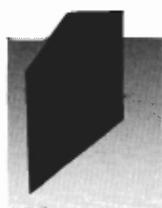


Banking 1989: Not quite a twice-told tale

Eileen Maloney
and George Gregorash



In some ways, U.S. bank performance in 1989 seemed a replay of 1987. Less developed countries (LDC) loan provisions at larger banks, a swift equity market correction, and dramatically weakening real-estate markets in distinct geographic regions left analysts borrowing adjectives and analyses from two years prior. But similar as events were to 1987's, 1989 put its own particular twist on things. Indeed, it is the structural differences in the banking environment between 1987 and 1989 that have been most instructive. These ongoing changes include the passage of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) and the new risk-based capital guidelines.

The LDC provisioning was least surprising and reflected U.S. banking's recognition of and adjustment to the debt-service difficulties of Latin America. These adjustments demonstrated the banking system's ability to weather a major-league difficulty in measured fashion over a number of years without systemic disruption, but the return to reserve building and Latin-induced earnings diminution at the larger banks strongly signalled that the problems with LDC debt are far from resolved.

The stock-market correction in October likewise burst the bubble of the optimists who wished to dismiss increased market volatility as a minor disruption in an increasingly rational game of global capital market integration. The impact on banks of the 1989 break was twofold. A slowdown in deal generation

Events in 1989 resembled those of 1987 in banking, but the differences were significant—and the stakes were higher

and the market's appetite for risk lessened the immediate appeal of securities underwriting while lower bank stock valuations dampened external capital enhancement prospects.

The real-estate implosion in New England signalled that the credit excesses experienced in the Southwest may not have been an aberration but rather may reflect a fundamental flaw in the concept of deposit insurance.

All told, banking in 1989 laid to rest any notion that the difficulties of prior years were one-time events. They were all, in fact, only facets of a more fundamental problem—credit quality.

Credit quality: The heart of the matter

At first glance, asset quality for the nation's banks showed only a moderate weakening in 1989 compared to 1988. Within these numbers however, are more sobering trends. The ratio of delinquent-loans-to-total-loans, the first indicator of credit quality problems, was higher in each quarter of 1989 compared to the year-ago quarter. Over the year, higher delinquencies translated into higher nonperforming assets. While the ratio of nonperforming-assets-to-total-assets had been declining each quarter since the latter half of 1987, it began inching upward in the first quarter of 1989 and continued to increase in small increments throughout the year.

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In addition, the mix of problem loans changed in 1989. Problem real-estate loans, which had always been the largest piece of the total, now hold an even larger share. Delinquent real-estate loans rose in each quarter of 1989 as did nonperforming real-estate assets. This was particularly true in the latter part of 1989. While real-estate problems were again a troubling influence on bank performance in 1989, the deterioration was not concentrated in one geographic region as it was in the Southwest in 1987. Rather, by year-end 1989, the weakness was beginning to spread throughout the U.S.

Delinquent loans (30 to 89 days past due) in the U.S. increased for all size groups of banks both in dollars and ratios in the last quarter of 1989. Based on frequency distributions in which individual, rather than aggregate, bank ratios are plotted, the increase in delinquent loans appears to be broad-based. The aggregate ratio of delinquent-loans-to-total-loans (DEL) for U.S. banks increased to 1.88 percent at year-end, up from 1.82 percent in the third quarter and 1.67 percent at year-end 1988.

Delinquent real-estate loans increased in all size groups of banks and for all regions except the Southwest. Consumer delinquencies were also higher for all bank size groups and regions. However, this increase was offset by declines in 'other' loan delinquencies, which include loans to depository institutions and foreign governments. (See Figure 1.) These higher delinquency levels portend larger

bank loan-loss provisions to cover developing problem credits.

The delinquent real-estate loan increase accounted for 82 percent of the 1989 fourth-quarter increase in total delinquent loans. U.S. real-estate loan delinquencies rose to 0.82 percent of total loans from 0.75 percent for the third quarter, up from 0.71 percent at year-end 1988. Real-estate delinquencies were higher in all regions in the fourth quarter with the exception of the Southwest and West where they declined modestly. The Northeast and the Southwest both reported delinquent-real-estate-loans-to-total-loans of 1.03 percent for fourth quarter 1989. However, the Southwest ratio represented a quarterly decline of 6 basis points while the Northeast ratio increased by 14 basis points over the period. At year-end 1988, this ratio had been 3.82 percent for the Southwest and 0.52 percent for the Northeast, compared to 0.87 percent for the U.S. as a whole.

Contrary to the fourth-quarter delinquent loan increase, U.S. nonperforming assets declined very slightly during the fourth quarter of 1989. Nonperforming assets the year before had totalled \$64.6 billion. With the deterioration in various real-estate markets in 1989, nonperforming assets were nearly back to the 1987 level of \$72.2 billion. The U.S. nonperforming-assets-to-total-assets ratio (NPA) declined from 2.30 to 2.23 percent in the last quarter of 1989. (See Figure 2.) This was due in part to a 2.9 percent increase in total U.S. assets in the last quarter of 1989. This down-

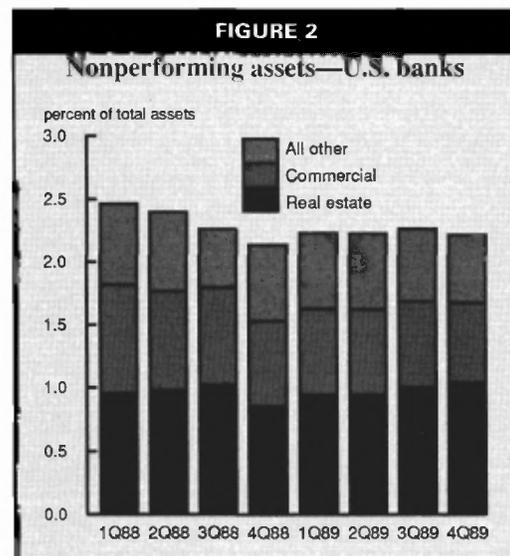
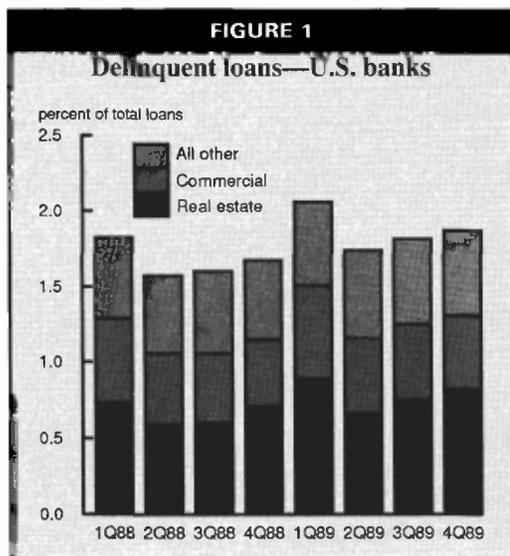
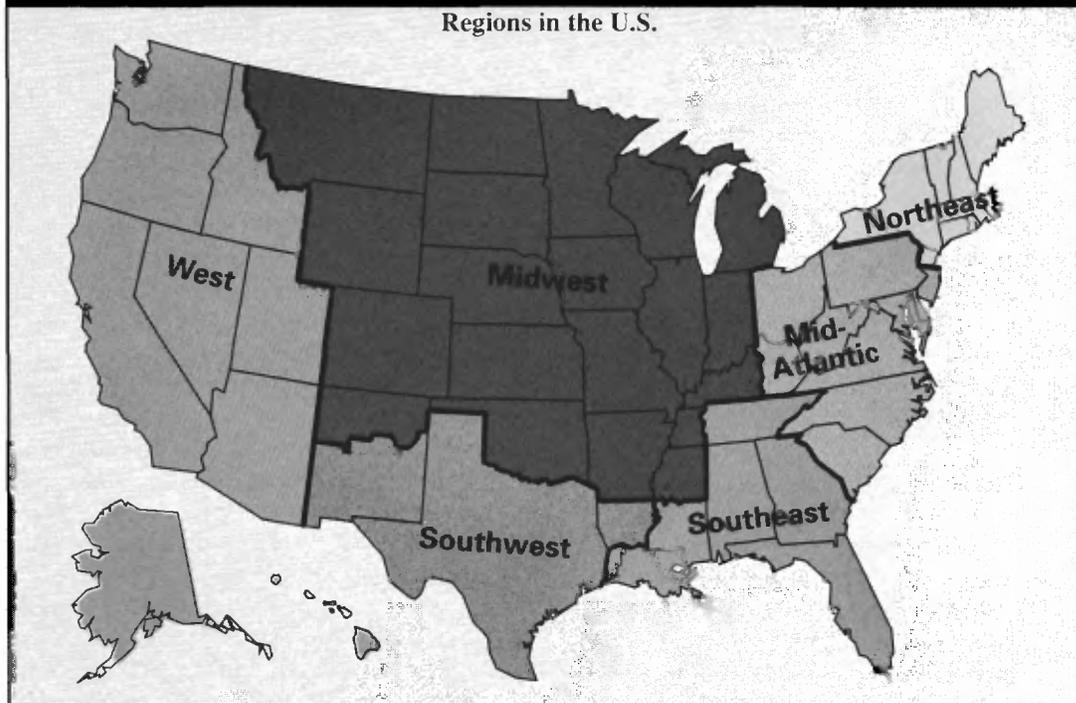


FIGURE 3
Regions in the U.S.



ward trend in the NPA was evident in all bank size groups and all regions of the country except the Northeast where NPA rose to 3.39 percent from 3.31 percent in the third quarter as a result of deteriorating real-estate credits. Note, however, that the 1989 NPA levels for both the eastern half of the U.S. and the nation were higher than 1988. (See Figures 3 and 4.)

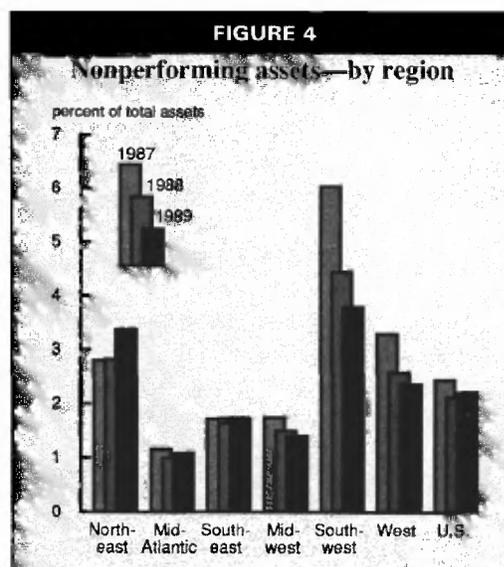
Record fourth-quarter net loan chargeoffs also helped reduce the U.S. NPA. Historically, fourth-quarter chargeoffs increase from the prior quarter. However, fourth-quarter 1989 chargeoffs rose 70 percent over the third quarter to \$8.6 billion as compared to a 41 percent increase to \$4.9 billion in 1988. The fourth-quarter increase was the major driving force behind the annual net chargeoff increase to \$20.9 billion for 1989 versus \$17.5 billion for 1988.

Fourth-quarter 1989 commercial loan losses were \$3.2 billion, which contributed to a decline of \$1.1 billion in nonperforming commercial loans. Likewise, loan losses on foreign government loans were \$2.6 billion, which contributed to a \$1.6 billion decline in nonperforming 'other' loans (these include LDC loans). Real-estate loan losses totalled \$1.2 billion for the fourth quarter of 1989.

These losses mitigated the nonperforming real-estate loan increase.

The shape of things to come?

The real estate woes have continued to grow as delinquent real-estate loans continued to increase and then moved into non-performing assets. Exacerbating this trend is the fact that real-estate loan growth is outpacing the growth of other loan categories and may trans-



late into future problem loans. In fact, the concern over the deterioration of real-estate credits is illustrated quite well in the nonperforming asset data. Nonperforming assets include not only nonperforming loans but also OREO (other real-estate owned, including foreclosed properties). The components of nonperforming assets exhibited vastly different characteristics. Fourth-quarter 1989 OREO increased \$0.9 billion to \$12.5 billion while U.S. nonperforming loans declined \$1.3 billion. Despite the massive net loan chargeoffs, which resulted in fewer nonperforming loans overall, U.S. nonperforming real-estate loans increased \$1.2 billion in the fourth quarter of 1989.

The greatest portion of emerging problem real-estate loans was concentrated in the Northeast. During 1989, the Northeast's nonperforming real-estate loans grew 148 percent, or \$5.2 billion, to \$8.8 billion. In the fourth quarter alone, the region's nonperforming real-estate loans increased \$1.7 billion, primarily at the large banks. This increase was partially offset within the U.S. by declines in such loans at banks in all size groups in the Midwestern and Western regions.

Over the year, U.S. nonperforming real-estate loans increased \$6.0 billion to \$21.1 billion while OREO rose \$2.2 billion to \$12.5 billion. As a result, nonperforming real-estate assets accounted for 47 percent of all U.S. NPA at year end 1989 compared to 40 percent at year-end 1988. The Northeast's nonperforming real-estate assets to NPA rose to 35 percent from 18 percent a year ago. In addition, the Northeast region accounted for 20.6 percent of all U.S. OREO at year-end 1989, up from 10.7 percent a year ago, and 9.8 percent in 1987. In contrast, the Southwest region accounted for 22.3 percent of all U.S. OREO, down from 27.3 percent a year ago, and 30.1 percent in 1987.

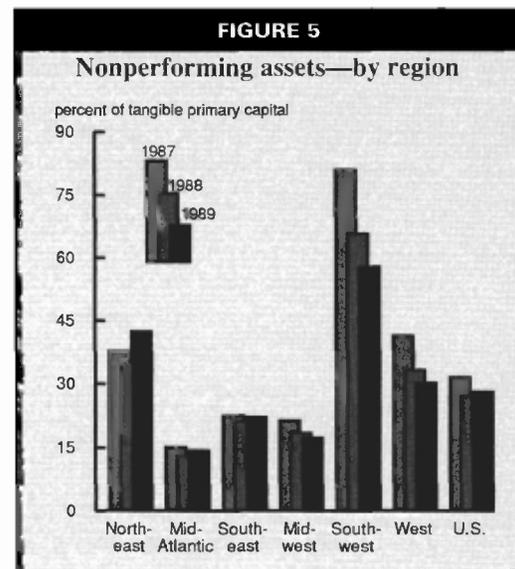
Fourth-quarter net loan chargeoffs rocketed to \$8.6 billion compared to \$4.9 billion a year before. However, fourth-quarter loan-loss provisions of \$9.2 billion barely exceeded the loan losses. As a result, the aggregate U.S. loan-loss reserve level was roughly unchanged at 2.63 percent of loans, despite increasing credit quality problems. This trend was true for all bank size groups.

However, the 2.63 percent reserve level represents an increase over 1988's level of

2.39 percent and indicates that reserve building took place during the year. The regions reflected their own economic climates. For the Northeast, which has struggled to deal with emerging real-estate and continuing LDC problems, the ratio of loan-loss-reserves-to-total-loans rose marginally in the last quarter of 1989 to 4.14 percent compared to 3.18 percent at year-end 1988. In contrast, the Southwest, which continued to make progress on credit quality problems, increased their loan-loss reserve ratio by a fifth in the last quarter of 1989 to 3.40 percent of loans.

Loan-loss reserve levels currently are considered part of an institution's tangible capital. U.S. tangible capital remained nearly flat from 1988 levels at 7.79 percent of assets. Dollars of tangible capital however, increased \$14.5 billion over the year. Combined with a small decrease in dollars of nonperforming assets, the U.S. ratio of nonperforming-assets-to-tangible-primary-capital declined from 27 percent in 1988 to 23 percent in 1989. However, the differing regional economic conditions were apparent again with notable increases in the Northeast and decreases in the Southwest. (See Figure 5.)

Even as real-estate delinquent and nonperforming loans increased, real-estate loans continued to grow. In 1989, U.S. real-estate loans increased 13.1 percent while total loans grew 6.7 percent. This trend was evident in all regions and in bank size groups with assets over \$100 million. The portion of real-estate



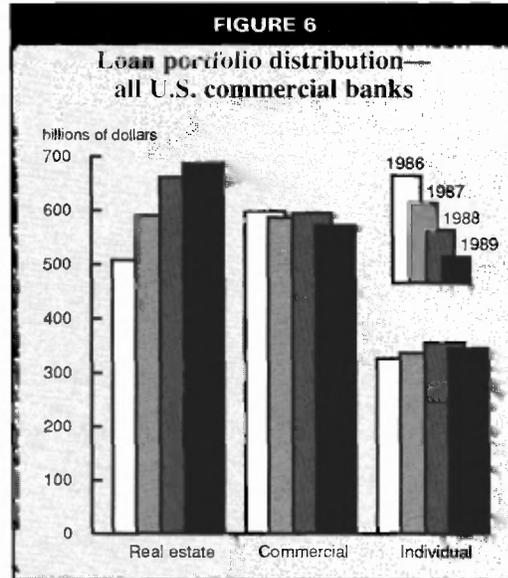
loans that exhibited the greatest growth was 1-4 family unit residential loans. At year-end 1989, real-estate loans comprised 37 percent of the U.S. loan portfolio compared to 35 percent the year before. (See Figure 6.)

For the multinational banks (those over \$10 billion in assets, which hold 36 percent of all U.S. banking assets and comprise 0.3 percent of all banks), relating real-estate loan growth to total loan growth may not tell the entire story. In 1989, total loans grew 5.1 percent for these banks while off-balance-sheet items (which include loan commitments, standby letters of credit, foreign exchange contracts, etc.) grew nearly 32 percent. In 1989, off-balance-sheet items for all U.S. banks were 138 percent of total assets, up from 112 and 101 percent in 1988 and 1987 respectively. For the multinational banks, these numbers increase dramatically. The respective percentages of off-balance-sheet items to total assets at year-end 1989, 1988, and 1987 were 346, 273, and 246 percent. (See Figure 7.)

New products, greater risk

The 1980s saw a rapid evolution of new and sophisticated financial products. There has been an explosion of highly leveraged transactions, increased holdings of junk bonds, participation in sophisticated financing and hedging instruments, and a decrease in traditional loan arrangements, particularly at large banks. Unfortunately, there is no historical means to measure the risk of these new instruments. They have not yet been through a complete business cycle and the rapidity at which they multiply and transform make it difficult to monitor and assess risk. The increased risk of some of these instruments has left some of the larger banks open for possible downgrading by the rating agencies. The risk-based capital guidelines being implemented from 1990 to 1992 will take these off-balance-sheet items into account by including them in the calculation of equity ratios. The majority of the multinational banks have correspondingly strengthened their capital ratios to meet these guidelines, although most adjustments occurred in 1988.

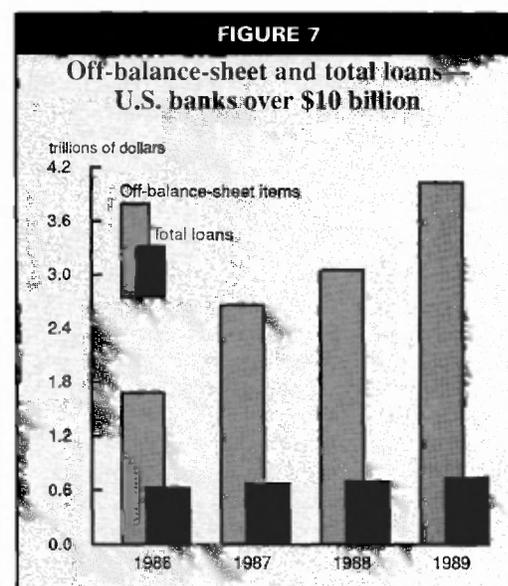
Bank loan portfolios are now riskier not only because of the proliferation of these new products but also because of the greater leverage in the economy. The nation is currently in its eighth year of economic expansion. During



that time, consumers and corporations alike have taken on additional debt. Should interest rates rise dramatically or the economy deteriorate in any significant manner, questions as to the financial stability and flexibility of these borrowers will certainly arise.

Seventh District trends better

In 1989, credit quality measures in the Seventh Federal Reserve District (which consists of portions of Illinois, Indiana, Michigan, Wisconsin and all of Iowa) reflected those of the U.S. but the trends were not as severe. DEL grew 3.5 percent in the fourth quarter of



Banking 1989: A market view

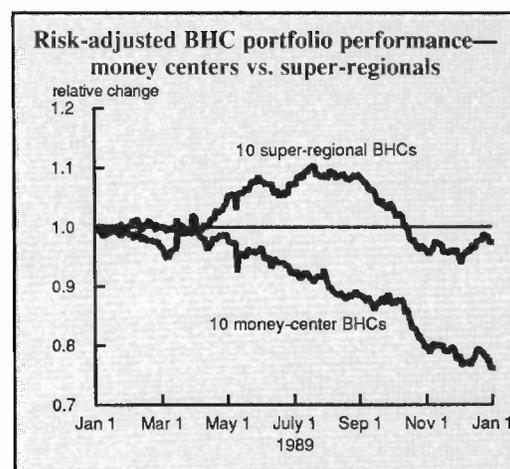
Bank stock price performance in 1989 can be summed up in two words: asset quality. In general, those banks with weak asset quality underperformed the market while banks with stronger asset quality outperformed the market. As seen in the graph, a portfolio of ten super-regional bank stocks outperformed a portfolio of ten money-center banks in the stock market during 1989.

By using Ordinary Least Squares regression, the performance of individual firm share values can be evaluated relative to the market (S&P 500) and the rest of the financial industry (NYSE Financial Index). That is, the effects of the changes in the market's perception of the individual firms are separated from the effects of the changes in the market's perception of the value of the stock market as a whole and of the value of the financial industry (made up of finance, insurance, and real estate companies) specifically. Thus, the model produces a return adjusted for market risk and industry risk.

The model is constructed using actual firm data and market returns (change in the firm's stock price, adjusted for dividends and stock splits) for 1988 to determine the relationships between the firm and market returns and the firm and industry returns. These values are then used to calculate the expected daily return in 1989, given the S&P 500 and the NYSE Financial Index return. This expected return is then compared to the observed return to determine the deviation of the actual performance from the expected levels. These deviations are cumulatively summed over the year to show risk-adjusted performance over time. Average performance is calculated for money-center banks and super-regional banks by selecting ten from each group, summing over the individual performance of each, and dividing the result by ten.

While weak earnings undoubtedly hurt the performance of some bank stocks, investor concerns about weakening asset quality appeared to drive bank stock price movements in 1989. The asset quality concerns were centered in two areas: HLT (highly leveraged transactions) lending and real-estate lending. The worries over HLT lending primarily affected money-center banks, while real-estate concerns affected both money-center and super-regional bank stock performance. These worries were precipitated not only by the perceived risk of these types of lending, but also by what drove the banks to increase their levels of such loans, namely the narrowing spreads in commercial lending and other traditional sources of income brought on by increased competition.

As the Figure indicates, the average performance of the share values of the ten money-center



banks decreased fairly consistently throughout the year relative to the market and the industry. Though not shown here, individual plots of nine of the ten firms included in the sample resulted in curves that were similar in shape and direction to the graph shown here. The lone money-center bank that outperformed the market did so primarily on the strength of its asset quality, despite weaker earnings. Several other money-center banks recorded improved earnings over 1988 but suffered in the stock market due to asset quality concerns. These concerns grew in the fourth quarter, particularly after the market break on October 13.

As a group, super-regional bank stock performance was more diverse. Several super-regional banks were plagued with similar asset quality concerns and tended to underperform the market, while those super-regional banks with stronger asset quality generally outperformed the market. While the asset quality worries began affecting money-center performance during the second quarter, super-regional bank credit quality concerns did not surface until September. Individual plots of the ten super-regional banks indicate that seven of the banks trailed the market from September to December, at which time super-regional bank stocks began staging a comeback. In fact, individual plots of all ten banks were positively sloped in December.

In summary, the stock market seemed to focus on the effect that asset quality might have on future earnings while discounting current earnings to some degree. An early look at 1990 performance suggests that asset quality remains a high priority among investors as those banks with weaker asset quality continue to struggle.

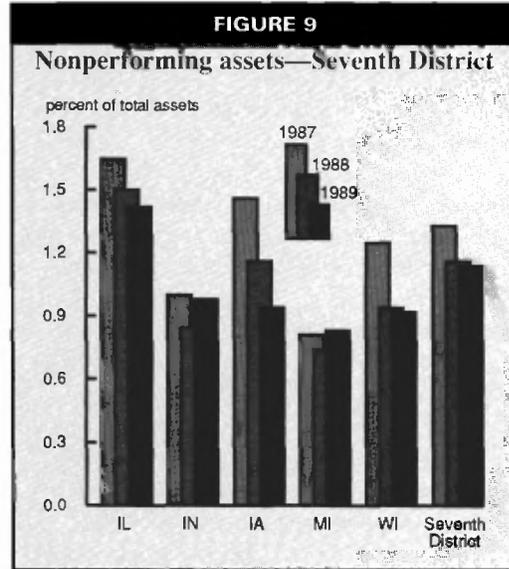
—Philip M. Nussbaum

1989 compared to a 5.6 percent increase for the U.S. As in 1987 and 1988, the District's ratio of DEL was the lowest of all Districts in the nation. Still, this ratio grew from 1.17 percent in 1988 to 1.29 percent in 1989. Past-due real-estate and consumer loans contributed greatly to the fourth-quarter delinquent loan increase, but were partially offset by declines in commercial and 'other' delinquent loans. (See Figure 8.) The delinquent loan ratio increased in the fourth quarter in all District states except Iowa where the ratio declined from 1.28 to 1.19 percent.

Primarily as a result of asset growth, District NPA was down just slightly, to 1.14 percent, from year-end 1988. NPA levels rose over the year for Indiana and Michigan primarily due to higher nonperforming real-estate assets. (See Figure 9.) Whereas U.S. NPA ratios showed fairly steady deterioration over the year, District NPA exhibited more volatility. Thus, the improvement in this ratio for the fourth quarter was all the more noticeable.

Fourth-quarter Seventh District NPA declined from 1.30 percent in the third quarter to 1.14 percent, almost one half the U.S. level. (See Figure 10.) This decline, in both dollar values and ratios, was seen in all size groups and in all states and reflected a stronger economic base in the Midwest compared to the U.S. as a whole. As with the U.S., the lower levels of nonperforming loans were due to substantial fourth-quarter loan losses.

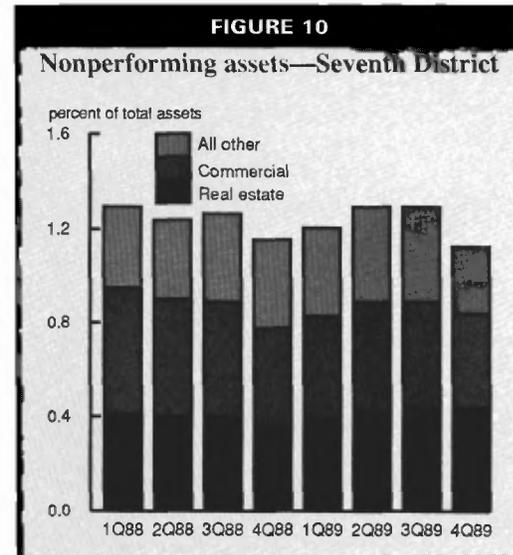
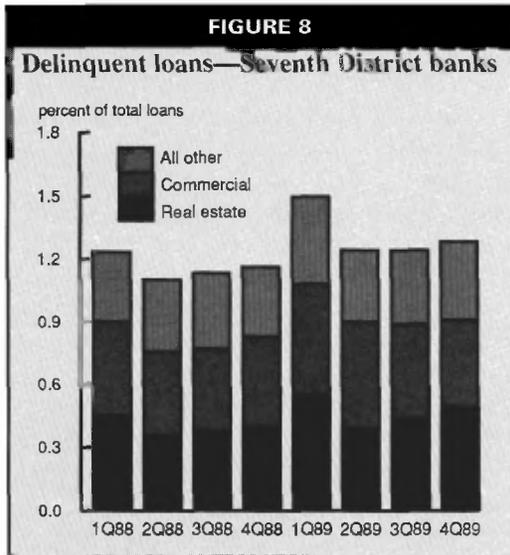
District nonperforming commercial and 'other' loans declined \$165 million and \$396



million, respectively. The declines were the result of fourth-quarter loan losses for commercial (\$214 million) and 'other' loans (\$535 million). District real-estate loan losses totalled \$44 million and were a much smaller portion of total loan losses than in the U.S. Contrary to the U.S., District nonperforming real-estate loans declined \$78 million over the quarter. However, OREO increased \$101 million. As a result, nonperforming real-estate assets accounted for 39 percent of all District NPA at year-end 1989 compared to 31 percent last year.

Problem credits seep into profits

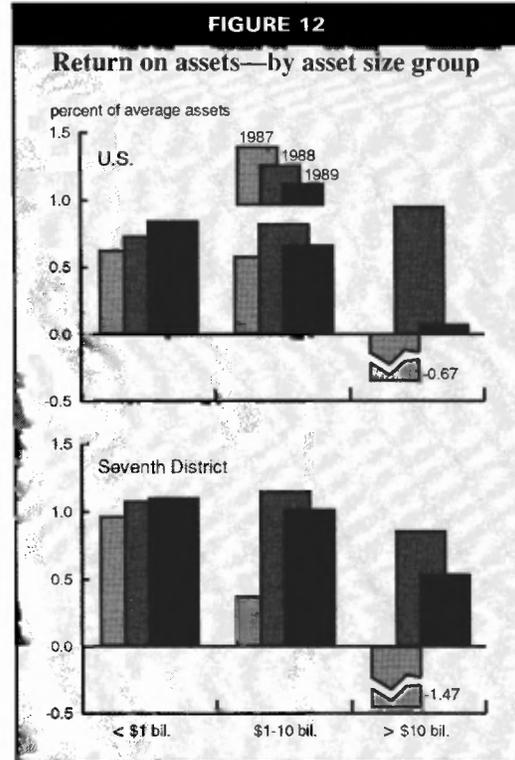
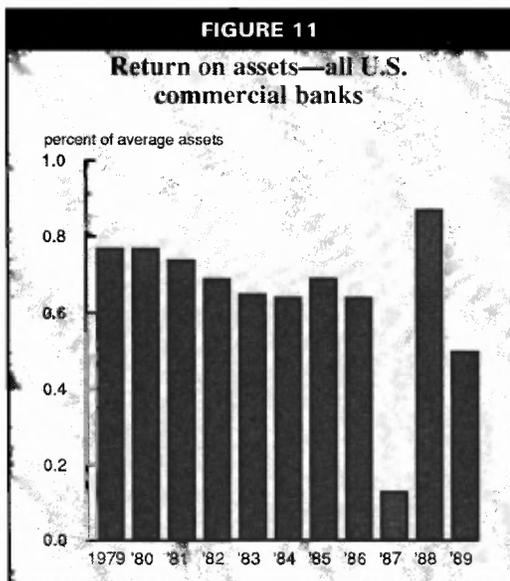
After rebounding strongly in 1988, the banking industry's financial performance in



1989 was marred not only by further LDC writedowns, but also by domestic asset quality. The full-year 1989 return on assets (ROA) for the U.S. was 0.50 percent versus 0.84 percent for 1988 and 0.13 percent for 1987. (See Figure 11.) In 1987, 17 percent of U.S. banks lost money. One-third of these banks were located in the Southwest. In fact, in this region alone, over 40 percent of the banks lost money in 1987. In contrast, 11 percent of U.S. banks reported losses in 1989; 29 percent of those with losses were still located in the Southwest. In each of the past three years, earnings trends varied based on bank size. (See Figure 12.)

On a year-to-year basis, the community banks (those with assets under \$1 billion) continued the improvement begun in 1987 with annual ROAs rising from 0.63 percent in 1987, to 0.77 percent in 1988, to 0.84 percent in 1989. Net interest margins improved slightly, along with 'other' discretionary non-interest income. Expense and loan-loss provision levels were generally flat. Fourth-quarter 1989 earnings for U.S. community banks were better than those of the year-earlier quarter but also, and more impressively, better than those of the previous full year.

Compared to 1988, large banks had substantially lower ROAs for the year. As in 1987, earnings were hurt by higher provisioning for domestic credit quality problems and for LDC loans. To some extent, the Latin-debt situation has improved as evidenced by the newly restructured and negotiated debt ac-



ords. But, concerns remain about the long-term debt service capacity of certain Latin American countries. Although multinational banks in particular set aside large LDC provisions in 1989, their future earnings could be further pressured because, as a group, their ratio of LDC-provisions-to-LDC-loans continues to lag their European counterparts.

The disproportionate weight of the larger U.S. banks stands out in the ROA numbers. The ROA for the U.S. for fourth-quarter 1989, at 0.29 percent of average assets, was roughly one-third the 0.93 percent reported for fourth-quarter 1988. The year-ago quarter, however, was abnormally high due to record earnings of large banks, which received a substantial boost from past-due Brazilian debt interest payments. While provisions had the greatest effect on large-bank earnings, fourth-quarter profitability was also hurt by narrowed net interest margins and higher expenses. The earnings decline was tempered for multinational banks by higher noninterest income. The 26-basis point increase from the third quarter to 2.18 percent in the fourth quarter was attributable mainly to higher 'other' discretionary noninterest income, followed by foreign exchange and trading account gains.

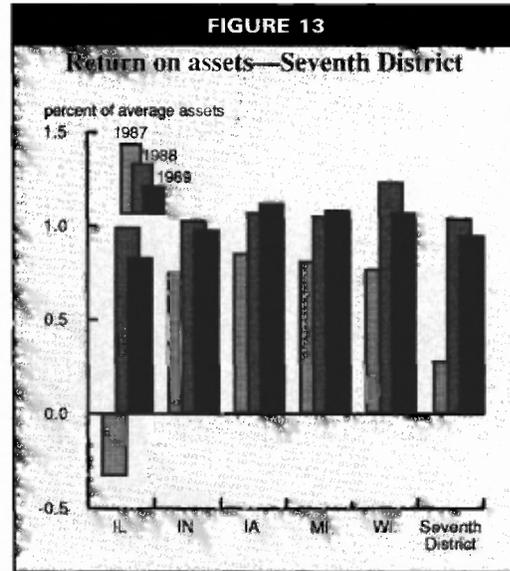
Large banks in particular have been generating less of their income from the traditional banking business of intermediation. The wide array of financial intermediaries is narrowing as regulated banking powers increase. Consequently, competition has escalated as these participants vie for a limited amount of business and has resulted in the creation of new products. This dependence on nontraditional sources of income has continued to grow. Noninterest income for multinational banks was 1.77 percent of average assets in 1987, 1.85 percent in 1988, and increased to 2.01 percent in 1989.

Earnings for U.S. regional banks (those with assets between \$1 and \$10 billion), fluctuated year-to-year for many of the same reasons as the multinational banks. Deteriorating credit quality resulted in larger provisions. Overhead costs, net interest margins, and non-interest income were flat over the year. Nonetheless, noninterest income has grown for these banks, as well, from 1.44 percent in 1987, to 1.49 percent in 1988, and to 1.51 percent in 1989.

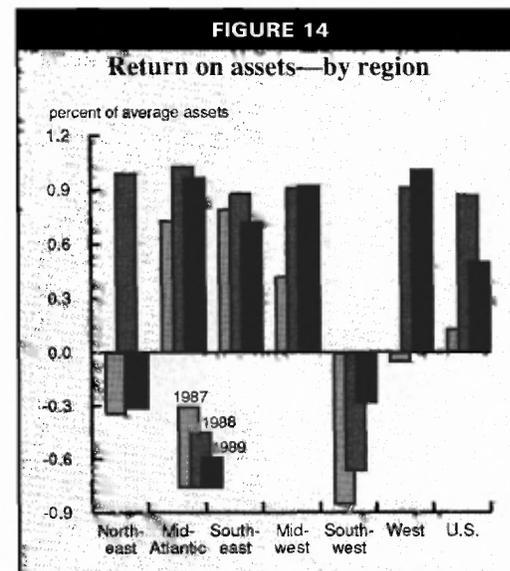
The mediocre earnings in 1989 did not impair the dividend payout rates of the large banks. Dividends equaled 116 percent of 1989 net income, compared to 47 percent in 1988. The higher level of retained income in 1988 led to sizable increases in tangible capital levels for these banks in that year. That was not the case in 1989. With less income retained, and slower growth in loan-loss reserve levels, tangible capital levels were only slightly higher at year end 1989 compared to year-end 1988.

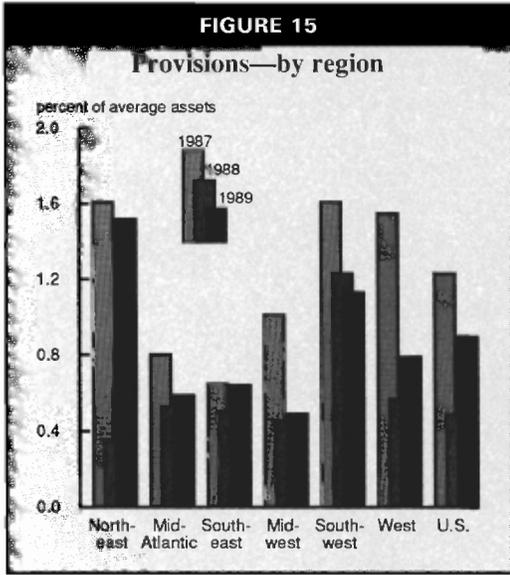
Full-year 1989 Seventh District ROA of 0.95 percent was down slightly from the 1.04 percent reported in 1988 but was much better than the 0.28 percent reported for 1987. (See Figure 13.) As in the rest of the nation, community bank earnings improved over the year while large-bank earnings were pressured by higher domestic and LDC provisions. The ROAs for the District states varied year-to-year primarily due to fluctuating noninterest income and provision levels. Nonetheless, the reported ROA levels are quite respectable, particularly when compared to the U.S.

On a regional basis, ROAs were down from a year ago for the Eastern areas of the U.S. but higher for the Midwest, Southwest,



and West. (See Figure 14.) The earnings trends were similar to those in the size group data, with the level of loan-loss provisions, (an important measure of credit quality) having the largest impact on earnings. Provisions for 1989 increased over 1988 in all regions except, notably, the Southwest, where provisions fell from 1.23 percent of average assets to 1.13 percent. (See Figure 15.) The Midwest, which includes the Seventh District, had the lowest annual provisions of all regions at 0.49 percent, reflecting better credit quality due to the diversified economic base and the continued improvement of the region's agricultural banks.





Post game

U.S. bank performance in 1989 appeared a replay of 1987, as both foreign and domestic credit quality considerations again reduced earnings. But both advancing interstate consolidation at home and increased integration abroad signalled a different environment in which to consider these events.

The 1990's will be a time of reckoning if regional pockets of recession grow and as the structural changes that have occurred since the early 1980s take full effect. Expertise, some degree of risk taking, better capitalization, and capable management will separate the participants from the bystanders.

Like a batter faced again with the same count, but later in the game, the banker faces familiar challenges in 1990 but with fewer options ... and more profound consequences.