A REVIEW OF BANK PERFORMANCE IN THE FIFTH DISTRICT, 1983

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The profitability of Fifth District banks improved dramatically in 1983. The .98 percent return on average assets and 15.2 percent earned on average equity capital were well above the average returns of recent years. With interest rates well below prevailing yields of the previous few years and loan demand that lagged the increase in business activity by several months, most banks found it difficult to generate a strong stream of interest revenue. Consequently, noninterest revenue sources and cost reductions contributed more to increased profits than did growth in interest income. Despite changes in liability structure and lower market rates, which caused a significant decrease in average interest expenses, net interest as a share of average assets still fell 17 basis points. A strong gain in noninterest income offset most of the decline in net interest margins, however. Reductions in provisions for loan loss and losses on securities transactions, and lower noninterest expense growth were major factors in increased net earnings.

The cost structure of Fifth District banks was strongly influenced by deposit deregulation. The Garn-St. Germain Depository Institutions Act of 1982 authorized banks to offer a money market deposit account (MMDA). MMDAs became available on December 14, 1982 and permitted the public to earn market rates of interest on deposits with limited transactions features. MMDAs are available to all customers and carry a reserve requirement of 3 percent on nonpersonal accounts, but no reserve requirements on personal accounts. The Depository Institutions Deregulation Committee (DIDC) also authorized banks to offer a Super-NOW account on January 5, 1983. Super-NOWs are fully transactional accounts that pay unregulated interest rates on initial and maintained balances of at least $2,500. Super-NOWs carry transaction account reserve requirements of 12 percent and are available to a limited clientele including nonprofit organizations, households and government agencies. Fifth District banks attracted over $15 billion in MMDAs and Super-NOWs. In doing so, these banks altered the structure of liabilities and greatly increased the yield sensitivity of deposits. This recomposition was instrumental in reducing interest expense since a large volume of the funds that flowed into these deregulated consumer accounts were shifted from higher cost-managed liabilities or longer term deposits.

Banks of all sizes expanded revenue from noninterest sources and reduced loan-loss provisions and noninterest expense. In spite of the increase in aggregate profitability, cash dividends declined 3 basis points as a percent of average assets. Retained earnings, however, increased almost 45 percent. As a consequence, both the rate of retained earnings and internal equity growth also increased substantially. Nonetheless, asset growth outpaced equity growth so that leverage increased for the third consecutive year. Table I summarizes the main components of income and expense relative to average assets for all Fifth District banks for the years 1979-83.

Interest Revenue

The gross return on assets, which is the ratio of gross interest revenue to average assets, declined for the second year in a row. In the aggregate, Fifth District banks collected 9.58 percent for each dollar of assets compared with 10.86 percent in 1982. This reduction in gross returns is a reflection both of prevailing market yields that remained substantially below the average yields of the past few years (see Chart 1) as well as the pattern and composition of asset growth over the year. While banks of all sizes expanded loan and investment security portfolios, security holdings grew substantially faster than loans until the fourth quarter. As a consequence, banks were less successful in generating current interest income than in expanding the asset base. Approximately 70 percent of Fifth District banks reported

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Table I

INCOME AND EXPENSE AS A PERCENT OF AVERAGE ASSETS
FIFTH DISTRICT COMMERCIAL BANKS, 1979-1983

Item	1979	1980	1981	1982	1983
Gross interest revenue	8.49	9.46	11.15	10.86	9.58
Gross interest expense	4.53	5.60	7.29	6.93	5.82
Net interest margin	3.96	3.86	3.86	3.93	3.76
Noninterest income	.80	.90	1.01	1.03	1.16
Loan loss provision	.26	.26	.25	.28	.25
Other noninterest expense	3.24	3.37	3.48	3.53	3.45
Income before tax	1.26	1.13	1.14	1.15	1.22
Taxes	.28	.20	.19	.18	.22
Other[2]	−.04	−.04	−.09	−.10	−.02
Net income	.94	.89	.86	.87	.98
Cash dividends declared	.30	.32	.33	.37	.34
Net retained earnings	.64	.57	.53	.50	.64
Average assets ($ millions)	80,671	88,280	97,217	108,439	121,173

[1] Average assets are based on fully consolidated volumes outstanding at the beginning and at the end of the year.

[2] Includes securities and extraordinary gains or losses after taxes.

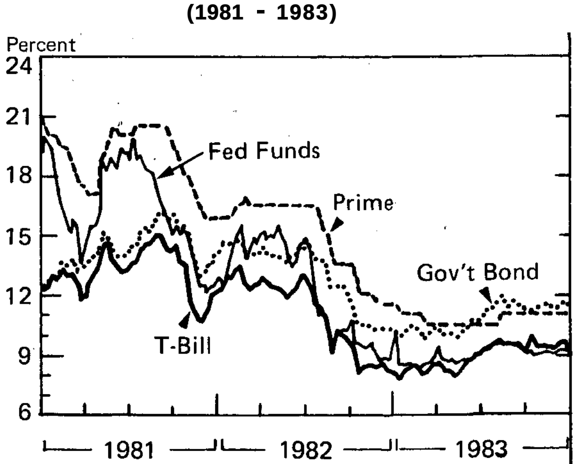
year-end 1983 interest earnings in excess of the previous year's figure. Of those that reported higher interest earnings, few were able to accumulate interest revenue proportionally to asset growth.

The sharpest deterioration in gross returns occurred at banks with $750 million or more in assets. As a group, these large banks experienced a 141 basis point reduction in the interest revenue average assets ratio (see Chart 2). None of these institutions reported an increase in gross return on assets. An inability to generate a stream of interest revenue commensurate with asset growth characterized banks in all size categories, however. Only 6 percent of the banks with less than $750 million in assets recorded an increase in the gross return on assets. In contrast, over 70 percent of all banks in the Fifth District reported an increase in interest revenue scaled to average assets in 1982.

Chart 1

SHORT- AND MEDIUM-TERM RATES

(1981 - 1983)



As indicated in Table II, the effective yield on gross loans declined 176 basis points on average. The reduction in loan yields at banks with less than $100 million in assets was more modest. Specifically, these small banks reported a decline in loan yields of 89 basis points. Because of a relatively high incidence in small bank portfolios of fixed-rate consumer loans and mortgages bearing the high yields inherited from the past, the average yield at small banks was partially insulated from the reduction in market rates. Conversely, the decline in the return on loan portfolios was steepest at the large banks because these institutions are more vulnerable to interest rate fluctuations. Short-term and floating-rate loans with yields that are sensitive to market conditions account for a large fraction of large-bank loan portfolios. Medium-sized banks with loan port-. folios similar in character to large bank portfolios

Table II

AVERAGE RATES OF RETURN ON SELECTED INTEREST-EARNING ASSETS
FIFTH DISTRICT COMMERCIAL BANKS, 1979-1983

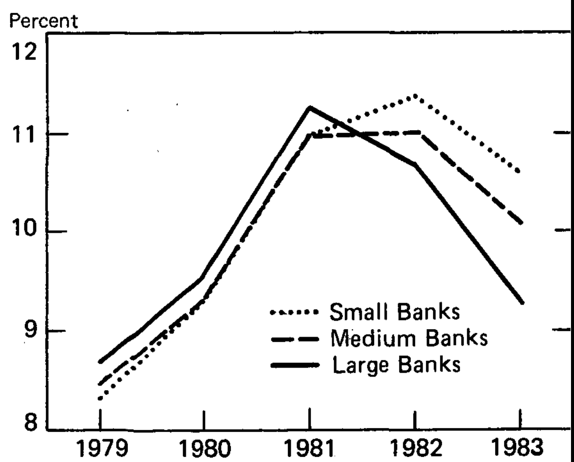
Item	1979	1980	1981	1982	1983
Gross loans	11.25	12.50	14.48	14.14	12.38
Net loans	11.37	12.63	14.64	14.30	12.53
Total securities	6.43	7.15	8.57	9.27	9.20
U. S. Government	8.14	9.16	11.22	11.79	11.17
State and local	5.17	5.56	6.11	6.68	6.74
Other	2.88	3.25	4.20	5.82	5.96
Total interest-earning assets	10.09	11.28	13.18	12.68	11.11

also reported a significant deterioration in average loan yields. Medium-sized banks are banks with less than $750 million in assets but more than $100 million.

The share of Fifth District bank assets allocated to loans rose by approximately one percent. There was significant variation in the pattern and rate of growth of different loan categories during the year (see Table III). Only the volume of commercial real estate loans grew steadily throughout the year, although consumer credit activity accelerated over the last three quarters after a lethargic first quarter. Consumer mortgage and commercial and industrial (C&I) loan extensions were considerably more erratic. Growth in all four major loan categories peaked in the fourth quarter. The expansion in C&I loans and consumer credit occurring after September exceeded 40 percent on an annual basis. C&I loan growth over that period was even stronger for the large bank group.

Chart 2

GROSS INTEREST RATIO*



*Interest revenue divided by average assets.

Table III

QUARTERLY GROWTH RATES IN
SELECTED LOAN CATEGORIES IN 1983

Loan Category	Q1	Q2	Q3	Q4
Home mortgages	2.1	2.0	1.6	7.0
Commercial real estate and development loans	3.0	4.1	6.5	9.2
Commercial and industrial loans	2.5	3.8	2.5	11.7
Consumer loans	−2.7	5.1	7.1	11.4

Returns from securities portfolios at all banks declined 7 basis points. This decline reflected the lower yields on federal treasury and agency securities and the enormous volume of these investments which banks purchased. Fifth District banks added almost $6 billion of these investments to asset portfolios. This growth in federal security holdings was especially strong over the first three quarters but tapered off in the fourth quarter to coincide with the resurgence in loan demand.

Interest Expense

With market rates remaining substantially below the average level of recent years, the average cost of interest-bearing liabilities declined 186 basis points (see Table IV). In response to the ongoing deposit deregulation, banks of all sizes expanded their holdings of rate-sensitive liabilities and reported sub-

Table IV

AVERAGE COST OF FUNDS FOR SELECTED LIABILITIES
FIFTH DISTRICT COMMERCIAL BANKS, 1979-1983

Item	1979	1980	1981	1982	1983
Time and savings accounts	7.15	8.68	10.63	9.91	8.19
Large time deposits	9.96	11.33	14.35	12.05	7.62
Deposits in foreign offices	10.28	13.17	15.18	12.79	7.73
Other deposits	6.16	7.54	9.23	9.12	8.34
Subordinated notes and debentures	8.19	8.20	8.11	8.34	8.32
Federal funds and repurchase agreements	11.94	13.34	15.54	11.21	8.52
Other	6.98	8.65	13.49	11.29	8.75
Total	7.60	9.13	11.23	10.10	8.24

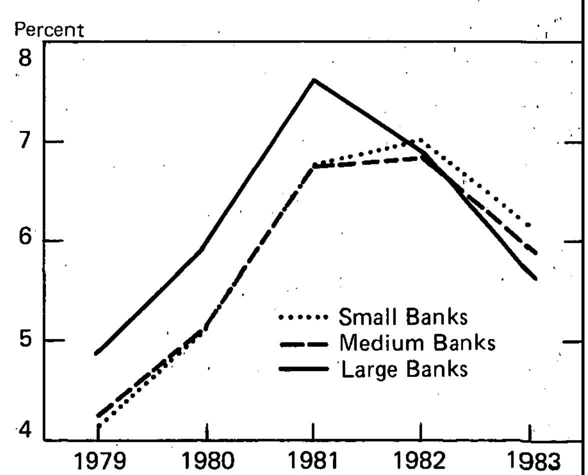
stantial reductions in the average cost of funds. Interest expense per dollar of average assets, the interest expense ratio, declined from 6.93 percent to 5.82 percent, on the average. The decline was most pronounced at the large banks where interest expense ratios declined 120 basis points (see Chart 3). Reductions in interest expense were evident at banks of all sizes, however. District-wide, 97 percent of the banks reported lower expense ratios and 65 percent lower total interest expenditures than in 1982.

Most categories of interest-bearing liabilities showed an average cost decline of at least 250 basis points compared with 1982. The decline in the effective interest rate paid on certificates of deposits (CDs) and balances of foreign offices was markedly steeper. Because a substantial portion of CDs bearing high interest rates matured and were repriced at the relatively lower yields that prevailed in 1983, the average cost of CDs decreased almost 4.5 percentage points; the 5.06 percentage point decline in the average cost of the highly liquid and rate-sensitive foreign office, deposits was also due directly to the lower market rates. On the other hand, the average interest expense associated with subordinated notes and debentures was virtually unchanged because of the fixed interest rates and relatively long maturities which these liabilities carry. The average effective rate paid on "other" deposits is a weighted average of the interest expense on deposits such as savings and small time deposits, negotiable order of withdrawal (NOW) accounts, Super-NOW accounts and MMDAs. The relatively small decline in the average cost of these funds reflects the net effect of lower market rates and a shift from fixed or low interest deposits, such as savings deposits and NOW accounts, to MMDAs and Super-NOWs, which carry market rates.

Both MMDAs and Super-NOWs were very successful, in attracting funds and both stimulated a major restructuring of Fifth District bank liabilities. The growth of MMDAs was especially dramatic (see, Table V). The weekly flow of funds into MMDAs averaged well over $1 billion for the first month that the deposit was offered. By early March, however, the weekly flow had decelerated to about

Chart 3

INTEREST EXPENSE RATIO*



*Interest expense divided by average assets.

Table V

MONTHLY BALANCES IN MONEY MARKET DEPOSIT ACCOUNTS AND SUPER-NOW ACCOUNTS'

(in millions of dollars)

Date	MMDA	Super-NOW
12/15/82	287.1	-
12/29/82	3,530.2	-
1/26/83	7,581.8	452.8
2/23/83	9,360.7	643.1
3/30/83	10,523.3	799.1
4/27/83	10,975.8	897.3
5/25/83	11,629.6	951.2
6/29/83	12,084.8	1,003.7
7/27/83	12,369.1	1,064.1
8/31/83	12,613.1	1,139.9
9/28/83	12,772.3	1,154.9
10/26/83	13,140.7	1,219.9
11/30/83	13,646.9	1,270.5
12/28/83	13,850.7	1,314.6

[1] Does not include balances at banks with less than $15 million in deposits.

$500 million but still remained at a greater than $100 million pace throughout the first half of the year. By midyear, MMDAs comprised more than one quarter of all savings and time deposits. By year end, they made up approximately 28 percent of these deposits. This share was about ten percentage points lower, on average, at small banks, however.

The growth of Super NOWs was less spectacular than that of MMDAs. However, Fifth District banks accumulated approximately $1.3 billion in Super-NOWs. By December, Super-NOW balances comprised almost 20 percent of all checkable deposits other than demand deposits, such as NOW, ATS and Super-NOW accounts, and 6 percent of traditional demand deposits. At small banks, however, Super-NOW balances comprised well over 30 percent of other checkable deposits and 14 percent of demand deposits by the end of the fourth quarter.

Rates available to MMDA depositors were substantially higher than yields on Super-NOWs throughout the year (see Chart 4).[1] Because of the broad transactions features of Super-NOWs, these accounts carry transaction account reserve requirements and are more costly to service than MMDAs. MMDAs have at most a small reserve requirement and lower service costs than Super-NOWs because they have limited transactions features. The positive spread between MMDA and Super-NOW yields is associated with the different costs of the two accounts. This rate differential was also influenced by marketing strategies, however. The widest spread between MMDA and Super-NOW rates occurred in January when banks were still competing aggressively for MMDAs, in some cases with promotional rates that were out of line with other short-term rates. The spread narrowed to as little as 108 basis points in March and April before rising again in the second half of the year and leveling off at around 140 basis points.

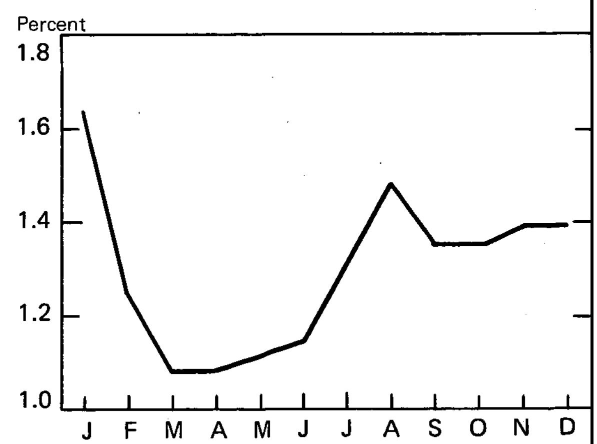
In spite of the higher average return associated with MMDAs, Super-NOW depositors maintained average balances that were substantially above the minimum required to avoid a ceiling on the interest rate paid on the account. Through August, Super-NOW balances exceeded the minimum requirement by an average of almost $12,000.[2] Depositors who maintained such large Super-NOW balances rather than shifting excess funds to an MMDA, forfeited interest at the average annual rate of 1.3 percentage

[1] Yields on MMDAs and Super-NOWs are based on a stratified sample of Fifth District banks and are weighted averages. Constituting the weights are the balances of the individual institutions.

[2] Based on a stratified sample of Fifth District banks. Data are not available after August 1983.

Chart 4

SPREAD BETWEEN MMDA AND SUPER-NOW RATES



points. Assuming average excess Super-NOW balances of approximately $12,000 per account were maintained throughout the year, then these depositors sacrificed approximately $150 in interest per account.

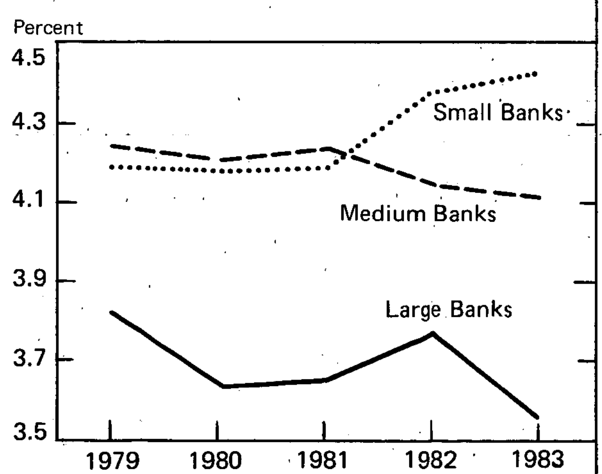
Net Interest Margins

Net interest income, that is, the difference between interest income and interest expense, declined 1 7 basis points relative to the average assets of Fifth District banks. Banks in different. size categories, however,, reported markedly different experiences, experiences that are obscured by the aggregate figure (see Chart 5). Only 13 percent of the banks with $750 million or more in assets recorded increases in net interest margins from 1982. The ratio of net income to average assets declined 21 basis points for these large institutions as a group. Net interest margins expanded 5 basis points at small banks as 55 percent of banks with less than $109 million in assets reported increased margins. While margins also increased at a majority of the medium-sized banks, the net income average assets ratio declined 4 basis points for these banks as a group because of the relatively steep declines registered at some of the larger banks in this asset category.

With aggregate interest income virtually unchanged and the ratio of interest income to average assets declining at 95 percent of Fifth District banks, the ability to control interest expense was a critical determinant of the level and pattern of change in net interest margins during 1983. On the average, banks with expanded net interest margins managed to generate only 1.1 percent more interest income in 1983 than in the previous year; banks with contracted margins reported a .l percent. decline in interest income (see Table VI). Differences in interest expense were more significant. Interest expense declined 7.2 percent and 3.4 percent, respectively, for banks reporting expanded, or conversely, contracted net interest margins. Banks with increased net margins were able to reduce interest costs more rapidly than banks with unchanged or depressed margins because these institutions held a higher proportion of liabilities bearing, market yields.

Chart 5

NET INTEREST MARGIN*



*Net income divided by average assets.

Noninterest Revenue and Expenses

Provisions for loan loss decreased relative to average assets for all banks. This decline accounted for a 3 basis point increase in aggregate profitability. The reduction in loan loss provisions relative to average assets was of approximately the same magnitude at large and small banks and was associated with an improvement in loan quality due to the cyclical expansion.

Cash losses net of recoveries declined approximately 12 percent. Relative to average assets, loan losses decreased most rapidly at the small banks, but were lower at banks of all sizes. Actual loan charge-offs declined 3 percent in the aggregate, while cash recoveries grew by over 22 percent.

Increases in noninterest revenue outpaced growth in assets, as noninterest income rose by over 26 percent in 1983. This dramatic increase in noninterest earnings reflects the more widespread use of explicit pricing of services and a greater dependence on noninterest income as a source of profit. For example, revenue from credit card fees, loan service fees and other miscellaneous fees rose by over 30 percent. Service charges on deposits increased by 19 percent. The increase in deposit service fees is associated with the growth of deposits bearing market interest rates. The largest banks registered the largest increase in deposits service charge income.

The ratio of noninterest expense to average assets declined at banks of all sizes. Increases in wages and salaries were almost 20 percent lower than in 1982. This deceleration in the rate of growth of labor costs accounted for three quarters of the 8 basis point contraction in noninterest expense ratios. Increases in other operating and occupancy expenses were in the order of 10 percent.

Table VI

CHANGES IN NET INTEREST MARGINS IN RELATION TO INTEREST INCOME AND INTEREST EXPENSE GROWTH RATES AND LIABILITY COMPOSITION IN 1983

Total Assets ($ millions)	Number of Banks	Interest Income Growth	Interest Expense Growth	Percent of Rate-Sensitive Liabilities[1]	Percent Change in Net Margin
Less than 100					
Increased margin	269	3.8	- 5.4	59.4	10.6
Others	228	4.1	2.4	57.4	- 8.0
100 to 750					
Increased margin	51	1.9	- 6.6	59.4	9.8
Others	38	.9	- 1.7	57.0	- 8.8
750 and over					
Increased margin	6	- .8	- 8.4	61.2	2.1
Others	28	- .7	- 4.2	59.5	- 8.9
All banks					
Increased margin	326	1.1	- 7.2	60.3	6.2
Others	294	- .1	- 3.4	59.1	- 8.8

[1] Rate-sensitive liabilities include deposits in foreign offices, fed funds purchased, interest-bearing demand notes issued to the U.S. Treasury and other liabilities for borrowed money, and all time and rovings deposits except: NOW accounts, ATS accounts, savings deposits subject to federal regulatory ceilings and IRA and Keogh plan accounts.

Profits and Dividends

Before-tax profits edged up 7 basis points to 1.22 percent of average assets in 1983. The improvement in profitability was twice as great at small banks. However, an increase in taxes relative to average assets offset more than half of the gains in before-tax returns. In the aggregate, taxes increased 4 basis points as a share of average assets. The increase in the tax average asset ratio was almost 6 basis points at small banks.

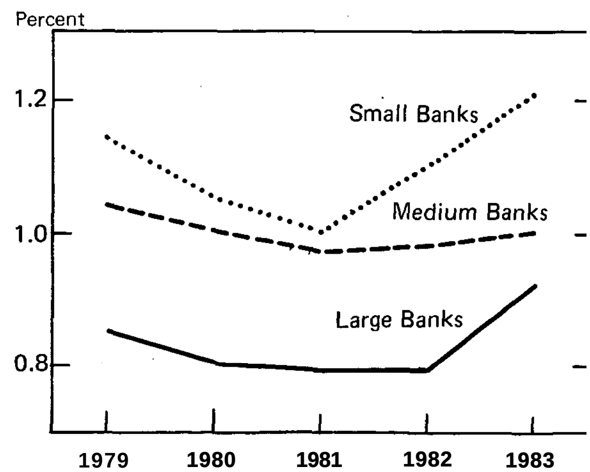
Banks of all sizes reduced losses on securities transactions. Small and medium-sized banks broke even on the year. While large banks registered some losses, these banks did report a substantial improvement in the performance of security operations. In the aggregate; reductions in securities and extraordinary losses contributed to an 8 basis point improvement in net returns.

Net income as a percent of average assets rose to .98 percent, an improvement of 11 basis points over 1982. The gains in average returns were equally impressive at both large and small institutions; gains in earnings rates at medium-sized banks were more modest (see Chart 6). The average return on equity rose by an impressive 2.09 percentage points (see Table VII). The increase in the return on average equity exceeded the improvement in the earnings rate on average assets due to the increase in aggregate leverage. Aggregate leverage measures, such as the average assets/average equity ratio, have increased every year in the Fifth District since 1980.

In spite of the increased profitability, cash dividends on common stock were virtually unchanged from last year and declined 3 basis points relative to

Chart 6

RETURN ON ASSETS*



*After-tax net income divided by average assets.

Table VII

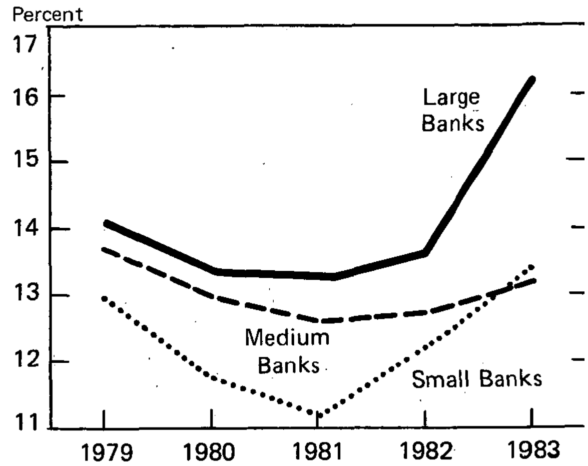
RATES OF RETURN AND LEVERAGE FOR FIFTH DISTRICT COMMERCIAL BANKS[1]

Year	Return on Assets		Assets/ Equity		Return on Equity
1979	.94	x	14.37	=	13.51
1980	.89	X	14.35	=	12.79
1981	.86	x	14.56	=	12.56
1982	.87	X	15.06	=	13.12
1983	.98	X	15.53	=	15.21

[1] The return is net income; assets and equity ore averages. Discrepancies in calculations are due to rounding error.

Chart 7

RETURN ON EQUITY*



*After-tax net income divided by average assets.

average assets in the aggregate. Dividend policies differed significantly at large institutions and banks with less than $750 million in assets. Most of the increase in income at small and medium-sized banks were distributed to stockholders, as, cash dividends increased 15 percent and expanded relative to average assets while retained earnings' kept pace with asset growth. On the other hand, large banks decreased cash dividends and increased retained earnings by an average of 80 percent. Consequently, retained earnings scaled to average assets increased 150 percentage points for the large bank group. In the aggregate, retained earnings relative to average assets rose 14.5 basis points.

Equity capital was expanded by $853 million in 1983, $300 million more than in 1982. Nonetheless, the capital growth rate of 10.3 percent was 2 percent slower than asset growth, and the aggregate leverage ratio, defined as average assets divided by average equity, increased by 47 basis points. This increase in leverage accounted for approximately 20 percent of the 209 basis point increase in the return on equity (see Table VII). The increase in profitability was responsible for the remaining 167 basis point increase in return on equity.

The rate of internal equity growth rose 2.5 percentage points in 1983 and, at an annual rate of 9.96, 'was higher than it has been in a number of years (see Table VIII). As a consequence, the discrepancy between asset growth and internal equity growth narrowed. Asset growth has exceeded internal equity growth since 1980, contributing to the increase in

Table VIII

INTERNAL EQUITY GROWTH RELATIVE TO ASSET GROWTH FOR FIFTH DISTRICT COMMERCIAL BANKS

Year	Return on Equity[1]		Rate of Retained Earnings[2]		Internal Equity Growth	Asset Growth	Internal Equity Growth - Asset Growth
1979	13.51	x	.6819	=	9.21	5.19	4.02
1980	12.79	X	.6418	=	8.20	9.43	-1.23
1981	12.56	X	.6116	=	7.68	10.12	-2.44
1982	13.12	X	.5695	=	7.47	11.54	-4.07
1983	15.21	X	.6547	=	9.96	12.30	-2.34

[1] See Table VII, footnote 1.

[2] The rate of retained earnings is the ratio of net retained earnings to net income.,

aggregate leverage over that period. The increase in the rate of retained earnings and greater profitability contributed about equally to a higher rate of internal equity growth. The rate of retained earnings in 1983 was higher than in any year since 1979. Nonetheless, the increase in equity capital from retained earnings declined substantially (see Table IX). Banks raised $80 million in equity from sources other than income retention such as the equity markets.

Summary and Conclusions

The profitability of Fifth District banks improved significantly in 1983. Dollar profits rose more than 25 percent, and the 98 percent earned on average assets was an 11 basis point improvement over the .87 percent earned in 1982. Moreover, the rate of return on average equity capital increased 209 basis points to 15.21 percent, as asset growth exceeded equity growth for the third consecutive year. This district-wide increase in leverage occurred even though the rate of retained earnings and the rate of internal equity growth increased.

Because market interest rates were below the average levels of the previous few years and loan growth lagged the economic expansion, few banks were able to expand the gross return on assets. As a consequence, the level and pattern of change for net interest margins were strongly influenced by the ability to control interest expense. Banks with a cost structure that was relatively sensitive to changes in market conditions were the most successful in reducing interest expense and increasing net interest margins; many of these low-cost institutions attracted a substantial volume of funds in MMDAs and Super-NOWs. Aggregate profitability was enhanced. by a large increase in noninterest revenue and reductions in noninterest expense and provisions for loan loss.

Given the continued strength in the economy, growth in loan demand and the upward movement in market interest rates, Fifth District banks should be able to expand the flow of interest revenue and increase the gross return on assets in 1984. Since deposit deregulation has led to an increased sensitivity of the commercial bank cost structure to changes in market rates, net interest margins and profitability in general will depend on the ability to contain interest expense should interest rates rise as the year progresses., Net interest margins are likely to be more volatile. Consequently, Fifth District banks must also attempt to increase the revenue flow from noninterest sources and control noninterest expense, especially labor costs, in order to maintain profitability.

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Table IX

RATE OF RETAINED EARNINGS AND SOURCES OF TOTAL EQUITY CAPITAL FOR FIFTH DISTRICT COMMERCIAL BANKS

Year	(1) Net Income ($000)	(2) Net Retained Earnings ($000)	(3) Rate of Retained Earnings1	(4) Increase in Equity Capital ($000)[2]	(5) Increase in Equity Capital from Retained Earnings[2,3]
1979	758,804	517,398	.6819	557,787	.9276
1980	788,145	505,872	.6418	542,487	.9325
1981	840,834	514,278	.6116	558,561	.9205
1982	944,785	538,068	.5695	545,990	.9855
1983	1,179,971	772,571	.6547	852,862	.9059

[1] See Table VIII, footnote 2.

[2] The figures for 1979-1982 have been adjusted to correct for data error.

[3] The increase in equity capital from retained earnings is calculated by dividing column (2) by column (4).