Banking & Finance

AN EIGHTH DISTRICT PERSPECTIVE

FALL 1987

Midyear Review of Large Bank Performance

An initial review of first half 1987 banking data suggests a deterioration in the performance of large Eighth District banks.[1] Large banks, as defined in this article, have assets between $1 and $10 billion. As of June 1987, there were 13 District banks in this asset range: three in Kentucky, two in Mississippi, five in Missouri and three in Tennessee.

Further analysis reveals, however, that poor earnings at two Missouri banks contributed heavily to the decline in District performance. The reason for lower earnings in both the District and the banking system as a whole was the decision of many large banks to reserve earnings as a buffer against potential losses on loans to developing countries. Increased loan loss provision levels for Latin American debt resulted in second quarter losses for many of the larger banks. Nationally, second quarter earnings were the worst in U.S. banking history.

Earnings

Two key measures of evaluating bank earnings and managerial performance are the return on average assets (ROA) ratio and the return on equity (ROE) ratio. The ROA ratio, calculated by dividing a bank's net income after taxes by its average assets, gauges how well a bank's management is employing its assets. The ROE ratio, obtained by dividing a bank's net income by its equity capital, indicates the return on the shareholders' investment.

Recognition of a deterioration in the quality of Latin American debt has reduced aggregate earnings (and therefore, returns on assets and equity) at District banks. During the first quarter of 1987, Brazil declared a temporary moratorium on its intermediate- and long-term debt payments, forcing many of the larger banks to move substantial portions of their Brazilian debt into nonperforming status. Influenced by this Latin American debt exposure, annualized 1987 ROAs for large District banks declined to 0.45 percent. As shown in Table 1, this marks a considerable reduction when compared to last year's 0.98 percent ROA; however, the District ROA is identical to the national average. Annualized ROE also declined, falling to 6.94 percent from 14.59 percent at year-end 1986.

Aggregate District profitability was severely weakened by negative earnings at two large St. Louis banks. Table 2 suggests that the Missouri profit decline is the direct result of increases in the provision for loan loss as these two organizations followed the lead of several multi-national banks in reserving for Latin American loans. The special provision at these two banks totaled $95 million, or 26 percent of the District's total loss provision, which was $364 million in the second quarter. In last year's second quarter, the Districtwide loan loss provision was $256 million. Discounting the effects of the Brazilian debt situation at these two banks, Eighth District banks earned an average annualized ROA of 0.82 percent and a 12.36 percent ROE.

Also indicated in Table 2 is the percent of loan loss reserves to total loans. When banks write off bad loans, they charge their loan loss reserves, not earnings. Charge-offs affect earnings only to the extent that banks provide enough funds for their reserves to offset the charge-offs. Increased allocations to loan loss reserves were reported by most District states. At the District level, loan loss reserves to total loans averaged 1.94 percent at midyear, with the level of reserves increasing 43 percent since year-end. Nationally, reserves as a percent of total loans rose from 1.46 percent to 1.85 percent.

Asset Quality

Asset quality is a primary factor influencing the banking industry's earnings pattern. One measure of asset quality, the nonperforming

[1] The Eighth District includes the state of Arkansas and portions of Illinois, Indiana, Kentucky, Mississippi, Missouri and Tennessee.

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loan rate, indicates the percentage of problem loans as well as the potential for future loan losses. Problem loans include the following: loans more than 89 days past due, nonaccrual loans and renegotiated loans.

Nonperforming loans at large District banks had shown signs of improvement in recent years; however, during the first six months of 1987, the level of nonaccrual loans rose sharply as a result of the debt problems of developing countries. As shown in Table 3, nonperforming loans to total loans at large District banks increased to 2.43 percent at midyear versus 1.81 percent at year-end. Nonperforming loan levels increased significantly in Missouri, rising from 1.71 percent in December 1986 to 3.06 percent in June. Future developments in loans to developing countries will continue to play an important role in large bank profitability for the second half of 1987.

—Lynn M. Barry

Table 1
Return on Average Assets and Return on Equity at Large Banks

	6/1987[1]	12/1986	12/1985
Return on Average Assets			
United States	0.46%	0.74%	0.85%
Eighth District	0.45	0.98	0.87
Kentucky	0.78	1.07	1.04
Mississippi	0.96	1.33	N.A.
Missouri	0.03	0.93	0.79
Tennessee	0.68	0.91	0.80
Return on Equity			
United States	7.41%	11.65%	13.49%
Eighth District	6.94	14.59	13.47
Kentucky	12.01	16.97	16.12
Mississippi	13.10	13.75	N.A.
Missouri	0.43	13.55	11.94
Tennessee	10.42	14.14	12.85

[1]Annualized

Source: FDIC Reports of Condition and Income for insured commercial banks.

Table 2
Loan Loss Provision and Loan Loss Reserve at Large Banks

	6/1987[1]	12/1986	12/1985
Loan Loss Provision[2]			
United States	0.98%	0.67%	0.56%
Eighth District	1.10	0.46	0.43
Kentucky	0.73	0.37	0.33
Mississippi	0.36	0.50	N.A.
Missouri	1.72	0.55	0.38
Tennessee	0.66	0.41	0.60
Loan Loss Reserve[3]			
United States	1.85%	1.46%	1.35%
Eighth District	1.94	1.40	1.41
Kentucky	1.62	1.40	1.45
Mississippi	1.54	1.63	N.A.
Missouri	2.50	1.45	1.40
Tennessee	1.47	1.27	1.37

[1]Annualized

[2]As a percent of average assets

[3]As a percent of total loans

Source: FDIC Reports of Condition and Income for insured commercial banks.

Table 3
Nonperforming Loans as a Percent of Total Loans

	6/1987	12/1986	12/1985
United States	2.51%	2.06%	2.24%
Eighth District	2.43	1.81	2.19
Kentucky	2.46	2.01	1.68
Mississippi	1.66	2.14	N.A.
Missouri	3.06	1.71	2.51
Tennessee	1.53	1.67	2.40

Source: FDIC Reports of Condition and Income for insured commercial banks.

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EIGHTH DISTRICT BANKING DATA

LARGE WEEKLY REPORTING BANKS[1]

	Level	Rates of Change			
		Current Quarter	Current Year	Same Periods Previous Year	
	III/1987 ($ millions)	II/1987-III/1987	III/1986-III/1987	II/1986-III/1986	III/1985-III/1986
Selected Assets & Liabilities					
Total Loans & Leases	$19,640	2.8%	9.7%	13.3%	9.7%
Commercial Loans	6,429	−2.4	8.6	−0.2	5.1
Consumer Loans	4,812	9.1	15.8	18.7	17.2
Real Estate Loans	5,222	27.5	24.7	19.3	9.0
Loans to Financial Institutions	879	−52.5	−21.3	121.8	10.6
All Other Loans	2,296	−10.0	−9.2	−0.4	10.3
Total Securities	4,660	−2.1	13.6	13.0	2.0
U.S. Treasury & Agency Securities	3,200	−1.1	29.0	32.9	−1.6
Other Securities	1,461	−4.3	−9.9	−10.7	8.0
Total Deposits	22,591	1.3	7.3	5.8	5.9
Non-Transaction Balances	14,059	10.4	8.2	1.9	3.0
MMDAs	2,738	−21.6	2.9	19.2	19.6
$100,000 CDs	4,492	38.1	19.0	−9.4	−1.0
Demand Deposits	6,050	−16.7	0.4	9.6	9.7
Other Transaction Balances[2]	2,481	1.9	22.3	21.6	20.3

EIGHTH DISTRICT INTEREST RATES[3]

	Sept 1987	Aug 1987	July 1987	Sept 1986
NOWs	5.04%	5.03%	5.03%	5.21%
MMDAs	5.38	5.32	5.31	5.48
Time CDS				
92 — 182 days	6.36	6.03	5.90	5.71
1 — 2½ years	7.03	6.67	6.57	6.40
2½ years and over	7.59	7.20	7.06	6.77

All data are not seasonally adjusted.

[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 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.

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

[3] Average interest rates paid on new deposits by a sample of Eighth District commercial banks.

BANK PERFORMANCE RATIOS[1]

	Eighth District			United States		
	II/87	II/86	II/85	II/87	II/86	II/85
Return on Average Assets (annualized)						
<$100 million	1.00%	1.09%	1.06%	.67%	.75%	.89%
$100 — $300 million	.97	1.04	1.05	.80	.92	.93
$300 million — $1 billion	.97	.89	.23	.57	.79	.85
>$1 billion	.45	1.02	.87	–.91	.60	.63
Return on Average Equity (annualized)						
<$100 million	11.23	12.32	12.17	7.71	8.66	10.15
$100 — $300 million	12.16	12.95	13.63	10.43	12.16	12.37
$300 million — $1 billion	12.34	11.68	2.96	7.93	11.21	12.26
>$1 billion	6.94	15.19	13.75	–17.97	10.59	12.09
Loans as Percent of Deposits						
<$100 million	55.61	55.16	56.26	58.40	58.62	60.61
$100 — $300 million	64.66	62.64	64.27	64.81	64.39	65.49
$300 million — $1 billion	67.92	68.61	66.50	74.39	72.54	72.72
>$1 billion	83.47	79.54	82.81	85.95	86.51	85.86
Nonperforming Loans as Percent of Total Loans[2]						
<$100 million	2.52	3.00	3.05	3.08	3.40	3.17
$100 — $300 million	2.15	2.31	2.19	2.50	2.66	2.55
$300 million — $1 billion	2.15	2.65	2.66	2.53	2.53	2.23
>$1 billion	2.43	2.02	2.49	4.15	2.91	3.25
Loan Loss Reserves as Percent of Total Loans						
<$100 million	1.51	1.38	1.23	1.63	1.48	1.24
$100 — $300 million	1.38	1.30	1.10	1.52	1.37	1.24
$300 million — $1 billion	1.44	1.38	1.35	1.65	1.47	1.24
>$1 billion	1.94	1.44	1.45	3.14	1.65	1.35
Net Loan Losses as Percent of Total Loans						
<$100 million	.30	.38	.43	.47	.57	.45
$100 — $300 million	.31	.32	.24	.35	.38	.32
$300 million — $1 billion	.33	.28	.31	.40	.37	.25
>$1 billion	.30	.27	.24	.37	.39	.30

[1] Size range based on bank assets.

[2] Includes past due greater than 89 days and nonaccrual.