

## Banking vital signs now vs. 1988-90 (October 2009)

Many comparisons are made to the last recession. So far, things are better now

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As the banking industry makes its way through the economic downturn, it's useful to put the situation in perspective by comparing industry performance in the current recession to that of the banking problems in the late 1980s to early 1990s. At present, the situation looks to be relatively better. Further examination reveals a strong foundation compared to the previous period.

### Higher provisioning, higher reserves

#### Despite Federal Reserve

Chairman Ben Bernanke's recent statement that the recession has likely ended, many banks are expecting more delinquencies. In second quarter of 2009, 4.4% of industry loans were 90 days past due or in nonaccrual status. Although on par with the peak levels reached in 1987 and 1990, the trend line today has yet to show signs of peaking.

It follows, then, that banks have had to provision more against loan losses. During the current cycle, the ratio of two-year average provisions to net charge-off reached 169% as of June 2009, compared to 150% as of December 1990. Loss provisions to net operating revenue also show the banking industry provisioning a higher percentage of dollars in this down-cycle than in the past. In the last two years, the industry provisioned on average 28% of net operating revenue compared to the average two-year provisioning in 1990 of 20%.

Due to the aggressive buffering, the industry is now better reserved than it has been in the last 30 years. As the industry grew during the strong economic period of the middle 2000s, reserve ratios generally fell. However, this was due to lending portfolios expanding to keep up with demand. Now, banks are reserving more than in the past—up to 2.8% of their portfolios. The unloading of bad loans and tightening of lending standards have also contributed to the rise in reserve ratios.

### Stronger capital

One of the other most noticeable differences between this period and

the last is the higher levels of capital held by banks. As the table below demonstrates, the industry increased its holdings in all categories of capital.

Moreover, there is broad evidence that banks of all asset sizes generally hold more capital now as compared to the earlier year.

This stronger capital base, coupled with greater reserves, has allowed banks to better absorb the shock of the current financial crisis. This goes a long way toward explaining why bank failures, while continuing, are way down in number as compared to the earlier period.

#### Industry profitability

The strong provisioning for losses has taken its toll on bank income. Over a three-year period ending in the second quarter 2009, the percentage of banks that had negative net income rose from 7% to over 25%. In comparison to the late 1980s to early 1990s, the level of non-profitable banks is higher and ramped up more quickly than in the previous cycle.

As a result, industry return-on-assets has fallen to lows last seen in the 1980s—after nearly two decades of holding over one percent. In the previous down-cycle, ROA bounced between positive and negative growth over a four-year period. If this cycle is like the last, then the industry is in for a longer spell of slow growth. This seems likely, as the current recession has already lasted longer than the recession of 1990-1991.

#### FDIC-insured banks' capital ratios

12/31/1990  
6/30/2009

Equity capital  
6.16%  
10.56%

Core capital  
5.74%  
8.25%

Tier 1 risk-based capital  
7.67%  
11.05%

Total risk-based capital  
9.52%  
13.76%

#### Total risk-based capital ratio

12/31/1990  
6/30/2009

Assets <\$100MM  
14.80%

18.88%

Assets \$100MM &ndash; \$1B  
11.41%  
14.10%

Assets \$1B &ndash; \$10B  
8.87%  
13.46%

Assets >\$10B

Source: FDIC

8.12%  
13.68%

#### Shift in revenue mix

Over the last 20 years, the industry's net interest margin averaged 3.8% and even exceeded 4% during the early 2000s. However, the current NIM environment of 3.5% is similar to that seen in 1990. Not surprisingly, the industry has responded by diversifying its sources of income, seeking more stable revenues. As a result, loans and leases have declined as a portion of industry assets. Over the last 20 years, loans and leases represented 60% of assets. Over the last two years, however, as the industry sold and wrote-off loans, the percentage of loans and leases fell to 55.7%.

With shrinking interest margins, a decelerating economy, and uncertain regulatory environment, banks have sought to diversify their revenue streams into more fee-based businesses. At year-end 1990, non-interest income represented just 1.4% of average assets. Through the mid-to-late 1990s, non-interest income climbed to a high of 2.5%. Due to the present economic fallout, non-interest income declined to 2.0%, which still represents significant change from 1990.

Another positive for earnings has been control of expenses. Helped by developments in technology and growing synergies across financial product lines, the industry has reduced operating costs. In comparing historic efficiency ratios, industry non-interest expenses fell as a percentage of net operating revenue from the mid-70% range in the 1980s to the high-50% range by the early 2000s. With the entry of more non-depository institutions into business lines and a spike in the cost of funding due to concerns over risk, the industry has continued to streamline expenses and grow its operating revenue.

The performance of every bank tracks the economy and customers it serves, sometimes with a lag.

The storm isn't over, but the banking industry has certainly shown its resilience through some pretty tough weather so far. BJ

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