

Banking by John Hoefle

The quarter of the living dead

That rosy glow we are being shown on the banking statistics comes from the mortician's makeup.

The 11,198 insured U.S. commercial banks earned \$10.4 billion in the second quarter of 1993, the second highest quarterly profit ever recorded, after the record \$10.9 billion reported in the first quarter of this year, the Federal Deposit Insurance Corp. (FDIC) reported in its *Quarterly Banking Profile* released Sept. 7. That gives the banks an unbelievable \$21.3 billion profit for the first six months of this year, higher than the full-year totals for all but two years in the past decade. The banks reported \$25.2 billion in profits in 1988 and \$32.2 billion in 1992, and are on a pace to top \$40 billion this year.

One would hardly know the banking system is bankrupt, from looking at those figures.

According to an FDIC press release, a record \$9.8 billion of the second quarter profit came from "core earnings," which the agency defines as "profits from traditional banking activities." Given that, as we have previously reported, 40% of the \$2.2 billion in second quarter profits at the six big derivatives banks (Citicorp, J.P. Morgan, Bankers Trust New York, Chemical Bank, Chase Manhattan, and BankAmerica) came from speculative trading, one wonders exactly what the FDIC means by traditional banking activities.

The "main source of the increase in core earnings," however, was an alleged "improvement in asset quality," according to the FDIC. This rebound of asset values, quite remarkable in a deepening depression in which asset values are collapsing, allowed the banks to set aside only \$4.2 billion in

new reserves for loan losses, the lowest quarterly provision since the \$3.6 billion set aside in the first quarter of 1989. For the first six months of 1993, the banks set aside \$4 billion less in loan loss reserves than they did in the same period in 1992.

The banks' reported levels of non-performing loans have dropped \$28.8 billion over the past 30 months, from a peak of \$85 billion in the first quarter of 1991, to \$54 billion at the end of the second quarter. That \$29 billion equals 40% of the \$72 billion in profits the banks reported over the period.

During that same period, the banks' loan loss reserves have dropped slightly, from \$55 billion to \$54 billion, peaking at \$55.8 billion in the first quarter of 1992.

This plummeting of reported non-performing loans has, despite the drop in reserves, caused the level of loan loss reserves to zoom from some 65¢ for every dollar of reported bad loans in the first quarter of 1991, to 100% today.

Another factor contributing to these alleged profits, the FDIC said, is "higher net interest income." The banks reported \$34.8 billion in net interest income in the quarter, up \$1.8 billion from the same period in 1992, thanks to a "net interest margin" of 4.47%. Average funding costs fell for the tenth consecutive quarter as interest rates remained low and banks continued to shift toward shorter-term, lower-cost sources of funds.

Total equity capital increased by \$8 billion during the second quarter, to \$282 billion, on top of a record rise of \$10 billion in the first quarter, for

a first half increase in capital of \$18 billion.

Thanks to this allegedly profitable environment, the number of banks on the FDIC's "problem list" continues to drop, to 580 banks with assets of \$326 billion at the end of the second quarter, from 956 banks with assets of \$495 billion a year earlier. The number of problem banks has dropped steadily since it peaked at 1,559 banks with assets of \$329 billion at the end of 1987. The amount of assets at banks on the problem list peaked at \$535 billion, in 981 banks, in the third quarter of 1992.

This miraculous improvement in the banking statistics — not to be confused with any improvement in the banking system itself, of course — has also resuscitated the FDIC's Bank Insurance Fund, which supposedly protects depositors. The BIF, which peaked at \$18 billion in 1987, plummeted to a negative \$7 billion at the end of 1991, then rebounded to a negative \$100,000 at the end of 1992 and a positive \$6.8 billion at the end of the second quarter.

Thanks to this \$6.9 billion in income for the first six months of 1993, the FDIC was able to complete the repayment of principal and interest on BIF working capital borrowings from the Federal Financing Bank. These Treasury borrowings, which were authorized in 1990 as part of the commercial bank bailout package, were as high as \$15 billion as late as September 1992, the FDIC reported.

Part of the BIF's recovery comes, not surprisingly, from a \$4.6 billion decline in its own reserves for loan losses, to \$6.2 billion. The justification for this decline, is the FDIC's new forecast that commercial banks and savings banks with assets of \$10 billion are likely to fail in 1993, down from the previous estimate of \$25 billion.