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# Banking & Finance

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AN EIGHTH DISTRICT PERSPECTIVE

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## Recent Loan Quality Changes at District Banks

The quality of bank loan portfolios has become a hot topic in banking circles. With loan losses rising at many commercial banks over the past few years, investors and regulators alike are placing added focus on asset quality when assessing the health of the banking industry. Mounting loan losses have decreased the average profitability of the industry, increased loan loss reserve levels, and contributed to the rising number of bank failures. This experience holds true for Eighth District banks as well; however, there is some recent indication that the average loan quality of banks in the District may be improving. This article examines loan losses and overall loan quality at District banks, comparing the performance of different loan types.

### *Loan Losses*

The most direct measure of a bank's loan problems is the percent of loans charged-off during the year. The ratio of net charge-offs (adjusted for recoveries) to total loans is a traditional measure of loan quality, showing the percentage of loans actually written off as losses.

The average charge-off rate at banks in the United States and the Eighth District has risen in recent years. Nationally, the average ratio of net loan losses to total loans has risen from 0.72 percent in 1984 to 0.93 percent in 1986. In the District, the average charge-off ratio at year-end 1984 was 0.60 percent compared with 0.87 percent in 1986.

Table 1 on the following page shows the distribution of total loan loss by type of loan. As indicated, for both the nation and the District, commercial loan losses constitute the greatest percent of overall loan loss. Farm-related charge-offs accounted for 16.30 percent of District losses in 1986, down from their 1985 levels.

Chart 1 on the next page compares loss rates for specific loan types. As one can see from the chart, the loss rate was highest for District banks' agricultural loans, with commercial loans a close second. As a percent of total agricultural loans outstanding, 3.79 percent were charged-off in 1986 while

2.04 percent of commercial loans were classified as a loss.

### *Nonperforming Loans*

Another measure of the severity of a bank's loan problems and potential for future loan losses is the percent of nonperforming loans. Nonperforming or problem loans include the following components: loans 90 days or more past due, nonaccrual loans and renegotiated loans. Nonaccrual loans are those with scheduled payments due and unpaid for more than 90 days, and for which full payment of interest or principal is unlikely. After a loan reaches nonaccrual status, the decision to charge it off on a bank's balance sheet depends on how well-secured the loan is, the extent to which scheduled payments are being met, and the future prospects for repayment. Banks have some discretion in making these judgements. Typically there is a flurry of charge-off activity at year-end, when the year's earnings picture is nearly complete and banks are concerned with their tax liability. Renegotiated loans have been restructured to provide a reduction of either interest or principal to facilitate payment. Insofar as a bank's own information on its loans is good, and its reporting accurate, we may expect that the percent level of problem loans will give us some indication of future levels of charge-offs.

Nonperforming loans in Eighth District states decreased from 2.50 percent of total loans in 1984 to 2.17 percent at year-end 1986. Nationally, nonperforming loans also declined, falling from 3.05 percent in 1984 to 2.77 percent in 1986.

Table 2 on the next page shows the distribution of total nonperforming loans by type of loan. As indicated, commercial and real estate loans contribute the greatest percentage to overall nonperforming loans at both the national and District levels. In 1986, farm-related nonperforming loans constitute 9.91 percent of all nonperforming loans in the District, more than double that of the nation, indicating the region's exposure in agricultural lending.



**Table 1**  
**Distribution of Loan Losses**

	1986	1985	1984
<b>UNITED STATES</b>			
Agriculture	7.72%	10.40%	8.35%
Commercial	54.48	60.29	68.34
Consumer	26.32	22.82	15.80
Real estate	11.76	8.63	8.18
<b>DISTRICT</b>			
Agriculture	16.30	19.46	16.91
Commercial	60.31	64.93	66.85
Consumer	18.71	14.05	13.85
Real estate	16.94	18.08	17.00

SOURCE: Federal Deposit Insurance Corporation, "Consolidated Reports of Condition and Income for Insured Commercial Banks," 1984-1986

NOTE: Percentages may sum to greater than 100 because agricultural loans are included in other categories as well.

**Table 2**  
**Distribution of Nonperforming Loans<sup>1</sup>**

	December 1986	December 1985
<b>UNITED STATES</b>		
Agriculture	4.20%	5.57%
Commercial	41.15	41.26
Consumer	6.88	6.55
Foreign	17.57	20.67
Real estate	28.68	24.89
<b>DISTRICT</b>		
Agriculture	9.91	11.23
Commercial	47.98	47.85
Consumer	8.43	7.63
Foreign	1.78	3.45
Real estate	38.33	37.92

<sup>1</sup>Consistent reporting of data was not available until 1985.

SOURCE: Federal Deposit Insurance Corporation, "Consolidated Reports of Condition and Income for Insured Commercial Banks," 1985-1986

NOTE: Percentages may sum to greater than 100 because agricultural loans are included in other categories as well.

Chart 2 compares nonperforming loans by category for the Eighth District. Nonperforming agricultural loans as a percent of total agricultural loans was 5.73 percent in 1986, followed by nonperforming commercial loans at 4.03 percent.

Chart 1  
LOAN LOSSES  
as a Percentage of Total Loans by Category  
Eighth District

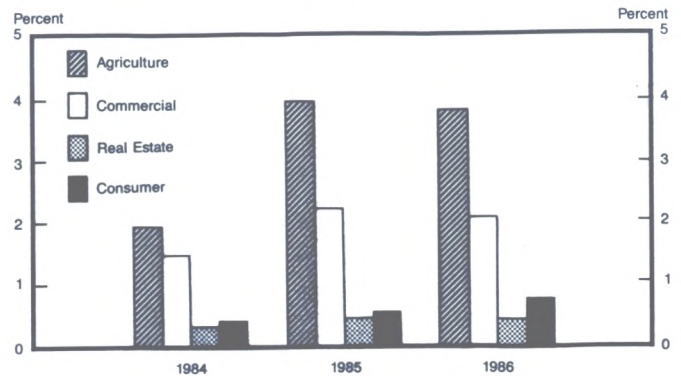
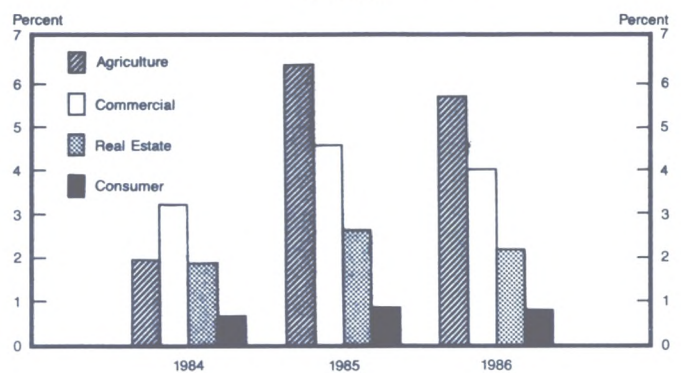


Chart 2  
NONPERFORMING LOANS  
as a Percentage of Total Loans by Category  
Eighth District



**Loan Loss Reserves**

Because of deteriorating asset quality during the past several years, banks in the Eighth District and across the nation have increased their allowance for loan losses as a share of their total loans outstanding. This action has been taken as a precautionary measure to absorb expected future loan losses. As a percent of total loans, Eighth District banks' loan loss reserve increased from 1.20 percent at year-end 1984 to 1.41 percent in 1986, while nationally this ratio rose from 1.24 percent to 1.63 percent. In a fundamental sense, this reserve protection against problem loans can be considered more important to balance-sheet strength than the degree of asset quality alone, and should provide investors, regulators and the general public with an extra measure of security.

—Lynn M. Barry

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## EIGHTH DISTRICT BANKING DATA

LARGE WEEKLY REPORTING BANKS<sup>1</sup>

	Level II/1987 (\$ millions)	Rates of Change			
		Current Quarter	Current Year	Same Periods Previous Year	
		I/1987- II/1987	II/1986- II/1987	I/1986- II/1987	II/1985- II/1986
<b>Selected Assets &amp; Liabilities</b>					
Total Loans & Leases	\$19,507	9.7%	12.4%	7.4%	7.6%
Commercial Loans	6,468	7.3	9.2	11.6	2.4
Consumer Loans	4,709	12.3	18.3	12.0	18.0
Real Estate Loans	4,914	21.6	22.7	0.6	5.9
Loans to Financial Institutions	1,059	-14.7	15.7	47.7	-5.1
All Other Loans	2,357	1.5	-6.9	-8.2	13.6
Total Securities	4,686	12.8	17.8	-8.8	-1.7
U.S. Treasury & Agency Securities	3,209	22.6	38.9	-0.6	-8.9
Other Securities	1,477	-5.2	-11.5	-18.8	10.5
Total Deposits	22,519	6.9	8.5	9.4	4.2
Non-Transaction Balances	13,715	9.8	6.0	5.3	1.5
MMDAs	2,910	-13.4	14.3	18.2	19.9
\$100,000 CDs	4,144	30.4	7.1	-3.1	-4.2
Demand Deposits	6,333	2.1	7.5	17.7	6.5
Other Transaction Balances <sup>2</sup>	2,470	4.3	27.9	17.0	16.8

EIGHTH DISTRICT INTEREST RATES<sup>3</sup>

	June 1987	May 1987	April 1987	June 1986
NOWs	5.06%	5.04%	5.02%	5.36%
MMDAs	5.27	5.25	5.23	6.09
Time CDS				
92 — 182 days	5.87	5.89	5.80	6.47
1 — 2½ years	6.61	6.55	6.36	7.14
2½ years and over	7.08	7.04	6.91	7.43

**All data are not seasonally adjusted.**

<sup>1</sup> 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 1986. These adjustment factors, which are computed each year, are used to construct a consistent time series for which year-to-year growth rates can be calculated. Adjustment factors are available upon request from the Statistics Section of the Research and Public Information Department. Rates of change are compounded annual rates.

<sup>2</sup> Includes NOW, ATS and accounts permitting telephone or pre-authorized transfers.

<sup>3</sup> Average interest rates paid on new deposits by a sample of Eighth District commercial banks.

## BANK PERFORMANCE RATIOS<sup>1</sup>

	Eighth District			United States		
	1/87	1/86	1/85	1/87	1/86	1/85
<b>Return on Average Assets (annualized)</b>						
< \$100 million	1.05%	1.20%	1.11%	.72%	.89%	.92%
\$100 — \$300 million	1.12	1.08	1.00	.88	1.01	.92
\$300 million — \$1 billion	.92	1.09	.93	.79	.84	.89
> \$1 billion	.89	.94	-.28	.70	.67	.65
<b>Return on Average Equity (annualized)</b>						
< \$100 million	11.96	13.66	12.82	8.43	10.20	10.59
\$100 — \$300 million	14.05	13.63	12.67	11.55	13.42	12.26
\$300 million — \$1 billion	12.01	14.13	12.61	11.34	11.25	12.72
> \$1 billion	13.22	14.44	-4.58	12.07	11.98	12.60
<b>Loans as Percent of Deposits</b>						
< \$100 million	53.73	54.67	55.21	72.26	70.53	60.23
\$100 — \$300 million	62.56	62.53	64.27	63.80	64.59	65.47
\$300 million — \$1 billion	68.54	69.65	65.71	73.07	72.78	72.81
> \$1 billion	81.14	80.14	82.40	86.14	86.16	85.78
<b>Nonperforming Loans as Percent of Total Loans<sup>2</sup></b>						
< \$100 million	2.71	3.29	3.11	3.49	4.08	3.17
\$100 — \$300 million	2.17	2.41	2.32	2.56	2.76	2.53
\$300 million — \$1 billion	2.41	2.75	2.46	2.59	2.54	2.30
> \$1 billion	2.43	2.23	2.61	4.28	2.93	3.28
<b>Loan Loss Reserves as Percent of Total Loans</b>						
< \$100 million	1.51	1.37	1.21	1.30	1.22	1.22
\$100 — \$300 million	1.34	1.24	1.11	1.49	1.36	1.23
\$300 million — \$1 billion	1.53	1.34	1.16	1.61	1.45	1.20
> \$1 billion	1.45	1.44	1.49	1.74	1.55	1.27
<b>Net Loan Losses as Percent of Total Loans</b>						
< \$100 million	.14	.15	.13	.17	.19	.18
\$100 — \$300 million	.13	.16	.16	.16	.16	.13
\$300 million — \$1 billion	.17	.15	.10	.20	.15	.11
> \$1 billion	.15	.15	.13	.18	.18	.14

<sup>1</sup> Size range based on bank assets.

<sup>2</sup> Includes past due greater than 89 days and nonaccrual.