## An Update on Emerging Issues in Banking

# Banks and Thrifts Post Record Earnings, Insurance Funds Slide

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Full-year 2001 financial data for all FDIC-insured institutions, released today in the Quarterly Banking Profile, depict record bank and thrift earnings even as the reserve ratios of the FDIC insurance funds continue to slide.

Strong and sustained monetary easing in 2001 significantly lowered insured institutions' funding costs and boosted their securities gains, in total more than offsetting the effects of a continuing rise in charge-offs and non-performing loans. The result was record earnings, continued high capital levels and a banking industry that, at least in aggregate, has not exhibited significant damage from the U.S. economic slowdown (Chart 1).

The year's interest-rate benchmarks opened with the discount rate at six percent and the fed funds rate at 6.5 percent. By year-end, aggressive action by the Federal Reserve brought these rates to 1.25 and 1.75 respectively, a reduction that contributed to declines in funding costs, particularly at large financial institutions. Interest expense during 2001 for all FDIC-insured institutions (9,613 as of December 31) declined to $235 billion (3.28 percent of all liabilities at year-end) from $277 billion (4.06 percent) during the previous year. Large commercial banks (80 institutions with greater than $10 billion in assets) saw the cost of funding their earning assets decline from 4.46 percent in 2000 to 3.35 percent in 2001. At the opposite end of the spectrum, smaller community banks (4,486 institutions with less than $100 million in assets) enjoyed only minimal relief. Funding costs for their earning assets in 2001 declined by only 26 basis points, to 3.61 percent. Interest rate declines also contributed to bottom line earnings for banks and thrifts by enabling them to sell appreciated securities, a tactic that, before taxes, contributed $8.7 billion to their $87.6 billion of net income. (In 2000, the banking and thrift industry lost $1.5 billion on securities sales.)

Credit quality problems generally offset the bolstering effects of interest rate declines on the industry's income. Loan loss provisions by all FDIC-insured institutions were $45.9 billion in 2001, up 43 percent from 2000 levels. Past due, noncurrent and restructured loans at all institutions, $128 billion at year-end, were up 18.5 percent for the year.[1] This increase in weak credits occurred even with net chargeoffs by banks and thrifts that amounted to $38.8 billion, up 48 percent from year 2000 levels.[2]

Most insured institutions are maintaining capital and reserves in the face of these credit difficulties at levels well in excess of the early 1990s recession, as illustrated in Table 1.[3]

Table 1

| Bank Capital and Reserves<br>Exceed Levels of Last Recession | | | | |
|---|---|---|---|---|
| | **Year-end** | | | |
| | 1990 | 1991 | 2000 | 2001 |
| Number of Institutions | 15,168 | 14,473 | 9,904 | 9,613 |
| Equity *(% of Assets)* | 6.15 | 6.60 | 8.29 | 8.99 |
| Equity and Reserves, Discounted* *(% of Assets)* | 3.33 | 3.96 | 7.81 | 8.37 |
| Loan Loss Reserves *(% of Weak Credits** )* | 33.6 | 35.2 | 66.1 | 62.3 |
| Loan Loss Reserves *(% of Noncurrent Loans)* | 63.5 | 64.2 | 146.4 | 127.6 |

Noncurrent loans are seriously (90 days or more) past due or do not accrue interest for other reasons.

*Discounted for Past Due, Noncurrent and Restructured Loans.

**Past Due, Noncurrent and Restructured Loans.

Source: Bank and Thrift Call Report and Thrift Financial Report Data

During the previous recession, the equity to assets ratio for the entire bank and thrift industry was about three-quarters of today's 8.99 percent level. A rough overall picture of the industry's capital relative to identified, potentially weaker credits can be obtained by subtracting such weaker credits (non-current, restructured and past due 30 days or more) from equity and reserves. The results of this "discounted equity" calculation stood at 8.37 percent at year-end 2001, compared to 3.96 percent ten years earlier.

Reserves now account for 62.3 percent of all identified, potentially weaker credits compared to 33.6 percent in 1990. Considered in the context of noncurrent loans only, the industry's reserves in 1990 covered less than two-thirds of its most serious problems, compared to about 128 percent today.

The Bank Insurance Fund (BIF) and Savings Association Insurance Fund (SAIF) both sustained reverses in 2001. The ratio of the BIF to the deposits it insures slid from 1.35 percent at year-end 2000 to 1.27 percent at year-end 2001. The SAIF reserve ratio followed a similar trend, slipping from 1.43 percent to 1.37 percent over the same period. If and when either fund's reserve ratio falls below 1.25 percent of its insured deposits, the FDIC is mandated to restore the shortfall through higher deposit insurance premiums.

The ramifications of a decline in the BIF reserve ratio have been discussed in an earlier edition of FYI. An important factor was an increase in the reserve for calendar-2002 insurance losses, largely driven by an increase in the population of problem banks. At year-end 2001 the number of institutions on the FDIC's problem list stood at 114, up from 94 at the end of 2000 and from 79 at the close of 1999. Assets of problem institutions amounted to $40 billion, 167 percent of last year's level and four times that of two years ago.

The decline in the SAIF reserve ratio, in contrast, was largely driven by net insured deposit inflows of $47 billion into savings institutions. While the fund's balance grew by 2.3 percent during the year, growth of insured deposits was 6.2 percent; as a result, the ratio of the fund's balance to insured deposits decreased.

Growth in insured deposits could still prove to be an issue for the BIF as well. During the fourth quarter of 2001, BIF-assessable deposits grew at a 12.5 percent annualized rate, but BIF-insured deposits grew at only a 0.8 percent annualized rate. The question remains open whether these numbers reflect the limitations of the data currently being collected to estimate the amount of insured deposits. New Call Report items, required for the first time in March 2002, may help to resolve this question.

More information is available in the Quarterly Banking Profile for fourth quarter 2001.

1. Noncurrent loans are seriously (90 days or more) past due or do not accrue interest for other reasons.
2. Net chargeoffs are the difference between loans charged off and recoveries of previously charged off loans.
3. The table entries account for all operating institutions that filed Call Reports or Thrift Financial Reports, including those that were in conservatorship at the time.

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| Bank Earnings Show Little Effect of Economic Slowdown | | |
|---|---|---|
| **Year** | **ROA** | **ROE** |
| 1935 | 0.36 | 2.82 |
| 1936 | 0.91 | 7.81 |
| 1937 | 0.65 | 5.61 |
| 1938 | 0.51 | 4.37 |
| 1939 | 0.62 | 5.71 |
| 1940 | 0.57 | 5.8 |
| 1941 | 0.59 | 6.46 |
| 1942 | 0.49 | 6.13 |
| 1943 | 0.6 | 8.59 |
| 1944 | 0.6 | 9.56 |
| 1945 | 0.61 | 10.79 |
| 1946 | 0.59 | 10 |
| 1947 | 0.52 | 8.18 |
| 1948 | 0.62 | 9.48 |
| 1949 | 0.63 | 9.33 |
| 1950 | 0.67 | 9.79 |
| 1951 | 0.61 | 9.04 |
| 1952 | 0.59 | 8.73 |
| 1953 | 0.57 | 8.3 |
| 1954 | 0.75 | 10.72 |
| 1955 | 0.64 | 9.03 |
| 1956 | 0.69 | 9.53 |
| 1957 | 0.72 | 9.55 |
| 1958 | 0.91 | 11.82 |
| 1959 | 0.65 | 8.31 |
| 1960 | 0.9 | 11.33 |
| 1961 | 0.89 | 11.11 |
| 1962 | 0.82 | 10.24 |
| 1963 | 0.79 | 9.78 |
| 1964 | 0.79 | 10.04 |
| 1965 | 0.79 | 10.43 |
| 1966 | 0.73 | 9.81 |
| 1967 | 0.81 | 11.15 |
| 1968 | 0.8 | 11.4 |
| 1969 | 0.85 | 12.01 |
| 1970 | 0.88 | 12.36 |

| | | |
|---|---|---|
| 1971 | 0.87 | 12.37 |
| 1972 | 0.83 | 12.23 |
| 1973 | 0.85 | 12.73 |
| 1974 | 0.76 | 12.42 |
| 1975 | 0.68 | 11.79 |
| 1976 | 0.69 | 11.53 |
| 1977 | 0.7 | 11.72 |
| 1978 | 0.76 | 12.91 |
| 1979 | 0.8 | 13.91 |
| 1980 | 0.79 | 13.68 |
| 1981 | 0.76 | 13.04 |
| 1982 | 0.7 | 12.02 |
| 1983 | 0.66 | 11.09 |
| 1984 | 0.64 | 10.52 |
| 1985 | 0.69 | 11.07 |
| 1986 | 0.63 | 9.94 |
| 1987 | 0.1 | 1.55 |
| 1988 | 0.82 | 13.19 |
| 1989 | 0.49 | 7.71 |
| 1990 | 0.48 | 7.46 |
| 1991 | 0.53 | 7.94 |
| 1992 | 0.93 | 12.98 |
| 1993 | 1.2 | 15.34 |
| 1994 | 1.15 | 14.61 |
| 1995 | 1.17 | 14.66 |
| 1996 | 1.19 | 14.45 |
| 1997 | 1.23 | 14.68 |
| 1998 | 1.19 | 13.93 |
| 1999 | 1.31 | 15.31 |
| 2000 | 1.19 | 14.02 |
| 2001 | 1.16 | 13.1 |