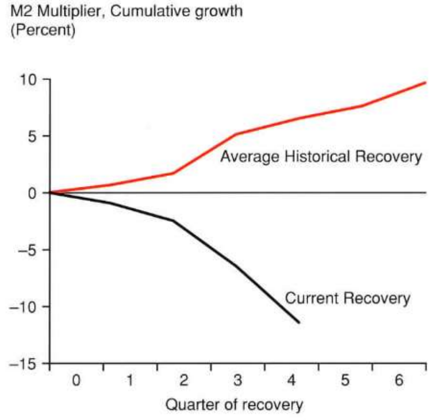
One source of weak money growth is weak reserve growth. The Federal Reserve supplies reserves to depository institutions, and an increase in reserves leads to an increase in the money supply. Chart 5 shows the path of total reserves, adjusted for inflation, in the current recovery compared with average growth in reserves during previous periods of economic upswings. In the early stages of the current recovery, reserve growth paralleled its average growth in previous recoveries. More recently, reserves

Chart 5
Total Reserves



DATA SOURCE: CITIBASE, Citibank Economic Database.

Chart 6
Relationship Between M2 and Reserves



DATA SOURCE: CITIBASE, Citibank Economic Database.

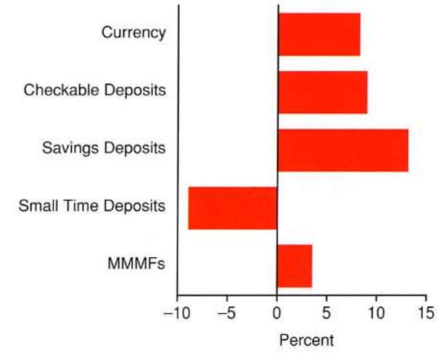
have grown much faster than average. Yet, despite this more rapid provision of reserves, M2 growth has remained weak. This weak M2 growth means that the ratio of M2 to reserves, sometimes referred to as the M2 multiplier, is much different now compared with historical recoveries, as shown in Chart 6. Usually, this multiplier tends to grow slightly in periods of recovery. Thus far, however, the multiplier has actually declined, and because of this, M2 growth has remained weak. An explanation for weak money growth, then, should center on the unusual relationship between M2 and reserves in the current environment.

The Changing Composition of M2. How the public chooses to hold M2 affects the relationship between M2 and reserves. If a greater proportion of M2 is held in deposits with reserve requirements, the multiplier relationship between M2 and reserves changes, because banks and thrifts must hold more required reserves against these deposits, with fewer "excess" reserves available to support money growth.

Chart 7 shows the growth in 1991 of major components of M2. Of these components, only checkable deposits now have a reserve requirement. Currency, checkable deposits, savings deposits and money market mutual funds (MMMFs) all increased. A decline in small time deposits during a recovery is unprecedented. At the end of 1990, small time deposits were the single biggest component of M2, accounting for more than one-third of the broad monetary aggregate. In 1991 the proportion of M2 held in the form of nonreservable deposits at banks and thrifts (savings deposits and small time deposits) declined by almost 2 percentage points. Thus, despite the growth in savings deposits, the run-off in small certificate of deposit (CDs) changed the composition of M2 toward deposits with reserve requirements, and banks and thrifts must now hold more required reserves. As a result, the multiplier effect on M2 from an injection of reserves is now much smaller than in previous recoveries.

The Role of Capital. Bank and thrift difficulties appear to underlie the compositional change in M2. Chart 8 shows the 1991 growth in M2 components at banks and thrifts based on their capital positions at the end of 1990. Institutions that met or exceeded their capital requirements in 1990 recorded increases in the major components of M2 during 1991. Even institutions that failed to meet regulatory capital guidelines recorded increases in checkable deposits and savings deposits. Banks and thrifts that were capital constrained recorded declines in small time deposits, and institutions that were not capital constrained recorded only slight increases in

Chart 7
1991 Growth in M2 Components



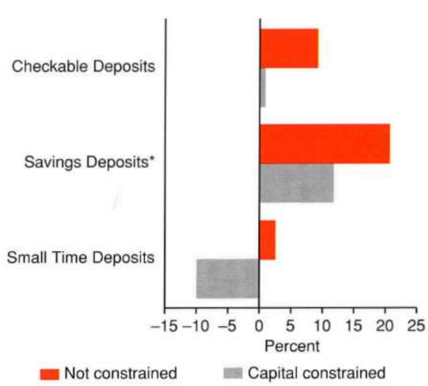
DATA SOURCE: CITIBASE, Citibank Economic Database.

small time deposits.

The role of capital is further demonstrated in Chart 9. As this chart shows, capital appears to affect the ability of banks and thrifts to extend loans. Chart 9 shows 1991 loan growth at both banks and thrifts on the basis of their capital positions at the end of 1990. From 1990 to 1991, loans outstanding declined at banks that failed to meet capital requirements and grew only slightly at banks that met or exceeded regulatory capital requirements. The situation was much worse for thrifts, however. Capital-constrained thrifts experienced much sharper declines in lending than their bank counterparts. And, contrary to the situation at banks, thrifts that met their capital requirements recorded a slight decrease in loans outstanding.

The decline in loans, which appears to be affected by financial institutions' capital positions, can affect the composition of M2. Because loans are usually funded with time deposits, if bank and thrift lending activity is weak, there is less need for small time deposits. As a result, institutions will be less aggressive in bidding for time deposits. Resolution activities, principally the ability of the Resolution Trust Corporation to renegotiate rates paid on CDs at thrifts placed in conservatorship, have also contributed to the decline in time deposits. This decline in time deposits has altered the composition of the money supply. By contributing to a change in the composition of M2, the problems faced by financial institutions over the past several years have affected the relationship between M2 and reserves and, thus, have indirectly affected the growth of the broad monetary aggregate.

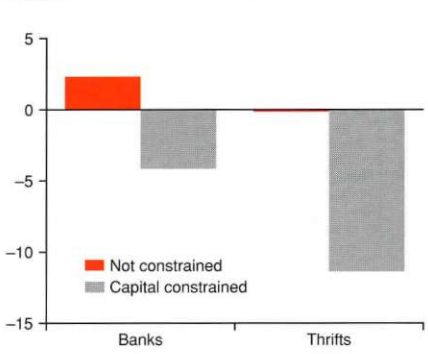
Chart 8
1991 Growth in M2 Components by Capital Position for Banks and Thrifts



*Includes MMDAs.

DATA SOURCES: Federal Financial Institutions Examination Council, Reports of Condition and Income; Office of Thrift Supervision, Thrift Financial Reports.

Chart 9
1991 Loan Growth by Capital Position



DATA SOURCES: Federal Financial Institutions Examination Council, Reports of Condition and Income; Office of Thrift Supervision, Thrift Financial Reports.

A Unique Environment

Financial-sector difficulties during the 1980s reached a level not seen since the Great Depression. These difficulties led to a decline in lending activity that is unusual for this stage of the business cycle. The result has been an unprecedented decline in small time deposits that has continued throughout the current economic recovery. These developments helped to alter the composition of M2 leading to a change in the normal relationship between M2 and reserves. As efforts to resolve insolvent financial institutions proceed, it is likely that more normal patterns will emerge in both lending activity and the growth of small time deposits.

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