Banking & Finance

AN EIGHTH DISTRICT PERSPECTIVE

FALL 1985

Thrifts — Their Recent Performance

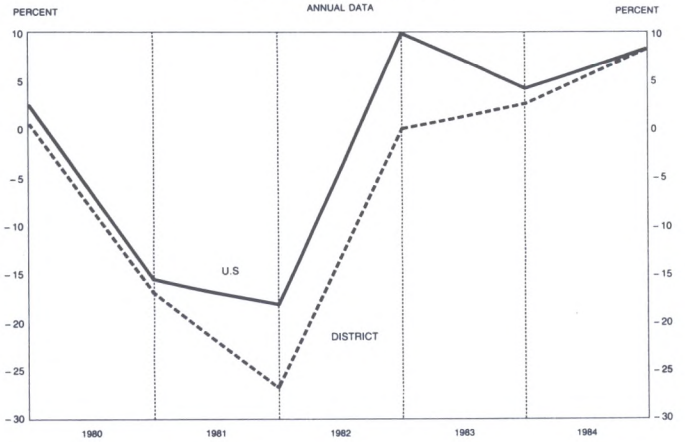
The thrift industry has recently shown signs of improvement over its performance in the early 1980s. At that time, with interest rates on short-term deposit liabilities higher than the returns to long-term fixed rate mortgage assets, thrifts' profitability slumped dramatically. However, as a result of the general decline in interest rates since 1982 and the corresponding increase in mortgage loan demand, the thrift industry became profitable for the U.S. in 1983 and for the District in 1984.

This issue analyzes balance sheet and income statement data from FSLIC- and FDIC-insured thrift institutions (savings and loans and savings banks) to document their performance over the past five years and to assess the outlook for recovery of the industry. This analysis is performed for institutions in the Eighth Federal Reserve District as well as the nation, using measures of capitalization and profitability that have been adjusted to reflect generally accepted accounting principles rather than regulatory accounting standards. This distinction is important because, since 1982, the regulatory accounting standards used by thrifts have overstated their tangible net worth position.

Earnings

One widely accepted measure of financial institutions' earnings performance is the ratio of returns to total net worth. Chart 1 plots this ratio on an adjusted basis (discussed later) and indicates that thrift institutions in the District and the U.S. suffered widespread losses in 1981 and 1982. These losses occurred as market interest rates rose to historically high levels and caused sharp increases in the cost of funds. A significant decline in the cost of funds that occurred in 1983 was the major factor contributing to the improved earnings of thrift institutions. In some part, this revitalization since the severe losses in 1981 and 1982 also has been due to the thrifts shifting to adjustable rate loans. These instruments cushion the interest rate sensitivity of earnings of financial institutions. Since 1982, the use of adjustable rate mortgages (ARMs) has grown steadily, and now account for more than half of all new mortgage issues.

Chart 1
RETURN ON AVERAGE ADJUSTED EQUITY
ANNUAL DATA



Preliminary profitability data for 1985 are projected based on earnings through the first quarter of the year. This assumption may be conservative since market interest rates have generally trended downward through the second and third quarters of this year, leading one to expect continued improvements in thrifts' earnings.

Net Worth

Despite recent improvements in profitability, years of low or negative earnings caused a serious deterioration in the industry's net worth position. Even putting the best light on thrift capital — by using regulatory accounting standards — shows that for national data as of March 1985, the industry had total capital of about $39 billion or only 3.8 percent of total liabilities. District total capital at the same time was about $1.2 billion, equivalent to 3.5 percent of total liabilities. This recorded net worth position, however, weak as it is, does not fully reveal the extent of the industry's vulnerability. Both the national and

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District figures reflect a sizable block of questionable asset and equity classifications, the inclusion of which is not in accordance with generally accepted accounting principles (GAAP). These categories, which are deducted from total reported net worth to provide more accurate measures of capital and returns, are briefly discussed.

Net Worth Certificates (Income Capital Certificates)

In 1982, the Garn-St Germain Depository Institutions Act authorized the FSLIC to acquire net worth certificates from weak institutions which had realized declines in their equity position as a result of operating losses. The FSLIC purchases these certificates and, in exchange, issues a promissory note which can be used as an asset to satisfy creditor claims in the case of insolvency. According to GAAP, this figure should be excluded from net worth calculations since the promissory note has book value only in the event of an institution's failure and forced liquidation.

Appraised Equity Capital

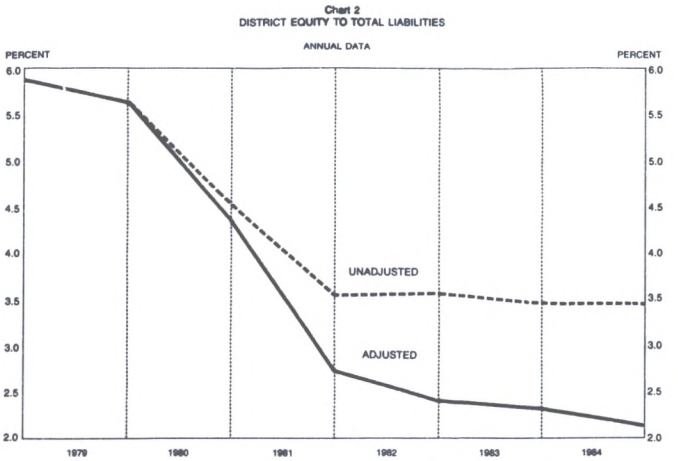
The Federal Home Loan Bank Board authorized FSLIC-insured institutions in 1982 to use another regulatory addition to net worth — appraised equity capital. This procedure allows an institution to book, as net worth, a one-time adjustment reflecting the difference between the market value and the book value of its capital assets (buildings and land). Given the subjective nature of property valuation, appraised equity capital is not accepted under GAAP because the accounting profession does not recognize real property appreciation until the property is actually sold.

Deferred Loss on Securities Sold

Deferral accounting, which is not permissible under GAAP, allows thrifts to defer the recognition of losses on the sale of existing loans and securities. Under this procedure, thrift institutions can sell existing loans and securities that have depreciated in value relative to their recorded values. This depreciation is booked as an intangible asset to be amortized over a specified period of years.

Net Worth Under GAAP

To present a more realistic assessment of the industry's tangible equity position, the above three factors are deducted from reported net worth before calculating capitalization and profitability ratios. To demonstrate the effect of these deductions, chart 2 plots the ratio of net worth to total liabilities on both an adjusted and unadjusted basis for all District thrifts since 1979. The chart indicates that, according to accounting practices sanctioned by the FSLIC,



the decline in net worth relative to total liabilities prevalent from 1979 to 1982 appears to have leveled off for District institutions. After adjusting for GAAP measures of capital, chart 2 suggests that although sharp declines in the ratio have been slowed, capitalization expressed as a percent of liabilities continues to erode.

Factoring out questionable intangible assets and deducting appraised equity capital and net worth certificates, one finds tangible net worth nationally in March 1985 to be $29 billion or 2.8 percent of total liabilities, rather than 3.8 percent on an unadjusted basis.

Summary

The large losses of the early 1980s depleted capital positions, and many firms failed or were merged out of existence. At the end of 1979, there were 352 thrifts in the District and 4,039 in the U.S. By the end of 1984, these numbers fell by 34 percent (to 231) in the District and 15 percent (to 3,424) in the U.S. The sharpest declines in the number of thrift institutions followed the years of the largest losses — 1981 and 1982.

Based on profitability measures, the thrift industry appears to be in the midst of a recovery after suffering severe losses and a resulting "shakeout" of many institutions early in the 1980s. Despite this improvement in earnings, the industry remains poorly capitalized with only a slight increase in the capitalization ratio for thrifts in the nation and a continuing decline for District thrifts as a whole.

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Banking & Finance—An Eighth District Perspective is a quarterly summary of banking & finance conditions in the area served by the Federal Reserve Bank of St. Louis. Single subscriptions are available free of charge by writing: Research and Public Information Department, Federal Reserve Bank of St. Louis, P.O. Box 442, St. Louis, Missouri 63166. Views expressed are not necessarily official positions of the Federal Reserve System.

EIGHTH DISTRICT BANKING DATA

LARGE WEEKLY REPORTING BANKS[1]

	Level III/1985 ($ millions)	Rates of Change: Current Quarter II/1985-III/1985	Rates of Change: Current Year III/1984-III/1985	Rates of Change: Same Periods Previous Year II/1984-III/1984	Rates of Change: Same Periods Previous Year III/1983-III/1984
Selected Assets & Liabilities					
Total Loans & Leases	$14,479	5.5%	11.1%	11.5%	19.3%
Commercial Loans	5,112	-11.3	3.8	3.9	9.1
Consumer Loans	3,223	25.8	24.9	6.1	13.6
Real Estate Loans	3,032	8.1	8.1	18.8	16.2
Loans to Financial Institutions	975	-20.8	-14.8	43.6	23.1
All Other Loans	1,983	-15.9	26.0	13.3	100.1
Total Securities	3,432	-2.9	2.7	-3.7	NA
U.S. Treasury & Agency Securities	2,008	-3.3	-1.6	-9.9	NA
Other Securities	1,423	-2.4	9.6	6.7	NA
Total Deposits	17,234	-0.9	4.5	7.7	9.6
Non-Transaction Balances	10,723	-4.3	4.9	15.8	NA
MMDAs	2,204	15.8	16.0	-6.1	2.6
$100,000 CDs	3,506	-21.9	-3.8	28.3	26.1
Demand Deposits	4,995	-2.8	-0.8	-4.6	2.0
Other Transaction Balances[2]	1,434	9.2	15.8	-1.1	NA

SMALL WEEKLY REPORTING BANKS[1]

	Level III/1985 ($ millions)	Rates of Change: Current Quarter II/1985-III/1985	Rates of Change: Current Year III/1984-III/1985	Rates of Change: Previous Year II/1984-III/1984
Selected Assets & Liabilities				
Total Loans & Leases	$4,542	4.2%	8.9%	12.5%
Commercial Loans	1,416	-9.4	0.6	3.4
Consumer Loans	920	3.4	11.4	19.5
Real Estate Loans	1,815	7.2	12.3	32.8
All Other Loans	392	58.0	21.8	-35.5
U.S. Treasury & Agency Securities	1,710	-0.4	3.2	5.1
Other Securities	665	9.3	1.8	-6.1
Total Deposits	7,138	6.6	9.2	4.4

[1] A sample of commercial banks with total assets greater than $750 million. Historical data have been revised to incorporate adjustment factors that offset the cumulative effects of mergers and other changes involving weekly reporting banks during 1984. All data are not seasonally adjusted. Rates of change are compounded annual rates.

[2] Includes NOW, Super NOW, ATS and accounts permitting telephone or pre-authorized transfers.

[3] A sample of commercial banks with total assets less than $300 million as of January 1984.

EIGHTH DISTRICT BANKING DATA

Bank Performance Ratios[1]

RATIOS	II/1985	II/1984	II/1983
Loans to Deposits			
Large Banks[4]	80.09%	74.94%	71.35%
Small Banks[5]	59.99	60.02	57.59
Loan Loss Reserves to Total Loans			
Large Banks	1.53	1.34	1.52
Small Banks	1.15	1.07	1.02
Delinquent Loans to Total Loans			
Large Banks	4.13	4.03	6.41
Small Banks	4.92	4.61	4.56
Net Loan Losses to Total Loans			
Large Banks	0.26	0.19	0.20
Small Banks	0.35	0.22	0.30

EIGHTH DISTRICT INTEREST RATES[6]

	September 1985	August 1985	July 1985	Year Ago September 1984
Super NOW	6.04%	6.04%	6.01%	7.63%
MMDAs	6.91	6.89	6.92	8.84
Time CDS				
92 — 182 days	7.44	7.48	7.55	10.45
1 — 2½ years	8.39	8.34	8.43	10.77
2½ years and over	8.84	8.79	8.80	10.89

[4] All Eighth District banks with total assets greater than $750 million. Ratios are derived from Call Reports.
[5] All Eighth District banks with total assets less than $300 million.
[6] Average interest rates paid on new deposits by a sample of District commercial banks.