A REVIEW OF BANK PERFORMANCE IN THE FIFTH DISTRICT, 1985

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The profitability of commercial banks in the Fifth Federal Reserve District[1] improved in 1985. Return on assets reached .98 percent and return on equity 15.41 percent, well above the average of the past seven years. In comparison, the corresponding figures for all banks in the United States were .70 percent and 11.33 percent. Such results, and those of the period since significant deregulation of banking began in 1980, indicate that Fifth District banks have been able to adjust well to a more competitive banking environment.

In the Fifth District, improved net interest margins and gains on sales of securities more than offset sharply increased provisions for loan and lease losses. In addition, net noninterest income improved somewhat from last year. The only item in which banks for the nation as a whole outperformed those in the Fifth District was noninterest income. Otherwise, net interest margins for all U. S. banks remained far enough below and loan and lease loss provisions far enough above those for the Fifth District to keep District profitability well above the national average.

Although higher loan and lease loss provisions reduced reported profitability levels, they also served to increase bank capital. In addition, retained earnings rose in 1985 relative to both assets and dividends. The resulting higher capital to asset ratios suggest that banks in the District took advantage of the opportunity provided by their improved performance to augment their capital rather than distribute the gains to stockholders.

Profits

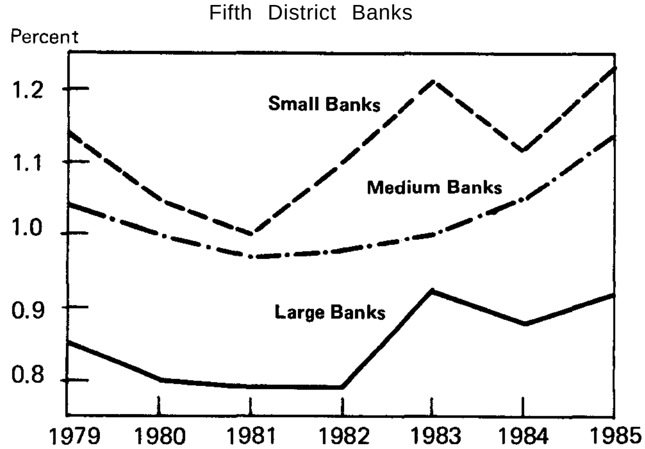
Return on assets (ROA) rose during 1985 from .93 to .98 percent of average assets for Fifth District banks (Table I). ROA also rose at the national level (see Appendix), but remains well below that for the Fifth District. While the District results are higher than the average of the previous six years, it appears that all U. S. banks are only beginning to reverse the steady decline in their ROA that has characterized the same period.

All three size classes of Fifth District banks enjoyed increases in ROA from 1984 levels (Chart 1). Small banks produced an ROA of 1.23 percent in 1985 while medium-sized banks produced 1.14 percent and large banks .92 percent. For large District banks, the improvement in net interest margin was more than offset by increases in loan and lease loss provisions, but noninterest income increased more than did noninterest expense. For small banks, noninterest expense increased slightly more than noninterest income, but the increase in loan and lease loss provision came nowhere near offsetting the increase in net interest margin. Medium-sized banks showed a small net interest margin improvement but had the lowest increase in loan and lease loss provisions. Securities gains ended up playing an important role in the increase in ROA for all three of the size classes.

Chart 1

RETURN ON ASSETS*

Fifth District Banks



***Net income divided by average assets.**

[1] Maryland, the District of Columbia, Virginia, North and South Carolina, and most of West Virginia.

Table I

INCOME AND EXPENSE AS A PERCENT OF AVERAGE ASSETS[1]
FIFTH DISTRICT COMMERCIAL BANKS, 1979-1985

Item	1979	1980	1981	1982	1983	1984	1985
Gross interest revenue	8.49	9.46	11.15	10.86	9.58	10.02	9.48
Gross interest expense	4.53	5.60	7.29	6.93	5.82	6.33	5.70
Net interest margin	3.96	3.86	3.86	3.93	3.76	3.69	3.78
Noninterest income	0.80	0.90	1.01	1.03	1.16	1.15	1.22
Loan and lease loss provision	0.26	0.26	0.25	0.28	0.25	0.33	0.46
Securities gains (- losses)[2]						- 0.02	0.06
Noninterest expense	3.24	3.37	3.48	3.53	3.45	3.37	3.40
Income before tax	1.26	1.13	1.14	1.15	1.22	1.12	1.20
Taxes	0.28	0.20	0.19	0.18	0.22	0.19	0.22
Other[3]	- 0.04	- 0.04	- 0.09	-0.10	- 0.02	0.00	0.00
Return on assets[4]	0.94	0.89	0.86	0.87	0.98	0.93	0.98
Cash dividends declared	0.30	0.32	0.33	0.37	0.34	0.31	0.31
Net retained earnings	0.64	0.57	0.53	0.50	0.64	0.62	0.67
Return on equity[5]	13.51	12.79	12.56	13.12	15.21	14.62	15.41
Average assets ($ millions)	80,671	88,280	97,217	108,439	121,173	137,131	156,574

Note: Discrepancies due to rounding error.

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

[2] Banks were required to report securities gains or losses above the tax line, on their income statements, for the first time in 1984.

[3] Includes securities and extraordinary gains or losses after taxes, for 1979-1983 data, and extraordinary items and other adjustments after taxes for 1984 and 1985 data.

[4] Return on assets is net income divided by average assets.

[5] Return on equity is net income divided by average equity. Average equity is based on fully consolidated volumes outstanding at the beginning and at the end *of* the year.

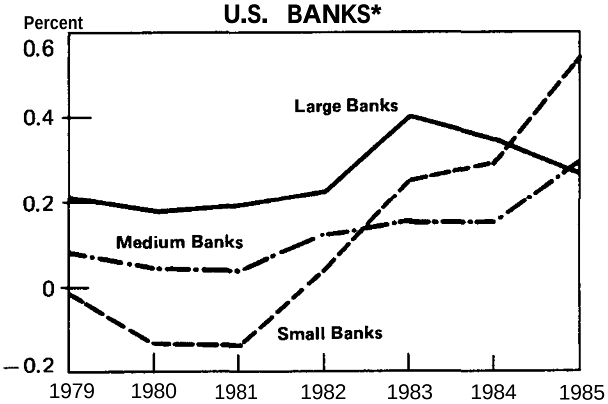
Source: Consolidated Reports of Condition and Income.

For the nation as a whole, ROA for both small and medium-sized banks actually fell. In Chart 2, the difference between Fifth District ROA and that for all U. S. banks is shown for each of the three size classes. While the differences for medium and large banks have remained positive for the years shown on the chart, the difference for small banks has gone from insignificant to negative to positive and increasing-a result of both the changes in small District banks' ROA shown in Chart 1 and the downward trend in small banks' ROA at the national level.

Fifth District banks improved their return on equity (ROE), which is net income divided by average equity capital, by 79 basis points in 1985 (Table II and Chart 3). All three size classes shared in this increase. District banks increased retained earnings as a percent of net income from 67 percent in 1984 to 68 percent in 1985, while banks at the national

Chart 2

DIFFERENCE IN RETURN ON ASSETS BETWEEN FIFTH DISTRICT AND U.S. BANKS*



*Return on assets for 5th District banks minus return on assets for all U.S. banks

Table II

RATES OF RETURN AND LEVERAGE FOR FIFTH DISTRICT COMMERCIAL BANKS

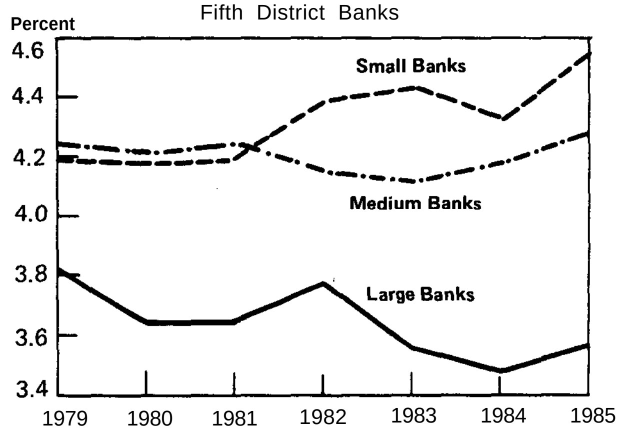
Year	Return on Assets		Assets/ Equity (Leverage)		Return on Equity
1979	0.94	x	14.37	=	13.51
1980	0.89	X	14.35	=	12.79
1981	0.86	X	14.56	=	12.56
1982	0.87	X	15.06	=	13.12
1983	0.98	X	15.53	=	15.21
1984	0.93	x	15.66	=	14.62
1985	0.98	X	15.72	=	15.41

Note: Discrepancies due to rounding error.

Chart 4

NET INTEREST MARGIN*

Fifth District Banks



*Net interest income divided by average assets.

level increased retained earnings from 52 to 53 percent. The higher retained earnings to net income ratio for the Fifth District suggests a greater than average preference for earnings retention as a means of capital growth.

Interest Margin

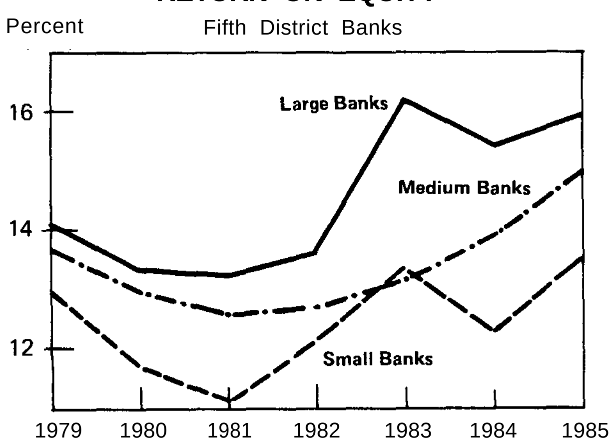
Net interest margin, which measures the difference between interest income and interest expense as a percentage of average assets, grew 9 basis points in the Fifth District in 1985. As Table I shows, the 1985 margin is not particularly high in comparison with the previous six years. At the national level, net interest margin increased by the same amount but to a higher level than any of the preceding six years (Appendix). Still, 1985 Fifth District net interest margin remained well above that for banks in the nation as a whole. Chart 4 shows that net margins increased for all three size categories of banks in the Fifth District. The following paragraphs will discuss the revenue and expense sides of margin performance.

Due largely to falling market interest rates (Chart 5), the ratio of interest revenue to average assets (gross interest ratio) at Fifth District banks fell 54 basis points during 1985. Average returns on both loan and securities portfolios fell by 67 basis points (Table III). As Chart 6 shows, the magnitude of the decline in gross interest ratios varied with bank size. Medium-sized Fifth District banks (total assets

Chart 3

RETURN ON EQUITY*

Fifth District Banks



*Net income divided by average equity

Chart 5

SELECTED INTEREST RATES 1982 - 1985

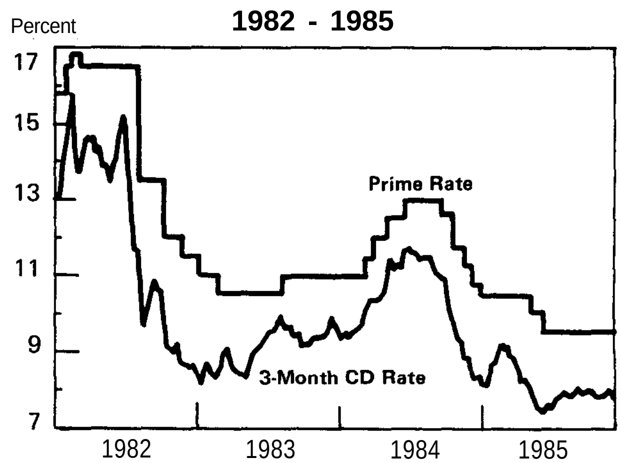


Table III

AVERAGE RATES OF RETURN ON SELECTED INTEREST-EARNING ASSETS
FIFTH DISTRICT COMMERCIAL BANKS, 1979-1985

Item	1979	1980	1981	1982	1983	1984[2]	1985[2]
Total interest-earning assets	10.09	11.28	13.18	12.48	11.11	11.77	11.06
Total loans	11.25	12.50	14.48	14.14	12.38	12.59	11.92
Net load	11.37	12.63	14.64	14.30	12.53	12.74	12.08
Total securities	6.43	7.15	8.57	9.27	9.20	9.68	9.01

[1] Net loans are: total loans net of allowance for loan losses, for 1979-1983; total loans net of the sum of allowance for loan and lease losses and allocated transfer risk reserve, for 1984 and 1985.

[2] Total and net loans here include leases while in other columns they do not.

between $100 million and $750 million) had a far larger average decline than small (total assets less than $100 million) and large (greater than $750 million) banks.

Dissecting the declines in interest income helps to show why each size class performed differently in response to falling interest rates. Due to a less rate-sensitive loan structure, small banks experienced a smaller decline in interest income than either large or medium-sized banks. For example, 48 percent of small Fifth District banks' loans had remaining maturities of one year or less during 1985, while medium and large banks reported an average of 57 percent and 66 percent. In addition, 31 percent of small banks' total loans were home mortgages, compared to 21 percent for medium banks and 12 percent for large banks. Further, consumer loans, which are not particularly interest sensitive, comprised 35 percent of small banks' loans but only 30 percent for medium banks and 27 percent for large banks. Finally, small banks had only 19 percent of their loans in the more interest-sensitive category of commercial and industrial loans, compared with 26 percent for medium and 29 percent for large banks.

The interest sensitivity of the asset portfolios of large Fifth District banks caused their interest income to decline more relative to interest-earning assets than was the case for small or medium-sized banks. Large banks, however, were able to slow the decline of interest income as a percent of average assets by increasing their proportion of earning assets to total assets. For that reason, large banks were able to limit the decline in their gross interest ratio to less than that for medium-sized banks.

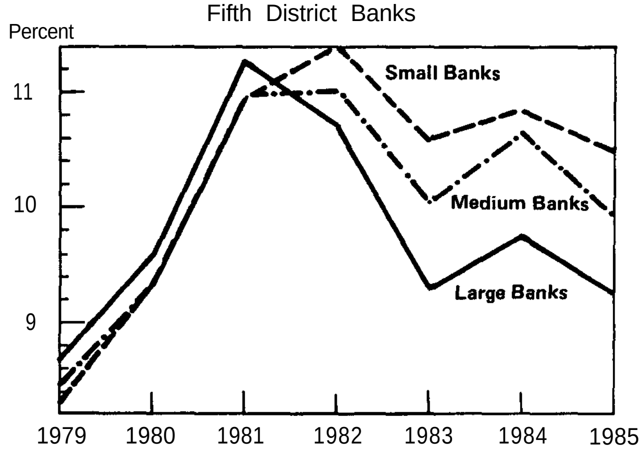
Although Fifth District bank assets grew by more than 14 percent in 1985, loans grew even more so that they constituted a greater proportion of assets than at the end of 1984 (Table IV). Even as money center banks lost business to the commercial paper market, District banks increased their commercial and industrial loans. Home mortgage and agricultural loans were the only categories of loans to fall significantly. Securities also grew as *a* percent of assets.

Turning to the interest expense side of net interest margins, Fifth District banks enjoyed a 63 basis point decline in the interest expense to average assets ratio (Table I). Table V shows that cost of funds fell in 1985 for all categories of liabilities except subordinated debt.[2] As in all the past few years the change in the interest expense ratio was greater for

Chart 6

GROSS INTEREST RATIO*

Fifth District Banks



*Interest revenue divided by average assets.

[2] Subordinated debt consists of fixed maturity debt obligations issued by a bank and subordinated to claims of depositors in case of insolvency.

Table IV

ASSET CATEGORIES AS A PERCENT OF TOTAL ASSETS FIFTH DISTRICT COMMERCIAL BANKS 1984 AND 1985

	1984	1985
Securities	20.72	21.46
Loans and leases - total	58.08	59.77
Home mortgages	9.59	9.07
Commercial real estate and development loans	8.49	9.52
Commercial and industrial loans	16.53	16.59
Consumer loans	15.87	16.73
Other loans	7.27	7.26
Leases	0.74	0.89
Agricultural loans	0.81	0.75
Less: Unearned income on loans	- 1.22	- 1.05
Less: Allowance for loan and lease loss	-0.71	-0.81
Cash and due from balances	12.00	10.39
Fed funds	4.40	4.57
Other assets	5.51	4.62
Total	100.00	100.00

Note: Discrepancies due to rounding error.

the average of all U. S. banks than for Fifth District banks. Just as Fifth District assets are less sensitive to rate changes than the national average, so apparently are District liabilities.

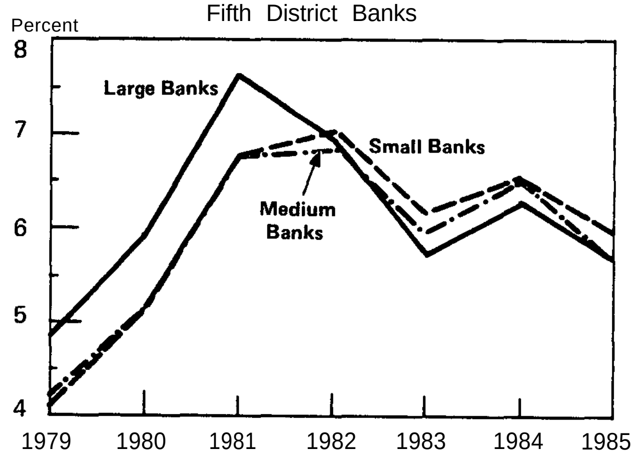
The composition of liabilities in the Fifth District is different from that for banks nationwide, and this may help explain the relatively low interest sensitivity in the District. For example, at Fifth District banks 58 percent of total liabilities had maturities of less than one year, compared with 62 percent for all U. S. banks. In addition, relatively rate-sensitive liabilities, such as large time deposits, deposits in foreign offices, and federal funds purchased, made up 25 percent of total liabilities in Fifth District banks (Table VI) while the corresponding number for all U. S. banks was 33 percent. At the same time, the relatively interest-insensitive category of Savings, Small Time Deposits, and NOW Accounts comprised 34 percent of liabilities in the Fifth District but only 25 percent nationwide.

Although differences between the size classes are not particularly striking, medium-sized District banks experienced the largest fall in interest expense (Chart 7). The implication is that medium banks have more

Chart 7

INTEREST EXPENSE RATIO*

Fifth District Banks



*Interest expense divided by average assets.

Table V

AVERAGE COST OF FUNDS FOR SELECTED LIABILITIES FIFTH DISTRICT COMMERCIAL BANKS, 1979-1985

Item	1979	1980	1981	1982	1983	1984	1985
Interest-bearing deposit accounts	7.15	8.68	10.63	9.91	8.19	8.72	7.89
Large certificates of deposit	9.96	11.33	14.35	12.05	7.62	9.47	7.91
Deposits in foreign offices	10.28	13.17	15.18	12.79	7.73	9.19	7.92
Other deposits	6.16	7.54	9.23	9.12	8.34	8.55	7.97
Subordinated notes and debentures	8.19	8.20	8.11	8.34	8.32	8.03	9.64
Fed funds	11.94	13.34	15.54	11.21	8.52	9.58	7.67
Other	6.98	8.65	13.49	11.29	8.75	9.18	6.73
Total	7.60	9.13	11.23	10.10	8.24	8.84	7.90

Table VI

LIABILITY CATEGORIES AS A PERCENT OF TOTAL LIABILITIES
FIFTH DISTRICT COMMERCIAL BANKS, 1985

	Small	Medium	Large	Total
Interest-bearing deposits	79.86	73.78	59.34	63.48
Large time deposits	8.06	8.03	9.00	8.76
Deposits in foreign offices	0.02	0.00	4.70	3.56
Other interest-bearing deposits	71.78	65.75	45.64	51.16
Super NOWs	3.08	3.39	1.16	1.67
Money market deposit accounts	15.73	17.80	14.86	15.35
Savings, small time, and NOWs	52.96	44.56	29.62	34.13
Subordinated notes	0.05	0.06	0.50	0.39
Fed funds	1.11	4.27	15.79	12.66
Non-interest-bearing deposits	17.46	19.94	19.33	19.21
Demand deposits	16.95	19.66	19.16	19.00
Other liabilities	1.52	1.95	5.05	4.25
Nontransaction savings	11.31	9.35	6.43	7.35

Note: Discrepancies due to rounding error.

rate-sensitive liabilities. Examination of Table VI, however, reveals only that medium-sized banks are heavier than others in the relatively rate-sensitive Money Market Deposit Accounts.

Noninterest Revenue and Expense

Fifth District banks expanded noninterest income relative to average assets from 1984 to 1985. In doing so they returned to the trend of the past few years, after a slight decline in 1984, of increasing reliance on noninterest income. At the national level, banks continued their dramatic gains in the category from last year with a rise of 12 basis points. Other noninterest income, which includes income from fiduciary activities, credit card fees, mortgage loan service fees, and safe deposit box rentals, was the fastest growing component of Fifth District noninterest income, increasing by 6 basis points relative to average assets (Table VII).

Some of the improvement in noninterest income was offset by a 3 basis point increase in noninterest expenses at Fifth District banks, which compared favorably with an increase of 10 basis points at the national level. Although District banks were able to control salaries and bank premises expenses, the Other Noninterest Expense category grew in 1985. This category includes such costs as legal fees, advertising costs, telephone expenses, and federal deposit insurance assessments.

Most of the increase in noninterest income was accounted for by an 8 basis point increase at large banks. Medium-sized banks produced no increase in this category, while small banks raised noninterest income by 4 basis points. The increase for small and large banks was concentrated in the Other Noninterest Income category. **Both large and small banks** experienced a 5 basis point increase in noninterest expense, while medium-sized banks were able to

Table VII

NONINTEREST INCOME AND EXPENSE AS A PERCENT OF AVERAGE ASSETS
FIFTH DISTRICT COMMERCIAL BANKS
1983 TO 1985

Item	1983	1984	1985
Total noninterest income	1.16	1.15	1.22
Service charge income	0.37	0.39	0.39
Leasing income	0.07	0.08	0.09
Other noninterest income	0.72	0.69	0.75
Total noninterest expense	3.45	3.37	3.40
Salaries	1.78	1.74	1.72
Bank premises	0.60	0.56	0.56
Other	1.07	1.07	1.13
Noninterest margin	- 2.29	2.22	- 2.18

Note: Discrepancies due to rounding error.

reduce these expenses by 5 basis points. Other Noninterest Expense was the most significant component of the increases for both large and small banks, while the decrease for medium-sized banks was due mainly to a decrease in salaries.

Loan and Lease Loss Provisions

After increasing 32 percent in 1984, loan and lease loss provisions in Fifth District banks grew 40 percent in 1985 (Table I). For all U. S. banks provisions grew by about 20 percent in 1985, although Fifth District provisions remained comfortably below their national counterparts as a percent of assets. As Chart 8 shows, large banks produced the greatest increases in the Fifth District.

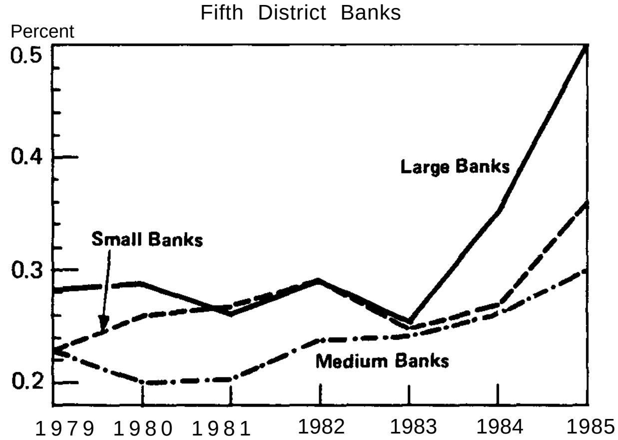
The increase in provision for loan and lease losses occurred in a year when classified loans[3] decreased as a percentage of total loans at large and medium-sized Fifth District banks. At the same time, 1985 chargeoffs net of recoveries were higher as a percent of loans at Fifth District banks than in 1984. This suggests three explanations, none of which are mutually exclusive, for the steep increase in loan and lease loss provisions. First, the increase in net chargeoffs in 1985 may have led bankers to increase provisions to build up allowances for loan and lease losses.[4] If bankers attempt to maintain a desired ratio of loan and lease loss allowance to loans, depleting the allowance by charging off loans will lead them to increase loan and lease loss provisions in order to keep this ratio at its desired level. Second, since allowance for loan and lease loss is included as capital in computing capital ratios, bankers may have taken advantage of improved net margins to build up allowances in order to increase capital. Finally, bankers may simply be trying to shield some of their improved interest income from taxes.

Classified loans constituted a smaller part of Fifth District bank loan portfolios in 1985 than was the case for banks nationwide. Specifically, classified loans were 2.9 percent of large banks' total loans, 3.1 percent for medium banks, and 4.7 percent for small

Chart 8

LOAN AND LEASE LOSS PROVISIONS AS A PERCENT OF AVERAGE ASSETS

Fifth District Banks



banks. The corresponding figures for all U. S. banks were 4.5 percent, 4.8 percent, and 6.2 percent. In the Fifth District, only small banks experienced an increase from the 1984 percentage, while nationally both small and medium banks experienced increases.

Gains on Sales of Securities

Declining interest rates in 1985 led to higher securities prices. As a result, gains on sales of investment securities helped performance both in the Fifth District and nationwide. Gains occur when securities, other than those held in trading accounts, are sold, redeemed, returned, or exchanged for more than their book value. Gains were significant for all three size classes.

Capital

Banks in the Fifth Federal Reserve District added to capital during 1985 (Table VIII). Primary capital[5] increased from 7.3 percent of adjusted assets in 1984 to 7.6 percent in 1985, while total capital grew from 7.5 percent to 7.8 percent. Large banks

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[3] Classified loans include loans over 30 days past due along with renegotiated and nonaccrual loans.

[4] Loan and lease loss provision is the income statement flow that adds to the balance sheet stock known as allowance for loan and lease loss. Net chargeoffs are loan and lease losses, net of loans recovered, actually charged against the allowance. In other words, they are flows subtracted from the allowance. Provision for allocated transfer risk is included in provision for loan and lease losses, and allocated transfer risk reserve is included in allowance for loan and lease losses (except in computing capital ratios).

[5] Primary capital here includes common stock, perpetual preferred stock, surplus, undivided profits, capital reserves, mandatory convertible instruments, allowance for loan and lease losses, and minority interest in consolidated subsidiaries. Secondary capital (total capital less primary capital) includes limited life preferred stock and those subordinated notes and debentures not eligible for primary capital. Also, intangible assets are subtracted from average assets plus allowance for loan and lease losses (to yield adjusted assets) and from capital. The measure used here corresponds closely but not exactly to the different measures used by the major bank regulatory agencies.

Table VIII

CAPITAL RATIOS
FIFTH DISTRICT AND ALL U. S. COMMERCIAL BANKS

1984	Small	Medium	Large	Total
Fifth District				
Primary ratio	9.60	8.35	6.64	7.28
Total ratio	9.63	8.41	6.92	7.49
All U. S. banks				
Primary ratio	9.24	7.94	6.35	7.11
Total ratio	9.31	8.15	6.66	7.36

1985	Small	Medium	Large	Total
Fifth District				
Primary ratio	9.91	8.35	7.04	7.56
Total ratio	9.96	8.40	7.34	7.79
All U. S. banks				
Primary ratio	9.31	7.92	6.84	7.41
Total ratio	9.37	8.10	7.26	7.73

augmented their ratios most, while medium-sized banks were the only banks in the Fifth District with stable or declining ratios. The same differences between the size classes occurred at the national level, although capitalization was higher for Fifth District banks as a group than for all U. S. banks.

At both the District and national levels, common stock decreased in importance as a component of capital while both undivided profits and loan and lease loss allowance became more important. Although banks seem to be relying relatively less on the stock market as a source of funds, use of the debt market appears to be increasing. Specifically, mandatory convertible debt and subordinated debt increased both nationally and at the District level. In 1984, mandatory convertible debt grew substantially at the national level but was insignificant as an element of Fifth District capital ratios. In 1985, this debt continued to grow at all U. S. banks but jumped in significance at District banks. Subordinated debt grew slightly in the Fifth District but quite noticeably nationwide. While District banks appear to be making more use of debt instruments than in the past, their reliance on such debt has not caught up with that of their peers at the national level.

APPENDIX

INCOME AND EXPENSE AS A PERCENT OF AVERAGE ASSETS ALL U. S. COMMERCAL BANKS, 1979-1985[1]

Item	1979	1980	1981	1982	1983	1984	1985
Gross interest revenue	8.62	9.87	11.81	11.19	9.50	10.11	9.23
Gross interest expense	5.50	6.78	8.75	8.02	6.36	6.95	5.98
Net interest margin	3.12	3.09	3.07	3.17	3.15	3.16	3.25
Noninterest income	0.78	0.89	0.99	1.05	1.12	1.27	1.39
Loan and lease loss provision	0.24	0.25	0.26	0.39	0.47	0.55	0.66
Securities gains (- losses)[2]						- 0.01	0.06
Noninterest expense	2.54	2.63	2.76	2.91	2.95	3.05	3.15
Income before tax	1.12	1.10	1.04	0.91	0.84	0.82	0.89
Taxes	0.28	0.28	0.24	0.17	0.18	0.19	0.21
Other[3]	-0.04	-0.03	-0.04	-0.03	0.00	0.01	0.01
Return on assets[4]	0.80	0.79	0.76	0.71	0.67	0.64	0.70
Cash dividends declared	0.28	0.29	0.30	0.31	0.33	0.31	0.33
Net retained earnings	0.52	0.50	0.46	0.40	0.34	0.33	0.37
Return on equity[5]	13.90	13.70	13.20	12.20	11.24	10.63	11.33
Average assets ($ billions)	1,593	1,768	1,940	2,100	2,253	2,398	2,604

Note: Discrepancies due to rounding error.

[1] See Table I, footnote 1.

[2] See Table I, footnote 2.

[3] See Table I, footnote 3.

[4] See Table I, footnote 4.

[5] See Table I, footnote 5.

Sources: Federal Reserve Bulletin, 1981, 1984 (1979-83 data); Consolidated Reports of Condition and Income (1984 and 1985 data).