The FDIC Quarterly Banking Profile

L. William Seidman, Chairman

Fourth Quarter 1987

COMMERCIAL BANKING PERFORMANCE — FOURTH QUARTER, 1987

- *U.S. BANKS POST LOWEST RETURNS SINCE THE GREAT DEPRESSION*
- *1987'S EXTRAORDINARY LOAN LOSS PROVISIONS ACCOUNT FOR DROP IN PROFITS*
- *MIDWESTERN BANKS SHOW SIGNIFICANT IMPROVEMENT*
- *SOUTHWESTERN BANKS SUFFER LARGE LOSSES*
- *FOURTH QUARTER OPERATING INCOME UP SHARPLY FROM YEAR-EARLIER LEVELS*
- *NUMBER OF BANKS ON PROBLEM LIST DECLINES — FIRST TIME SINCE 1981*
- *SIGNIFICANT IMPROVEMENT IN INDUSTRY PERFORMANCE EXPECTED IN 1988*

Commercial banks earned $3.7 billion in 1987, down nearly 80 percent from the $17.5 billion earned in 1986, in their worst year for profitability since the Great Depression. Their return on assets of 0.13 percent and return on equity of 2.56 percent were the lowest levels since 1934. These results had been anticipated since the second quarter, when the nation's largest banks began setting aside sizable reserves for troubled loans to developing countries (LDCs). The soaring loan-loss provisions, over 67 percent higher than in 1986, fully accounted for the banking industry's year-to-year drop in earnings. Loan-loss provisions attributable to the international operations of U.S. banks were $20.6 billion, $18 billion higher than a year ago. Absent the extraordinary reserving for LDC loans, aggregate loan loss provisions would have declined $3 billion from a year ago, and net income would have been roughly equal to 1986's level.

Chart A — Returns on Assets and Equity at Insured Commercial Banks 1935—1987

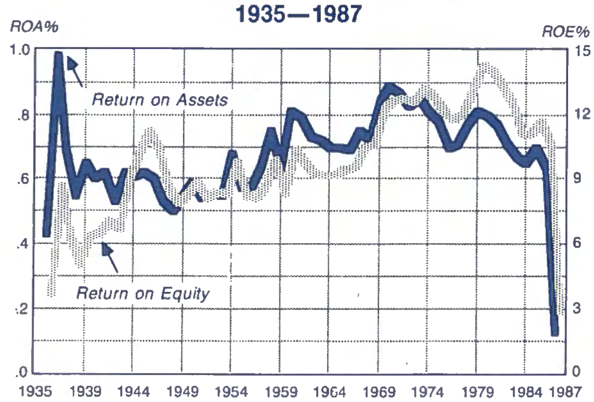
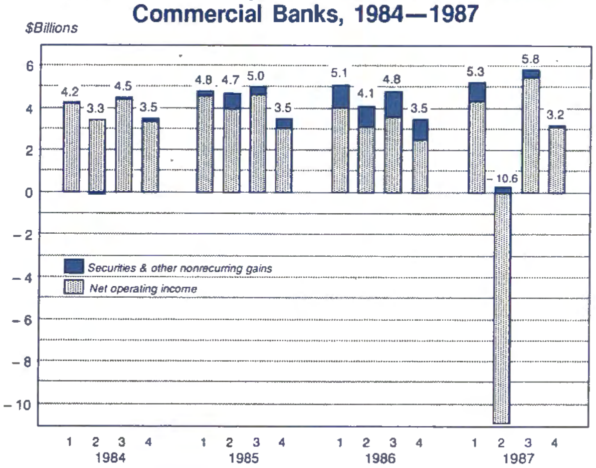


Chart B — Quarterly Net Income of FDIC-Insured Commercial Banks, 1984—1987



The loan-loss provisions had the positive effect of raising the aggregate allowance for loan and lease losses 71 percent. At year-end, the ratio of the loss allowance to loans stood at 2.70 percent, compared to 1.65 percent at the end of 1986. The ratio of equity capital to assets fell by 16 basis points to 6.05 percent, while the ratio of primary capital (which includes the loss allowance) to assets increased by 47 basis points to 7.69 percent. Nonperforming assets were up 29 percent from a year ago, largely due to the impaired status of LDC loans, ending the year at 2.56 percent of total assets. Most of the growth in nonperforming assets took place in the first quarter of the year; nonperforming assets shrank by $1.5 billion in the fourth quarter. The possibility that some nonaccruing LDC loans may return to accrual status in 1988 increases the potential for further reductions.

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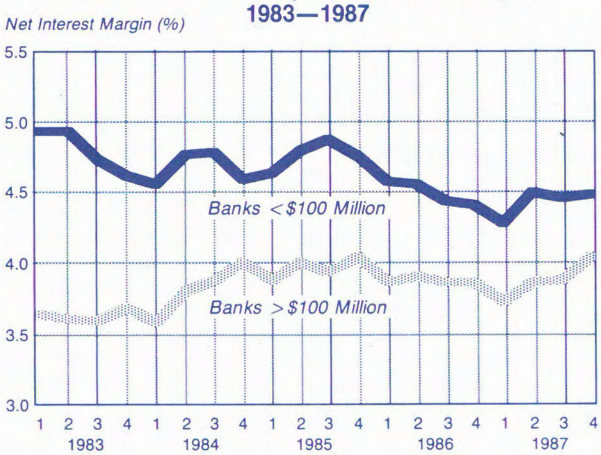
Fourth quarter operating income was $3.2 billion, up over 25 percent from the fourth quarter of 1986, despite loan loss provisions of $7.7 billion that were nearly 12 percent higher than the year-ago period. Interest margins, which narrowed for the full year, improved slightly during the second half of the year. They were especially strengthened in the fourth quarter in the wake of the October stock market decline, as banks enjoyed a large inflow of deposits and interest rates fell. Banking sector deposits, up only 2.2 percent for the year, grew at an annualized rate of 11.7 percent in the fourth quarter. The events of Black Monday also triggered a surge in loan demand as financial services firms sought to maintain liquidity. The largest banks were the greatest beneficiaries of the flight to quality; they also experienced a marked increase in noninterest income in the fourth quarter, especially from foreign exchange operations.

Chart C — Quarterly Net Interest Margins 1983—1987



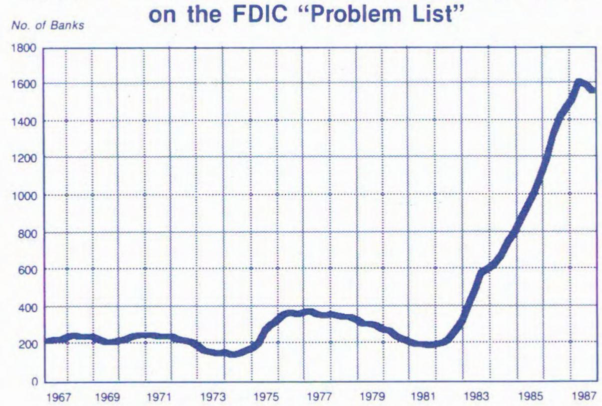
Asset growth was less than two percent during 1987, the smallest annual increase since 1948, and commercial loans were down two percent from year-earlier levels. The four percent growth in total loans was driven by increased real estate and consumer lending. Real estate loans outstanding at year-end actually exceeded banks' commercial loans by $10 billion, reflecting the restructuring of banks' traditional operations in the face of increased competition. Much of the increase in real estate lending was in the form of home equity loans, which stood at nearly $33 billion at year-end.

The outlook for 1988 is cautiously optimistic. Barring any new shocks, loan loss provisioning should be lower than usual this year, and profitability at money-center and regional banks will be much improved. The effectiveness of banks' efforts to expand noninterest income sources and curb operating expense growth will be an important determinant of profitability. Community banks showed improved results in 1987, with return on assets up 43 basis points at banks smaller than $100 million, and 22 basis points for banks in the $100-to-300 million range. Unaffected by overseas loan problems, both of these size groups, representing 93.5 percent of all banks, saw charge-offs and loss provisions decrease by 10 to 25 percent from year-earlier levels. Smaller banks outside the Southwest should continue to show strong or improving earnings in 1988.

The Southwest will continue to be a major source of earnings weakness. The levels of problem banks and failures remain high and the region's banking sector continues to operate at a loss. For the full year, 36 percent of the banks in the region were unprofitable and return on equity was a negative 11.81 percent. Persistent growth of nonperforming assets, despite high levels of loan charge-offs, points to more of the same this year. In contrast, the worst of the problems experienced by banks in the Midwest are behind them, and they can be expected to return soon to more traditional levels of profitability. The number of Midwest bank failures was down slightly, from 48 to 40, but the number of unprofitable banks was almost cut in half. Loan charge-offs declined 22 percent compared to 1986, while at the same time, asset quality improved, as nonperforming assets fell 6.5 percent. Midwestern banks showed the greatest improvement over 1986 results, with a 78 percent increase in net operating income on a year-to-year basis.

The results for the Northeast and, to a lesser extent, the Central and West regions, were dominated by the loan-loss provisioning at the big money-center banks. Actions by the largest banks overshadowed generally strong performance by banks in the Central region. Loan loss provisions were almost twice 1986 levels, halving net income, but actual loan losses grew by only five percent. The Central region had the lowest proportions of both failed and unprofitable banks, and the second highest rate of loan growth. The Southeast enjoyed the strongest loan demand of the six regions, as loans grew 11.3 percent and assets by 6.5 percent. That demand, combined with strong net interest margins, yielded a regional-high return on assets of 0.93 percent.

Chart D — Number of Insured Commercial Banks on the FDIC "Problem List"



The number of banks with full-year earnings losses fell 15 percent to 2,366 in 1987, while the number of "Problem" banks leveled off, after peaking at mid-year. On the whole, the number of banks on the "Problem List" increased by 102, 7.0 percent higher at the end of 1987 than 1986. This increase was the lowest, both in number of net additions and in percentage terms, since 1981. The outlook for 1988 is for fewer troubled institutions, but the number of failures is not expected to be significantly lower than 1987's record. Industry profits for 1988 should be close to the $17.5 billion earned in 1986, as banks return to a more normal pattern of operations.

Table I. Aggregate Condition and Income Data, FDIC-Insured Commercial Banks

(dollar figures in millions)

	Preliminary 4th Qtr 1987	3rd Qtr 1987	4th Qtr 1986	% Change 86:4-87:4
Number of banks reporting	13,654	13,851	14,200	-3.8
Total employees (full-time equivalent)	1,554,885	1,554,142	1,563,057	-0.5
CONDITION DATA				
Total Assets	$2,998,428	$2,942,652	$2,941,082	1.9
Real estate loans	599,135	579,046	515,365	16.3
Commercial & industrial loans	588,971	580,375	600,878	-2.0
Loans to individuals	350,361	341,829	335,698	4.4
Farm loans	29,317	31,066	31,607	-7.2
Other loans and leases	259,909	265,778	273,102	-4.8
Total loans and leases	1,827,693	1,798,094	1,756,650	4.0
LESS: Reserve for losses	49,429	47,407	28,903	71.0
Net loans and leases	1,778,264	1,750,687	1,727,747	2.9
Temporary investments	450,623	446,390	463,627	-2.8
Securities over 1 year	396,452	387,372	357,523	10.9
All other assets	373,089	358,203	392,185	-4.9
Total liabilities and capital	$2,998,428	$2,942,652	$2,941,082	1.9
Noninterest-bearing deposits	479,073	450,361	532,347	-10.0
Interest-bearing deposits	1,853,600	1,816,254	1,751,121	5.9
Other borrowed funds	361,351	367,418	358,964	0.7
Subordinated debt	17,586	17,528	16,993	3.5
All other liabilities	105,554	110,675	99,411	6.2
Equity capital	181,264	180,416	182,246	-0.5
Primary Capital	234,471	231,492	214,304	9.4
Nonperforming assets	74,390	75,914	57,667	29.0
Loan commitments and letters of credit	792,136	773,589	751,859	5.4
Domestic office assets	2,572,769	2,519,010	2,532,352	1.6
Foreign office assets	425,649	423,642	408,730	4.1
Domestic office deposits	1,991,066	1,922,217	1,969,673	1.1
Foreign office deposits	341,607	344,398	313,795	8.9
Earning Assets	2,625,339	2,584,449	2,548,897	3.0

INCOME DATA	Preliminary Full Year 1987	Full Year 1986	% Change	Preliminary 4th Qtr 1987	4th Qtr 1986	% Change
Total interest income	$244,695	$237,806	2.9	$64,270	57,865	11.1
Total interest expense	144,810	142,824	1.4	38,392	33,593	14.3
Net interest income	99,885	94,982	5.2	25,878	24,272	6.6
Provisions for loan losses	36,965	22,075	67.5	7,725	6,924	11.6
Total noninterest income	41,490	35,890	15.6	12,070	9,852	22.5
Total noninterest expense	96,933	90,247	7.4	25,691	24,196	6.2
Applicable income taxes	5,425	5,288	2.6	1,381	494	179.6
Net operating income	2,052	13,262	-84.5	3,151	2,510	25.5
Securities gains, net	1,436	3,950	-63.6	42	961	-95.6
Extraordinary gains, net	219	274	-20.1	38	61	-37.7
Net Income	3,707	17,486	-78.8	3,231	3,532	-8.5
Net charge-offs	15,901	16,550	-3.9	5,253	5,448	-3.6
Net additions to capital stock	2,506	3,244	-22.7	1,392	2,251	-38.2
Cash dividends on capital stock	10,620	9,228	15.1	3,650	3,245	12.5

Table II. Selected Indicators, FDIC-Insured Commercial Banks

	1981	1982	1983	1984	1985	1986	1987
Return on assets	0.78%	0.71%	0.66%	0.65%	0.70%	0.64%	0.13%
Return on equity	13.08	12.11	10.70	10.73	11.31	10.18	2.56
Equity capital to assets	5.83	5.87	6.00	6.15	6.20	6.21	6.05
Primary capital ratio	6.39	6.47	6.59	6.91	6.91	7.22	7.69
Nonperforming assets to assets	N/A	1.85	1.97	1.97	1.87	1.95	2.46
Net charge-offs to loans	0.37	0.56	0.67	0.76	0.84	0.99	0.89
Asset growth rate	9.36	8.12	6.75	7.11	8.86	7.62	1.95
Net operating income growth	7.60	-0.62	-3.69	3.40	6.30	-16.20	-84.53
Number of unprofitable banks	741	1,196	1,530	1,891	2,453	2,784	2,366
Number of problem banks	196	326	603	800	1,098	1,457	1,559
Number of failed/assisted banks	7	34	45	78	118	144	201

N/A — Not available

Table III. Preliminary Fourth Quarter 1987 Bank Data *(Dollar figures in billions, ratios in %)*

		Asset Size Distribution						Geographic Distribution					
								EAST			WEST		
	All Banks	Less than $100 Million	$100-300 Million	$300-1,000 Million	$1-5 Billion	Greater than $5 Billion	Ten Largest Banks	Northeast Region	Southeast Region	Central Region	Midwest Region	Southwest Region	West Region
Number of banks reporting	13,654	10,891	1,876	535	268	74	10	1,079	1,916	3,042	3,230	2,860	1,527
Total assets	$2,998.4	$392.6	$302.8	$272.2	$589.6	$761.3	$679.9	$1,179.7	$406.5	$479.7	$208.4	$279.9	$444.2
Total deposits	2,332.7	350.5	266.1	226.4	455.1	536.4	498.2	865.0	323.2	387.1	163.7	229.3	364.1
% total banks	100.0%	79.8%	13.7%	3.9%	2.0%	0.5%	0.1%	7.9%	14.0%	22.3%	23.7%	20.9%	11.2%
Asset share (%)	100.0	13.1	10.1	9.1	19.6	25.4	22.7	39.3	13.6	16.0	7.0	9.3	14.8
Deposit share (%)	100.0	15.0	11.4	9.7	19.5	23.0	21.4	37.1	13.9	16.6	7.0	9.8	15.6
Number of unprofitable banks	3,478	3,055	287	78	35	21	2	160	418	395	746	1,288	471
Number of failed/ assisted banks	50	46	2	2	0	0	0	1	0	1	14	26	8
Performance ratios *(annualized)*													
Yield on earning assets	9.86%	9.83%	9.84%	10.11%	10.46%	10.18%	10.48%	10.17%	9.79%	9.44%	9.83%	8.93%	10.20%
Cost of funding earning assets	5.89	5.34	5.35	5.58	5.92	6.23	7.14	6.53	5.45	5.56	5.56	5.61	5.31
Net interest margin	3.97	4.49	4.49	4.53	4.54	3.95	3.34	3.64	4.34	3.88	4.27	3.32	4.89
Net noninterest expense to earning assets	2.09	3.12	2.76	2.72	2.47	2.01	1.08	1.52	2.45	2.06	2.02	2.73	2.90
Net operating income to assets	0.42	0.24	0.62	0.51	0.40	−0.20	1.04	0.57	0.78	0.48	0.77	−1.08	0.42
Return on assets	0.43	0.23	0.63	0.53	0.41	−0.19	1.07	0.61	0.80	0.48	0.74	−1.12	0.42
Return on equity	7.14	2.65	8.15	7.56	6.32	−3.68	25.98	11.27	11.58	7.33	9.89	−18.02	7.42
Net charge-offs to loans and leases	1.15	1.55	1.16	1.21	1.32	1.75	0.39	0.71	1.14	1.10	1.99	2.43	1.31
Condition Ratios													
Loss allowance to loans and leases	2.70%	1.63%	1.50%	1.60%	1.85%	2.93%	4.65%	3.15%	1.38%	2.24%	2.21%	3.09%	3.13%
Nonperforming assets to assets	2.48	2.09	1.75	1.87	1.93	2.28	3.88	2.44	1.04	1.27	1.87	5.80	3.28
Equity capital ratio	6.05	8.61	7.62	6.88	6.41	5.11	4.24	5.43	6.81	6.53	7.46	6.07	5.77
Primary capital ratio	7.69	9.36	8.35	7.69	7.36	7.01	7.55	7.51	7.53	7.80	8.58	7.55	7.97
Net loans and leases to assets	59.31	51.10	56.61	60.91	63.08	61.21	59.19	59.61	60.14	57.56	53.15	53.90	65.95
Net assets repriceable in one year or less to assets	-7.26	-9.46	-7.73	-7.43	-8.21	-8.01	-4.06	-6.05	-12.11	-4.60	-13.67	-11.39	-3.28
Growth Rates *(year-to-year)*													
Assets	1.9%	4.0%	5.9%	7.7%	9.4%	8.4%	−1.8%	4.1%	6.5%	3.5%	1.0%	−7.3%	−2.2%
Earning assets	3.0	4.6	7.0	9.0	10.7	10.0	−1.3	5.1	7.6	4.1	1.4	−7.4	0.3
Loans and leases	4.0	6.9	10.4	12.0	14.9	9.3	−3.0	5.9	11.3	6.9	3.3	−8.4	−0.6
Loss reserve	71.0	10.7	16.6	21.0	43.5	98.8	140.7	123.8	18.0	65.6	16.9	19.7	63.5
Net charge-offs	−3.6	−33.4	−21.0	−1.4	42.9	113.4	−62.3	2.8	44.5	23.7	−13.4	−32.2	−6.2
Nonperforming assets	29.0	0.4	9.5	19.7	41.7	58.3	49.6	64.5	15.7	0.9	−6.5	31.5	7.7
Deposits	2.2	4.1	5.4	6.1	9.1	9.0	0.2	4.7	5.9	4.3	1.5	−7.0	−2.4
Equity capital	−0.5	4.2	8.8	8.6	11.7	0.8	−16.3	−2.7	10.3	−0.5	5.7	−12.1	−0.6
Interest income	11.1	4.3	9.0	11.5	25.4	24.9	14.6	19.9	11.6	9.0	4.5	−4.9	4.8
Interest expense	14.3	2.4	8.1	13.1	28.2	31.5	21.3	27.1	13.6	10.1	3.7	−4.4	4.0
Net interest income	6.6	6.6	10.1	9.5	22.0	15.6	2.4	8.8	9.2	7.6	5.5	−5.6	5.7
Loan loss expense	11.6	−37.1	−32.2	−2.5	39.2	157.0	−28.0	42.6	14.1	75.5	−28.9	−32.2	12.4
Noninterest income	22.5	4.8	6.6	8.8	36.8	23.8	45.2	44.3	15.5	20.8	−5.7	1.3	0.8
Noninterest expense	6.2	4.7	6.4	9.5	22.5	18.5	8.0	13.3	4.5	4.4	0.3	−0.1	0.6
Net operating income	25.5	N/M	163.9	26.2	−10.8	N/M	126.3	−3.0	33.9	−17.1	83.3	N/M	44.8
Net income	−8.5	N/M	75.2	−0.4	−29.3	N/M	89.5	−13.4	3.7	−28.5	26.7	N/M	7.4

REGIONS: Northeast — Connecticut, Delaware, District of Columbia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Puerto Rico, Rhode Island, Vermont

Southeast — Alabama, Florida, Georgia, Mississippi, North Carolina, South Carolina, Tennessee, Virginia, West Virginia

Central — Illinois, Indiana, Kentucky, Michigan, Ohio, Wisconsin

Midwest — Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, South Dakota

Southwest — Arkansas, Louisiana, New Mexico, Oklahoma, Texas

West — Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, Nevada, Oregon, Pacific Islands, Utah, Washington, Wyoming

Table IV. Preliminary Full-Year 1987 Bank Data *(Dollar figures in billions, ratios in %)*

		Asset Size Distribution						Geographic Distribution					
								EAST			WEST		
	All Banks	Less than $100 Million	$100-300 Million	$300-1,000 Million	$1-5 Billion	Greater than $5 Billion	Ten Largest Banks	Northeast Region	Southeast Region	Central Region	Midwest Region	Southwest Region	West Region
Number of unprofitable banks	2,366	2,070	174	62	33	18	9	104	230	184	412	1.038	398
Number of failed/ assisted banks	201	186	12	3	0	0	0	3	6	7	40	116	33
Performance ratios													
Yield on earning assets	9.53%	9.65%	9.59%	9.66%	9.62%	9.55%	9.99%	9.75%	9.54%	9.19%	9.65%	8.70%	9.83%
Cost of funding earning assets	5.64	5.22	5.17	5.23	5.34	5.73	6.82	6.23	5.17	5.36	5.45	5.38	5.10
Net interest margin	3.89	4.43	4.41	4.43	4.28	3.82	3.17	3.52	4.37	3.83	4.20	3.32	4.73
Net noninterest expense to earning assets	2.16	2.86	2.66	2.63	2.37	1.98	1.51	1.74	2.48	2.13	1.95	2.43	2.93
Net operating income to assets	0.07	0.53	0.75	0.62	0.53	−0.05	−0.89	−0.22	0.88	0.41	0.66	−0.66	−0.05
Return on assets	0.13	0.58	0.81	0.67	0.57	−0.00	−0.81	−0.13	0.93	0.45	0.68	−0.61	−0.01
Return on equity	2.56	6.70	10.61	9.59	8.77	−0.01	−18.29	−2.96	17.16	8.28	11.48	−11.81	−0.32
Net charge-offs to loans and leases	0.89	1.14	0.81	0.95	0.92	1.04	0.67	0.61	0.69	0.68	1.57	1.99	1.08
Growth Rates *(year-to-year)*													
Net charge-offs	-3.9%	-21.2%	-10.8%	16.1%	24.4%	40.6%	-26.9%	7.5%	24.8%	5.2%	-22.4%	-12.8%	-11.3%
Interest income	2.9	−1.2	3.3	6.0	11.3	11.6	3.8	10.2	5.1	1.2	−1.6	−11.5	-2.6
Interest expense	1.4	−5.7	−1.3	1.6	7.4	11.2	6.3	11.6	1.4	−1.9	−4.7	−12.9	-8.3
Net interest income	5.2	4.9	9.3	11.6	16.6	12.1	−1.1	7.7	9.8	6.0	2.6	-9.1	4.4
Loan loss expense	67.5	−23.8	−16.1	5.3	35.7	141.5	173.8	203.7	23.6	96.1	−19.2	−17.6	42.9
Noninterest income	15.6	10.5	11.5	13.0	22.9	18.7	23.6	27.3	11.5	10.1	12.4	4.5	2.0
Noninterest expense	7.4	6.2	9.0	10.7	15.5	15.9	9.1	12.6	7.0	5.8	4.1	−0.4	4.3
Net operating income	−84.5	51.0	28.5	13.6	−3.7	N/M	N/M	N/M	10.6	−42.3	77.6	N/M	N/M
Net income	−78.8	12.6	11.3	−0.9	−12.1	N/M	N/M	N/M	0.5	−45.5	−1.4	N/M	N/M

NOTES TO USERS

COMPUTATION METHODOLOGY FOR PERFORMANCE AND CONDITION RATIOS

All income figures used in calculating performance ratios represent amounts for that period, annualized (multiplied by the number of periods in a year).

All asset and liability figures used in calculating performance ratios represent average amounts for the period (beginning-of-period amount plus end-of-period amount plus any periods in between, divided by the total number of periods).

All asset and liability figures used in calculating the condition ratios represent amounts as of the end of the quarter.

DEFINITIONS

"Problem" Banks—Federal regulators assign to each financial institution a uniform composite rating, based upon an evaluation of financial and operational criteria. The rating is based on a scale of 1 to 5 in ascending order of supervisory concern. "Problem" banks are those institutions with financial, operational or managerial weaknesses that threaten their continued financial viability. Depending upon the degree of risk and supervisory concern, they are rated either "4" or "5".

Earning Assets—all loans and other investments that earn interest, dividend or fee income.

Yield on Earning Assets—total interest, dividend and fee income earned on loans and investments as a percentage of average earning assets.

Cost of Funding Earning Assets—total interest expense paid on deposits and other borrowed money as a percentage of average earning assets.

Net Interest Margin—the difference between the yield on earning assets and the cost of funding them, i.e., the profit margin a bank earns on its loans and investments.

Net Noninterest Expense—total noninterest expense, excluding the expense of providing for loan losses, less total noninterest income. A measure of banks' overhead costs.

Net Operating Income—income after taxes and before gains (or losses) from securities transactions and from nonrecurring items. The profit earned on banks' regular banking business.

Return on Assets—net income (including securities transactions and nonrecurring items) as a percentage of average total assets. The basic yardstick of bank profitability.

Return on Equity—net income as a percentage of average total equity capital.

Net Charge-offs—total loans and leases charged off (removed from balance sheet because of uncollectibility) during the quarter, less amounts recovered on loans and leases previously charged off.

Nonperforming Assets—the sum of loans past-due 90 days or more, loans in nonaccrual status and noninvestment real estate owned other than bank premises.

Primary Capital—total equity capital plus the allowance for loan and lease losses plus minority interests in consolidated subsidiaries plus qualifying mandatory convertible debt (cannot exceed 20 percent of total primary capital), less intangible assets except purchased mortgage servicing rights.

Net Loans and Leases—total loans and leases less unearned income and the allowance for loan and lease losses.

Net Assets Repriceable in One Year or Less—all assets with interest rates that are repriceable in one year or less plus assets with remaining maturity of one year or less, minus all liabilities that are repriced or due to mature within one year of the reporting date. A positive value indicates that banks' income from assets is more sensitive to movements in interest rates than is the expense of their liabilities, and vice-versa for a negative value.

Temporary Investments—the sum of interest-bearing balances due from depository institutions, federal funds sold and resold, trading-account assets and investment securities with remaining maturities of one year or less.

Loan Loss Expense—the quarterly addition to the loan loss reserve that will keep the balance of the reserve adequate to absorb the quarter's anticipated loan losses.

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