Banking 1988: The eye of the storm

Profits up, asset quality improved, regional performance better, banking enjoys a spell of calm weather—but will it last?

George Gregorash and Eileen Maloney

After a downbeat 1987, U.S. banks rallied in 1988, posting record earnings and registering return-on-assets (ROA) rates unseen since the 1970s. In large part, the reversal reflected the rebound at the nation's largest banks, where Latin debt provisions had greatly reduced 1987 profits. But, even absent the large-bank recovery, commercial banking profitability in 1988 rose smartly, as lower loan-loss provisions mirrored generally improving asset quality.

These impressive results gave surprisingly little comfort to industry observers, as the year's good earnings news was overshadowed by a nagging array of difficulties and uncertainties in the financial services arena. Foremost among the concerns was the impact of the resolution of current thrift industry problems. The details of the Financial Institution Reform, Recovery, and Enforcement Act remain in negotiation, but the resolution of thrift insolvencies will influence banking both in the short term and well into the future. The immediate task for bankers is to maintain depositor confidence, particularly in the wake of adverse thrift publicity and over 200 bank insolvencies in 1988, while adjusting to the potential real estate market effects of new management of sizable thrift holdings. In the longer term, the issues of redesigned or repriced deposit insurance premiums, altered supervision and regulation, and the conflict between aggressive profit and safe and sound operations leaves bankers and analysts alike wondering, "Who will be our competitors? What will be our powers?" And "How and how much will we pay for safety net privileges?"

Likewise, the granting of limited underwriting powers under Section 20 of the Glass-Steagall Act offered an immediate palliative in the ongoing debate on expanded bank powers, but the ultimate reconciliation of the evolution in financial products with the structure of financial regulation remained elusive. Even under the most desirable expanded-powers scenario for bankers, the stock market break of 1987 and the subsequent slowdown in underwritings served as a reminder of the risks, as well as the opportunities, of the trading/underwriting environment.

On the international scene, both Europe 1992 and the continuing Latin debt situation further complicated the financial services equation. The Europe 1992 initiative added immediacy to the complex issue of national treatment versus reciprocity in international bank powers. Although 1988 bank earnings were not hindered by Latin debt provisioning (unlike 1987), the debt-servicing capacity of certain Latin countries remained a difficult and continuing problem. Add to these, the problems in the Southwest oil patch and other primary commodity-producing areas, leveraged-buyout financings and the continuing

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financial restructuring of corporations, and highly localized but dramatic real estate losses in the eastern U.S. and it is clear that despite strong earnings and stronger balance sheets, the outlook for banking was rich with volatility and uncertainty.

Although most of these issues are not new, and have been much discussed, by the close of 1988 they seemed to have moved from the theoretically challenging to the pressingly real. These issues penetrate deep into the heart of contemporary finance. But for the record books, the scorecard for banking in 1988 was an enviable one that recalled simpler days.

Profits rebound

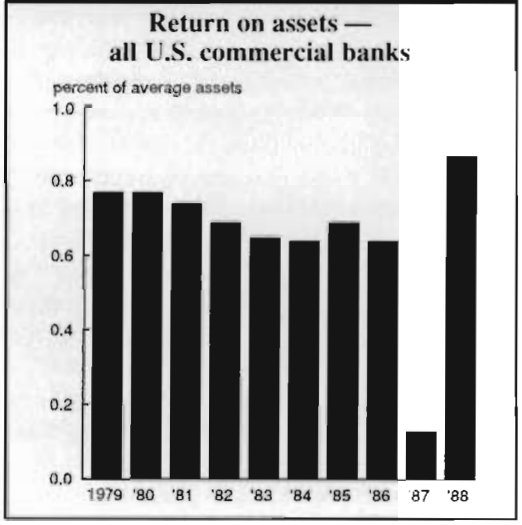
The ROA for U.S. banks in 1988 was 0.87 percent of average assets, a considerable improvement over the 0.13 percent reported in 1987, the lowest ROA since the Depression era. And, except for 1985, 1988 was also the first time in the last ten years that U.S. ROA rates increased over the prior year. (See Figure 1.) Further, the distribution of U.S. earnings rates narrowed, reflecting fewer unprofitable firms. (See Figure 2.) In 1988, approximately 13.5 percent of U.S. banks lost money, compared with 18 percent in 1987. The bulk of the decline in unprofitable banks came from the Midwest and the Southwest, where the number of banks losing money, relative to the U.S. total, dropped 56 percent and 35 percent respectively compared with 1987.

At yearend 1988, the U.S. had 12,792 banks with total assets of $3.1 trillion. Most of the banks (97 percent) are community banks with less than $1 billion in assets. The 349 banks over $1 billion made up 3 percent of all U.S. banks, but they held 69 percent of total banking assets. Consequently, the largest banks in the country have a disproportionate effect on the aggregate performance of the industry. This is best demonstrated in the 1988 reported ROAs.

Sectoral improvement

While large-bank performance had the greatest impact on aggregate measures, earnings improvements were spread across all size groups and sectors. All regions' ROAs rebounded from 1987 and most also surpassed their 1986 levels (which did not reflect LDC provisioning). (See Figures 3 and 4.) The strongest rebound was in the West where both provisions and high noninterest expenses declined. ROA rates in the West went from 0.35 percent in 1986, to –0.05 percent in 1987 to 0.91 percent in 1988. The Southwest also showed signs of moderating stress. While the composite Southwest region continued to register losses, the rate of decline slowed. The Southwest region ROA remained in the negative range at –0.66 percent in 1988 compared with –0.83 percent in 1987 and –0.41 percent in 1986. The number of unprofitable firms in the Southwest declined from 1987 although more than 30 percent of these banks still have negative earnings. In both 1987 and 1988, the unprofitable Southwest banks accounted for a third of U.S. banks with losses.

FIGURE 1



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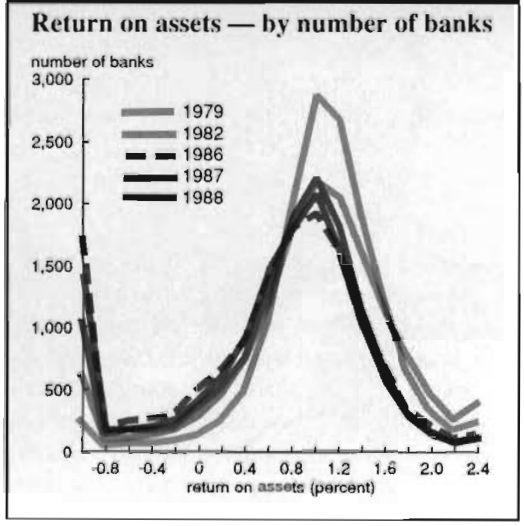

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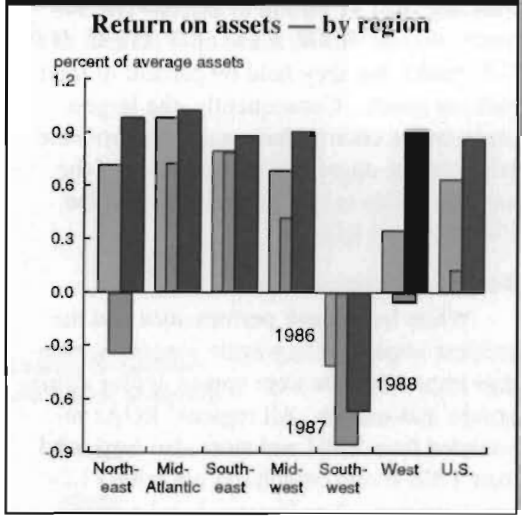


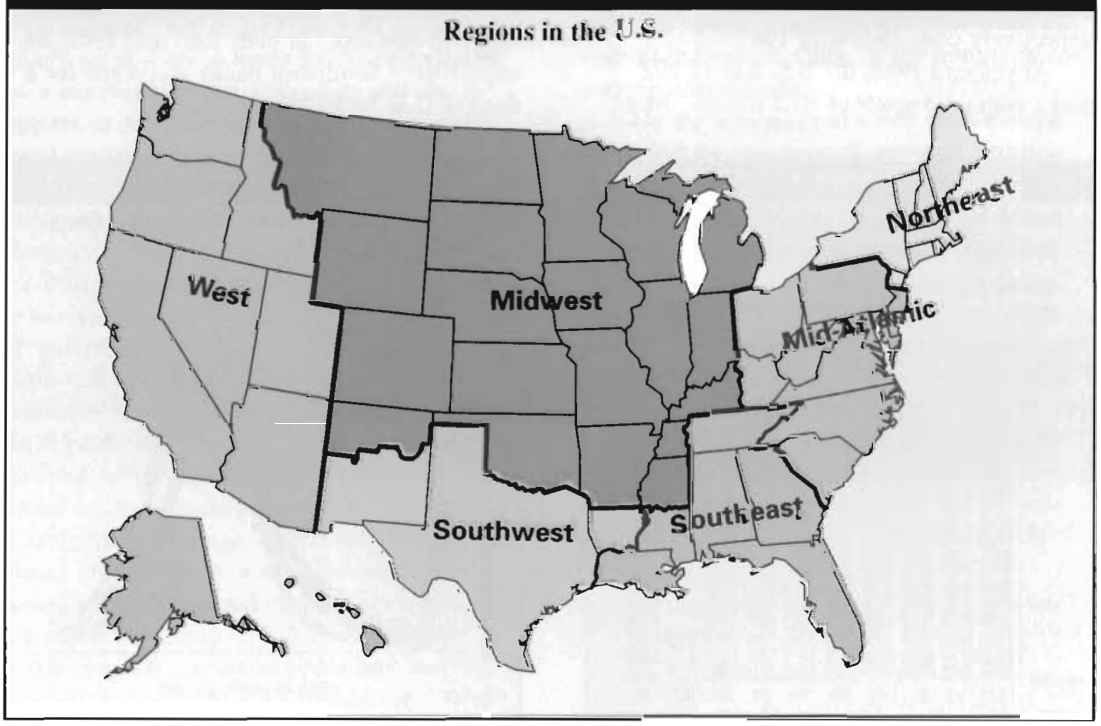
Asset quality improves

Reductions in provisions set aside for problem loans drove the earnings improvement. U.S. provisions declined to 0.49 percent of average assets in 1988 from 1.24 percent in 1987. The drop in loan-loss provisions was consistent with the steadily declining levels of nonperforming assets. (See Figures 5 and 6.) Nonperforming assets for the U.S. totalled 2.12 percent of total assets, down from 2.46 percent in 1987. This reversed the increase experienced by the large banks in 1987, reflecting Latin debt nonaccruals. Nonperforming assets to total assets declined for all regions of the country in 1988, with the exception of the Northeast. Its ratio increased marginally to 2.84 percent from 2.81 percent in 1987 because of slight increases in nonperforming real estate and individual loans.

With roughly stable net charge-offs, lower loan-loss provision levels, and growing loan portfolios, the U.S. loan-loss reserves relative to total loans declined in 1988 to 2.39 percent from 2.70 percent in 1987. But as nonperforming levels also declined, the U.S. coverage ratio of loan-loss reserves to nonperforming loans actually rose in 1988 to 83 percent versus 79 percent in 1987 and 60 percent in 1986. This was true for all regions except the Northeast where the coverage ratio dropped to 72 percent from 79 percent in 1987.

While total U.S. assets grew 3.7 percent in 1988, that is not the cause for the decline in the nonperforming-assets-to-total-assets ratio—merely a contributing factor. The dollar value of nonperforming assets declined over

FIGURE 4



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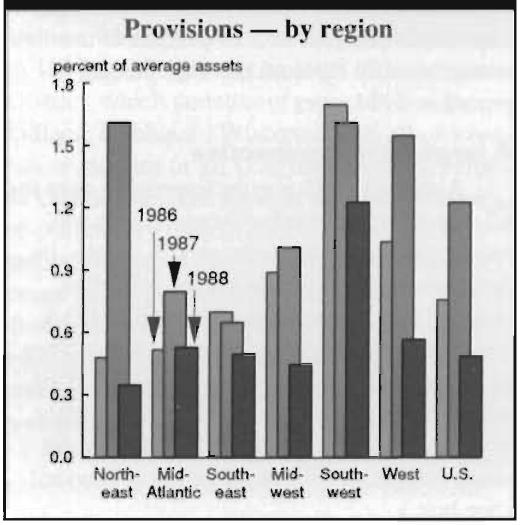

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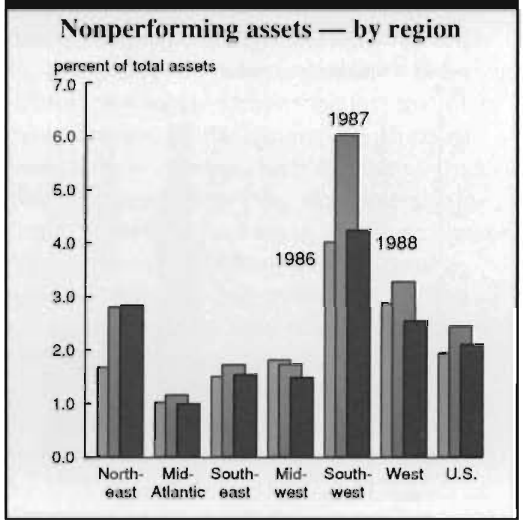


the year from $72.2 billion in 1987 to $64.6 billion in 1988 as a result of LDC restructuring and charge-offs and general improvement in loan portfolios across the country. The bulk of the decline in nonperforming assets came from nonperforming loans although other real estate owned also declined for all size groups and all regions with the exception of the Northeast and the West. Barring any economic downturn, the downward trend of nonperforming assets should continue as sectoral weaknesses continue to improve.

Delinquent loans, 30-89 days past due, were stable in 1988 for the nation. However, this was true only as a percent of loans, not in terms of dollar value. Delinquent loans totalled $31.2 billion in 1987 compared with $31.6 billion in 1988. But because the U.S. loan growth was 5.1 percent in 1988, the ratio remained the same, year to year. Real estate delinquencies were up in all regions with the exception of the Midwest and the Southwest. The Southwest region's total delinquent loans moved from 2.97 percent of loans in 1987 to 2.18 percent in 1988. In contrast, the Northeast region exhibited an increase with total delinquencies moving from 1.31 percent of loans to 1.61 percent in 1988 as real estate loan delinquencies increased 66 percent.

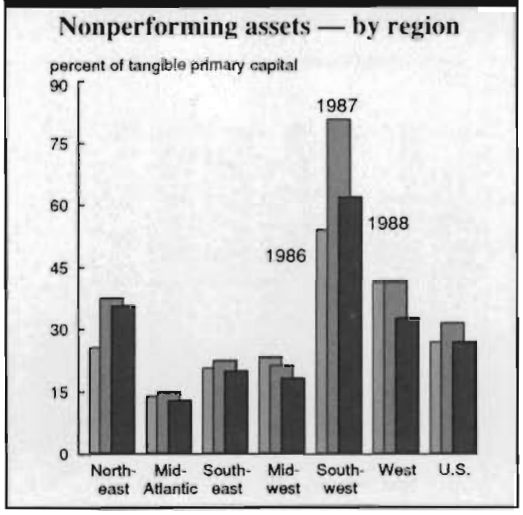
Declining dollar levels of nonperforming assets were part of improved balance sheet positions of banks. Growing capital levels were also a factor. With the exception of the Southwest region, all sizes and sectors of U.S. banks showed improvement in capital from 1987. For the U.S. as a whole, tangible primary capital grew to 7.78 percent of tangible assets in 1988 from 7.67 percent a year ago. Unlike in 1987, capital growth in 1988 was not the result of increased loan-loss reserves but rather higher income retention and equity financings.

On a national level, then, the proportion of tangible primary capital encumbered by nonperforming assets declined to 26.82 percent in 1988 from 31.44 percent in 1987. However, the decline in the ratio was brought about primarily by the large banks. As with ROA, the Southwest region showed improvement with nonperforming assets moving to 62.08 percent of tangible primary capital from 79.54 percent in 1987. (See Figure 7.)

Stronger cost control

The issue of rising overhead costs relative to assets is one that transcends economic cycles. The cost of doing business has been steadily rising over the past decade as the banking environment has rapidly evolved. As competition in the industry increased from interest rate deregulation, interstate banking, and expanded bank powers, the pressure to control costs and increase the bottom line has also grown. Over the past two years, many headlines announced cost-cutting measures within the banking industry. The increased emphasis on cost containment and the focus on improving efficiency appears to have begun

FIGURE 7



paying off for U.S. banks in that overhead costs did not rise in 1988 but remained constant since last year at 3.25 percent of average assets, but still up from the 3.02 percent reported in 1984.

A large-bank perspective

Although 1988 was an improving year for all size groups of banks, improvement was most pronounced at the large U.S. banks, i.e., those over $10 billion in assets, reflecting reduced LDC provisions. Their 1988 ROA soared to 0.95 percent of average assets from -0.67 percent in 1987. (See Figure 8.) This positive performance was reflected not only in their financial statements but also by the stock market as their stock prices rebounded. (See box.)

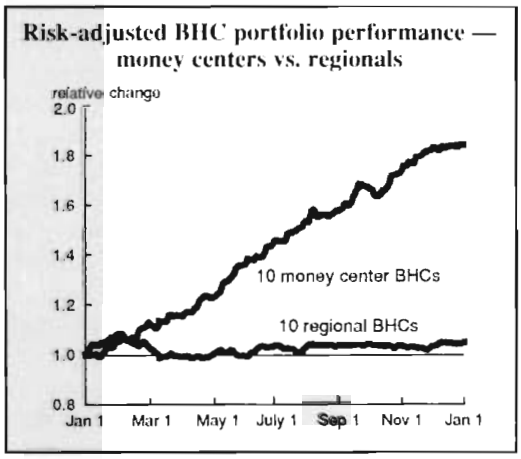
Banking 1988: A market view

Money center bank stocks performed impressively during 1988, rebounding from a lackluster performance during the prior year. Concerns about the LDC debt problem, domestic asset quality, and low relative capital levels abated during the year as money center banks began reaping the benefits from actions taken to address these concerns.

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 (finance, insurance, and real estate) specifically. Thus, the model produces a return adjusted for market risk and industry risk.

The model uses actual firm and market returns (change in the firm's stock price, adjusted for dividends and stock splits) for 1987 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 1988, 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 then cumulatively summed over the year to show risk-adjusted performance over time. Average performance is then calculated for money center banks and regional banks by selecting ten banks from each group, summing the performances of each bank in the group, and dividing the result by ten.

The average performance of the share values of the ten money center banks increased consistently throughout the year relative to the market and the industry. Although a few money center banks enjoyed returns of well over 50 percent from depressed 1987 levels, their large gains



Improvement was also the case for the large banks in the Seventh Federal Reserve District whose ROA went from –1.47 percent in 1987 to 0.86 percent in 1988. The Seventh District, which consists of parts of Illinois, Indiana, Michigan, Wisconsin and all of Iowa, has 18 percent of all U.S. banks and 12 percent of U.S. assets. The District consists primarily of community banks (2,323) although 32 banks with more than $1 billion in assets account for 48 percent of District assets. The disproportionate effect of large banks on aggregate performance measures noted earlier was also true for the District, though the effect was not as evident as it is in the U.S.

In addition to declining provision levels, net interest margins for U.S. large banks improved to 3.04 percent of average assets in 1988 from 2.86 percent in 1987. Improved margins were generally attributable to better interest yields and the recognition of Brazilian interest payments. Despite the fact that most banks recognized the income, the Brazilian loans remain in nonperforming status. Under current financial reporting requirements, income on the Brazilian loans will be recognized only to the extent of cash received until a period of payment performance by the Brazilian government has been established. While not readily apparent in the ratios, large bank margins were adversely affected in 1988 as Argentine loans went into nonperforming status.

accounted for only part of the increase in the average. Individual plots of eight of the ten firms included in the sample resulted in curves that were similar in shape and direction to the one shown.

Several factors contributed to this impressive performance. The market apparently downgraded its perception of the LDC situation from crisis to problem proportions as money center banks increased loan-loss reserves during 1987 to reflect more conservatively the value of these loans. Several money center banks also decreased their LDC exposure either by outright loan sales or some other form of restructuring. The substantial reduction in loan-loss provisions in 1988, combined with the results of cost containment measures initiated during the past two years and an increase in noninterest income resulted in substantially higher profits during 1988. This increase in income led to improved capital ratios (i.e., total equity to total assets) at nearly all of the money center banks examined as well as increased dividend payouts at several banks. Still another factor that contributed to impressive stock price performance by money center banks in 1988 was an improvement in asset quality reflected by drops in both non-LDC nonperforming loans and non-LDC charge-offs. In addition, recent underwriting powers granted by the Federal Reserve as well as further development of investment banking activities may have contributed to increased optimism among investors.

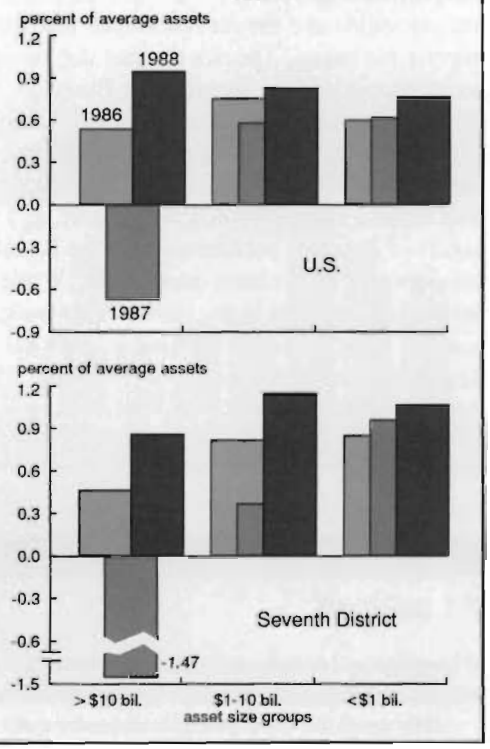
The portfolio of large regional bank stocks did not fare as well as the money center banks during 1988. As shown by the graph, the risk-adjusted return of the ten money center banks exceeded the risk-adjusted return of the ten regional firms. However, within the group of ten regional banks, there was significant disparity in performance. Some regional bank firms experienced deteriorating fundamentals due to management changes, credit quality concerns, merger difficulties, as well as various other problems, while others continued their stellar performance of previous years.

The impressive performance of regional banks in 1987 actually contributed to the disparity between the two lines shown in the graph. Regional bank stocks were already highly valued by the market by the end of 1987. Thus a relatively flat performance in 1988 by regionals should not be viewed too negatively in light of their strong 1987 performance. In contrast, money center bank stocks performed poorly in 1987. The positively sloped line for money centers indicates improved performance relative to the prior year.

—Philip M. Nussbaum

FIGURE 8

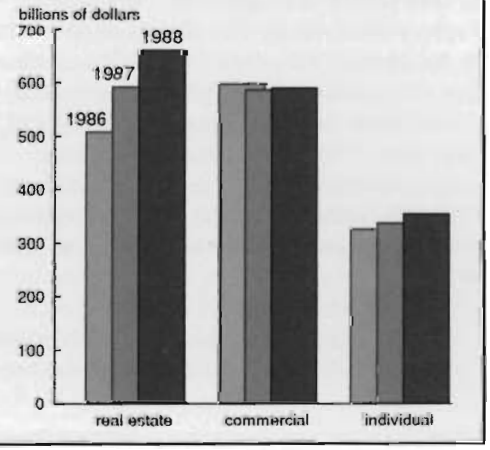
Return on assets — by asset size



Given the rising margins, one might look more closely at the loan portfolio. In 1988, large banks' total loans accounted for 37 percent of the U.S. loan portfolio. Within the U.S. loan portfolio distribution, commercial loans have been displaced by real estate loans as the largest portion of the total portfolio. (See Figure 9.) Given the weakness in various real estate markets across the country and the increase in real estate loan delinquencies, this could be an alarming trend. But, one must also consider the changing activities of the large banks in the United States. Large banks are not booking as many commercial loans, because their corporate customers can issue their own commercial paper to raise needed funds. And, securitization of loans allows banks to book loans and then package and sell them to increase fee income.

FIGURE 9

Loan portfolio distribution — all U.S. commercial banks



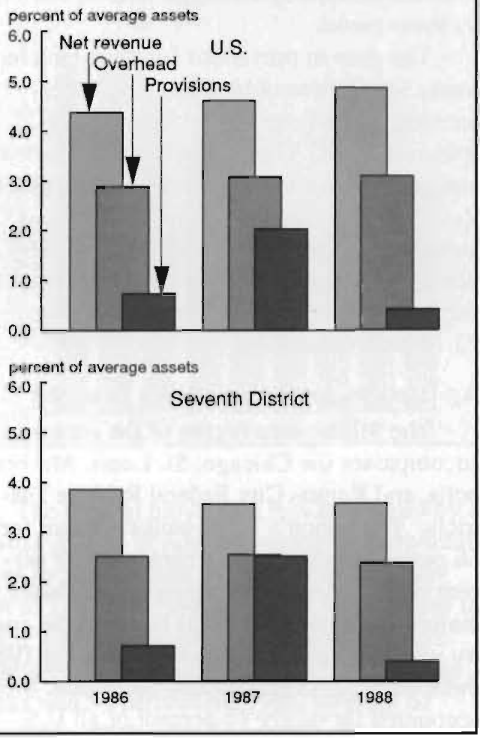
Increased noninterest income also aided large-bank revenues. Technological advances have led to increases in and greater dependence on noninterest income as increased competition has cut banks' income from traditional banking activities. Total noninterest income for District large banks was 1.43 percent of average assets compared to 1.29 percent in 1987. Income from foreign exchange continued to be a major contributor to the earnings of District large banks and accounted for 0.21 percent of average assets for 1988 compared to 0.18 percent in 1987. The bulk of the increase in noninterest income, however, comes from the "other" category which includes the sale of buildings, pension reversals, and other discretionary income items. It appears that this category has become increasingly important to the large banks. The noninterest "other" category for District large banks grew to 0.80 percent from 0.75 percent of average assets in 1987. Total noninterest income for U.S. large banks was 1.85 percent in 1988, up from 1.77 percent in 1987. The "other" category for these banks grew from 1.07 percent in 1987 to 1.10 percent in 1988.

In addition to generating additional revenues to improve the bottom line, large banks also benefitted from increased overhead cost control. District large banks showed substantial improvement with overhead costs dropping to 2.41 percent of average assets from 2.57 percent a year ago. The overhead costs for U.S. large banks rose very marginally to 3.12 percent from 3.10 percent a year ago. (See Figure 10.)

Nonperforming asset levels have declined. District large banks reported nonperforming assets of 2.11 percent of total assets, down from 2.26 percent in 1987. The higher ratio in 1987 was caused by LDC exposures, especially Brazilian loans. District large banks

FIGURE 10

Earnings analysis — banks with over $10 billion in assets



also reported a 1988 increase in net charge-offs to 1.17 percent of total loans (versus 0.96 percent in 1987), attributable to charge-offs made against LDC loans. Similar trends were seen nationally. Nonperforming assets as a percent of total assets for U.S. large banks declined to 3.02 percent from 3.55 percent in 1987. This represents a substantial decline despite the Argentine nonaccruals in 1988. And, net charge-offs rose to 1.08 percent of total loans from 0.89 percent in 1987.

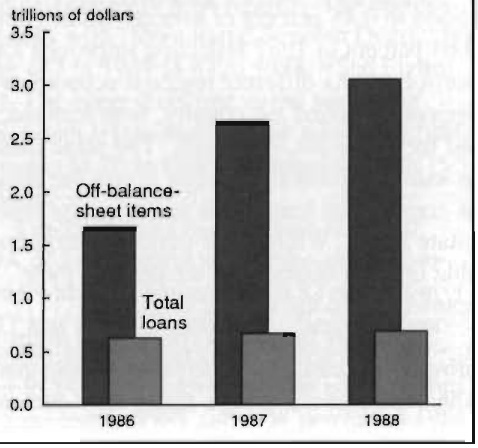
An ongoing issue, particularly for the large banks, will be the ability to resolve the LDC concerns without significant additional charge-offs. The Brady Plan envisions resolving each LDC debt problem with a customized plan of forgiveness, interest abatement, and new money loaned on some form of collateralized basis. The economic and political uncertainties of some of these countries presents a continuing adverse environment for either short- or long-term solutions.

Despite the decline in loan-loss reserves as a result of decreased provision levels and stable net charge-offs, tangible primary capital levels grew in 1988. Like ROA ratios, most of the growth in capital was attributed to the large U.S. banks, whose tangible-primary-capital-to-tangible-assets ratio grew to 7.66 percent from 7.39 percent in 1987. With record earnings, the large U.S. banks contributed to capital levels by increasing the amount of income retained in 1988 to 61 percent of income, up from 56 percent in 1986 and from 1987 when this size group had negative earnings (although they still paid dividends). As did large U.S. banks, District large banks also retained a larger share of income in 1988 (72 percent) versus 1987, causing tangible primary capital to increase to 7.83 percent of tangible assets from 7.20 percent in 1987.

These measures of capital adequacy, however, only take into account the assets on banks' books. Off-balance-sheet items such as loan commitments, standby letters of credit, foreign exchange contracts, and interest rate swaps, through which much of the large banks' noninterest income is generated, will also be considered for risk-based capital ratios being implemented from 1990 to 1992. As these items are growing rapidly, it is appropriate that tangible-primary capital ratios are also increasing. (See Figure 11.) At yearend 1988, District off-balance-sheet items were 81 percent of total assets compared to 66 percent in 1987. Comparative totals for the U.S. were 112 percent in 1988 and 101 percent in 1987. For District large banks, these ratios are considerably higher at 295 percent of total assets for 1988 and 220 percent for 1987. Likewise, U.S. large banks had off-balance-sheet items

FIGURE 11

Off-balance-sheet items and total loans — banks with over $10 billion in assets



equalling 273 percent of total assets in 1988 compared to 246 percent in 1987. Off-balance-sheet items for the large banks in the New York Federal Reserve District were 391 percent of total assets in 1988, up from 337 percent in 1987. If these items were to be included as assets on the balance sheet, the effect would be to reduce risk-adjusted returns far more substantially.

Smaller banks

Although the improvement in bank earnings was driven principally by the large banks, other size groups also reflected improvement. Banks in the $1-to-$10-billion-asset category reflected the trends seen in the largest U.S. banks. ROA rates improved in 1988 to 0.83 percent from 0.58 percent in 1987 when LDC provisions negatively influenced earnings. Noninterest income also rose 5 basis points to 1.49 percent of average assets in 1988. Asset quality also improved in 1988 as nonperforming assets to total assets declined to 1.47 percent from 1.71 percent in 1987. This also bodes well for the future because regional and super-regional banks were more aggressive than money center banks in eliminating LDC risk from their portfolios. This reduction was accomplished through loan sales, charge-offs, and debt-for-equity swaps.

The smaller community banks, under $1 billion in assets, continued the trend of improved ROAs, moving to 0.77 percent from 0.63 percent in 1987. Noninterest income and net interest margins were fairly stable from 1987 at 0.89 percent and 4.07 percent of average assets, respectively.

The rise in 1988 profitability for smaller banks came from two sources. As with the rest of the industry, loan-loss provisions declined to 0.48 percent of average assets from 0.64 percent in 1987 reflecting improved loan portfolios. As different regional economies improved around the country, loan demand, led by real estate, increased. The same trend in loan distribution was seen in smaller banks as commercial loans were surpassed by real estate loans. While these trends are explainable in large banks, they are perhaps more noteworthy in the smaller ones.

The other factor that contributed to improved profitability was lower overhead costs. The overhead-to-average-assets ratio declined to 3.27 percent from 3.30 percent in 1987. Given the amount of workouts with problem loans, the fact that overhead declined at all should be considered a major accomplishment by these banks.

The drop in provisions for these smaller banks was borne out by a drop in nonperforming assets from $18.4 billion to $16.2 billion in 1988. The nonperforming-assets-to-total-assets ratio fell from 1.91 percent in 1987 to 1.71 percent in 1988. Asset quality was better with respect to capital, also, as 19.65 percent of tangible primary capital was encumbered by nonperforming assets versus 22.18 percent last year.

Ag banking strong despite drought

The Midwestern region of the country encompasses the Chicago, St. Louis, Minneapolis, and Kansas City Federal Reserve Districts. The region's 7,134 banks account for 56 percent of the nation's banks and 23 percent of the assets. The region also includes the majority of agricultural (ag) banks in the country which are generally small in size. In 1988, there were 1,635 ag banks in the region; these accounted for nearly 13 percent of all U.S. banks but only 1.3 percent of total banking assets. For the purposes of this article, we define ag banks as those having more than 30 percent of their loan portfolio consisting of agricultural loans.

Midwestern ag areas, benefitting from government subsidies and higher prices obtained for available inventories, continued the improvement begun in 1987. Despite severe drought in parts of the Midwest, agricultural banks continued their regeneration from the lean times of the early 1980s. The Midwestern ag banks reported a 1988 ROA of 0.94 percent of average assets versus 0.65 percent in 1987, and a substantial increase from the 0.29 percent reported in 1986. These ROAs have not yet reached the levels of the early 1980s, but they are a marked improvement from the mid-1980 levels. This recovery is even more significant when compared with the Midwestern non-ag banks' ROAs of 0.91 percent, 0.41 percent and 0.71 percent for 1988, 1987 and 1986, respectively. (See Figure 12.) Once again, the driving factor behind earnings was the decline in loan-loss provisions to 0.37 percent of average assets in 1988 from a high of 1.59 percent in 1985.

FIGURE 12

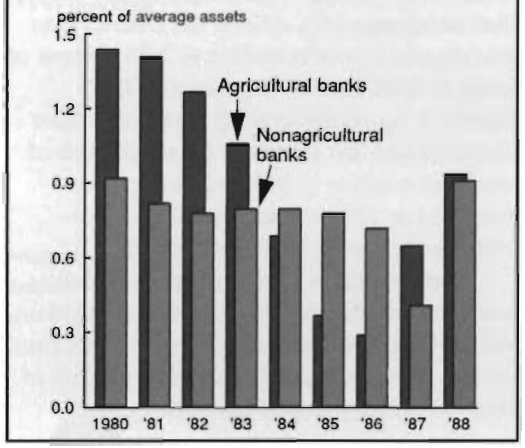
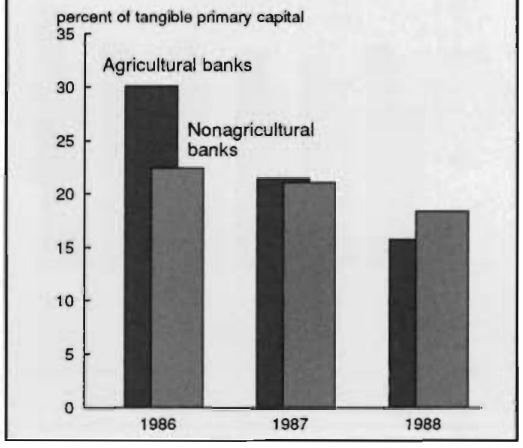


FIGURE 13



The drop in provisions was backed up by a similar decline in nonperforming loans to total loans to 2.45 percent in 1988 from 3.53 percent in 1987 and from a high of 5.50 percent in 1985. Further, the coverage ratio (loan-loss reserves to nonperforming loans) for these ag banks was 94 percent for 1988, up from 67 percent in 1987.

Asset quality with respect to capitalization looked even stronger. Nonperforming assets to tangible primary capital fell from 21.53 percent in 1987 to 15.81 percent in 1988. The ag banks' ratio is now lower than the non-ag banks in the region, which reported 18.49 percent this year compared to 21.13 percent last year. (See Figure 13.) This can be attributed to one of the ag banks' traditional strengths—strong capitalization despite some very dark times. Tangible primary capital for these banks grew to 10.60 percent of tangible assets in 1988, up from 10.21 percent in 1987. This far exceeds the 7.99 percent reported by non-ag banks in the region in 1988.

Performance in 1989 will be dependent on whether the drought conditions of 1988 are repeated in the new year. The current forecasts for 1989 are still guarded. Based on the 1988 ratios, it would appear that the drought did not seriously affect farmers, or their bankers, in 1988. However, concerns remain over the current level of subsoil moisture and the ability to continue to recover should dry conditions prevail for another year.

Seventh District

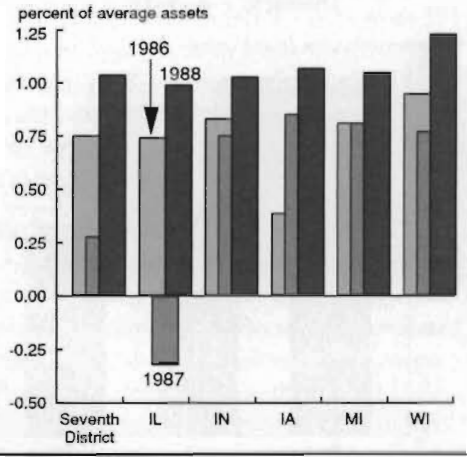
Seventh District banks shared in 1988's bounty, with particularly strong gains recorded by community banks. A stronger industrial economy buoyed many District banking firms. In the early years of the current economic recovery period, the Seventh District did not share in the national recovery and was in fact adversely affected by both the poorly performing agricultural and manufacturing sectors. Now, as economic improvement continued, banks in these sectors demonstrated stronger performance.

In fact, since 1986, Seventh District banks outperformed the U.S. as a whole. The Seventh District's 1988 ROA of 1.04 percent easily surpassed the District's prior decade high set in 1979. (See Figure 14.) Further, fewer banks registered losses or low earnings rates. This was partially offset by fewer banks earning extremely high returns. The number of banks with losses in the Seventh District fell from 173 in 1987 to 82 in 1988. (See Figure 15.) The biggest decline in the number of banks with losses was in Iowa which fell from 60 banks to 20 in 1988, as compared with 165 in 1986.

The District ag banks reported a 1988 ROA of 1.08 percent of average assets compared with 0.76 percent and 0.32 percent in 1987 and 1986, respectively. Nearly 70 percent of these ag banks are located in Iowa; their ROA has improved to 1.06 percent from 0.85 percent in 1987 and 0.38 percent in 1986.

FIGURE 14

Return on assets — Seventh District

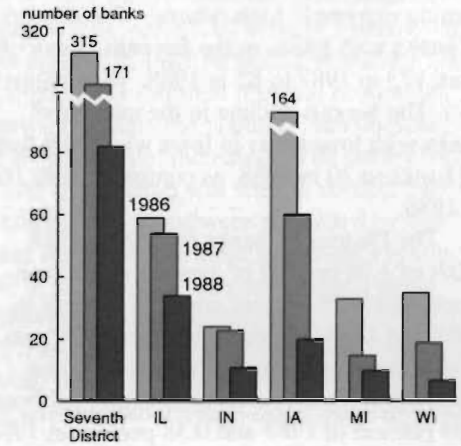


As in the rest of the nation, reduced provision levels resulted in higher ROAs. Notably, Iowa banks had the highest provision levels of the states in the District in 1986 with 1.17 percent; in 1988 they had the lowest with 0.24 percent of assets.

In addition to lower provisions, overhead cost control has also contributed to an improved bottom line. In 1984, overhead expenses for District banks were 2.82 percent of average assets and they rose steadily through 1986. The incremental upward spiral of the past several years reversed in 1987 as District overhead expenses declined to 2.95 percent from 2.97 percent in 1986. District overhead expenses improved further in 1988 to 2.91 percent of average assets.

FIGURE 15

Banks with net losses — Seventh District

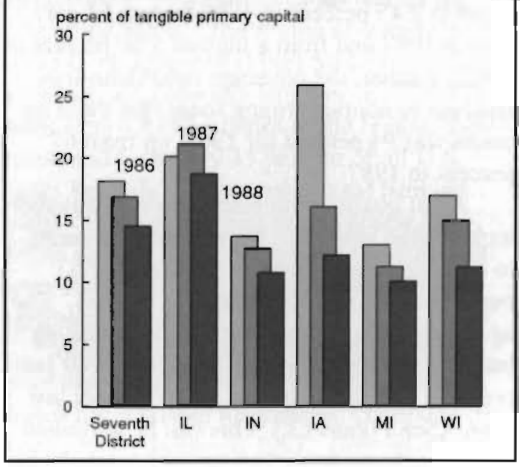


As with most of the nation, District nonperforming assets improved from 1.33 percent of total assets in 1987 to 1.16 percent in 1988. Reduced provision levels coupled with stable loan net charge-offs, caused the District loan-loss reserve levels to decline to 2.23 percent of loans in 1988 from 2.58 percent in 1987. However, as nonperforming loan levels have also declined, the District's coverage ratio of loan-loss reserves to nonperforming loans remained at 128 percent, unchanged from 1987, and up from 75 percent in 1986.

Both decreases in nonperforming assets and increases in tangible primary capital resulted in a lesser encumbrance of District bank capital. Nonperforming assets as a percent of tangible primary capital declined to 14.52

FIGURE 16

Nonperforming assets — Seventh District



percent compared to 16.90 percent in 1987. (See Figure 16.) Tangible primary capital to tangible assets for the Seventh District in 1988 was 7.91 percent, up from 7.74 percent in 1987.

Conclusion

While traditional banking performance measures in 1988 harkened back to a calmer period for banking, the year was one that placed the industry in the center of revolutionary change. Basic, long held assumptions about bank product lines and competition became increasingly difficult to maintain, while regulatory reform and crisis resolution moved the banking industry toward less calm—and more unpredictable—weather.