A REVIEW OF BANK PERFORMANCE IN THE FIFTH DISTRICT, 1987

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Bank profitability as measured by return on assets and return on equity declined in the Fifth Federal Reserve District[1] in 1987 due largely to increased loan and lease loss provisions. Nationwide the profitability decline was considerably larger because the average loss provision greatly exceeded that in the Fifth District. These results should come as no surprise because of the well-publicized additions to reserves against Third World debt made by large banks both within and outside the District.

For Fifth District banks, a decline in net interest margin and securities gains was offset by lower noninterest expense. For the average of all U.S. banks, securities gains were down and noninterest expense was up, but higher noninterest income offset them completely.

Profits

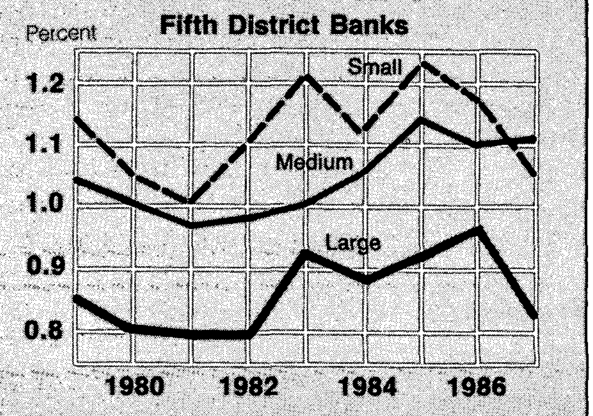
Return on Assets Table I shows that return on assets (ROA) for Fifth District banks declined from 1.00 percent in 1986 to .88 percent in 1987. The drop was more dramatic at the national level, where return on assets fell from .63 percent in 1986 to .11 in 1987 (Table II). Net income in the Fifth District fell for the first time in the past thirteen years, dropping 2.1 percent. For the sum of all U.S. banks, net income fell 80.6 percent. Slightly less than 10 percent of Fifth District banks and 18 percent of all banks in the country suffered losses during the year. While Fifth District banks' average return on assets and return on equity (ROE) were below their average for the last ten years, the national average for the ratios was the lowest in post-World War II history.[2]

Much of the decline in the average ROAs for banks in the Fifth District (and banks throughout the United States) reflected ROA declines at large banks. Chart 1 shows that large Fifth District banks' (more than $750 million in 1987 total assets) average ROA fell from .97 percent in 1986 to .82 percent in 1987. Medium-sized Fifth District banks (1987 total assets between $100 million and $750 million) experienced a slight increase in ROA from 1.10 percent in 1986 to 1.11 percent in 1987 while the ROA for small District banks (less than $100 million in total assets) fell from 1.17 percent in 1986 to 1.05 percent in 1987.

The decline in average ROE reflected declines in both ROA and the ratio of book value of assets to book value of owner's equity. Chart 2 shows that while large banks suffered the greatest decline in ROE, medium and small banks also had diminished ROEs compared with their 1986 levels. Large banks' ROE fell to 14.32 percent in 1987 while medium and small banks' ROEs fell to 13.82 and 11.19 percent, respectively. Average ROE for all U.S. banks fell from 10.22 percent in 1986 to 1.88 percent in 1987 (see Table II).

The lower profits for 1987 reflected the higher loan and lease loss provisions against Third World debt made by large banks. Because loss reserves are

Chart 1
RETURN ON ASSETS*
Fifth District Banks



*Net income divided by average assets.

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[1] Maryland, Virginia, North Carolina, South Carolina, the District of Columbia, and most of West Virginia. A table summarizing performance by state is in the Appendix.

[2] Office of Research and Strategic Planning, Federal Deposit Insurance Corporation, "Commercial Banking Performance—Fourth Quarter, 1987," *Quarterly Banking Profile*, Fourth Quarter 1987, Chart A, p. 1.

Table I

INCOME AND EXPENSE AS A PERCENT OF AVERAGE ASSETS[1]
FIFTH DISTRICT COMMERCIAL BANKS, 1979-87

Item	1979	1980	1981	1982	1983	1984	1985	1986	1987
Gross interest revenue	8.49	9.46	11.15	10.86	9.58	10.02	9.48	8.51	8.09
Gross interest expense	4.53	5.60	7.29	6.93	5.82	6.33	5.70	4.97	4.59
Net interest margin	3.96	3.86	3.86	3.93	3.76	3.69	3.78	3.54	3.50
Noninterest income	0.80	0.90	1.01	1.03	1.16	1.15	1.22	1.22	1.22
Loan and lease loss provision	0.26	0.26	0.25	0.28	0.25	0.33	0.46	0.40	0.50
Securities gains[2]						-0.02	0.06	0.15	0.07
Noninterest expense	3.24	3.37	3.48	3.53	3.45	3.37	3.40	3.29	3.17
Income before tax	1.26	1.13	1.14	1.15	1.22	1.12	1.20	1.23	1.12
Taxes	0.28	0.20	0.19	0.18	0.22	0.19	0.22	0.23	0.25
Other[3]	-0.04	-0.04	-0.09	-0.10	-0.02	0.00	0.00	0.00	0.00
Return on assets[4]	0.94	0.89	0.86	0.87	0.98	0.93	0.98	1.00	0.88
Cash dividends declared	0.30	0.32	0.33	0.37	0.34	0.31	0.31	0.34	0.47
Net retained earnings	0.64	0.57	0.53	0.50	0.64	0.62	0.67	0.66	0.41
Return on equity[5]	13.51	12.79	12.56	13.12	15.21	14.62	15.41	15.87	13.83
Average assets ($ millions)	80,671	88,280	97,217	108,439	121,173	137,131	156,574	181,133	203,376

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 1979-83 data, and extraordinary items and other adjustments after taxes for 1984-87 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.

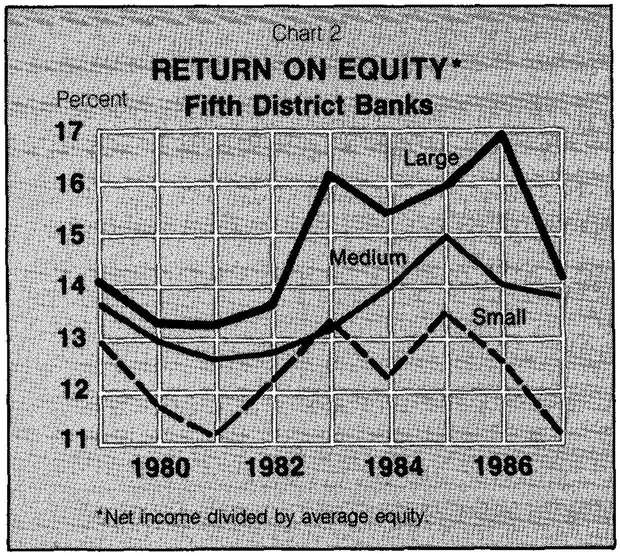
Table II

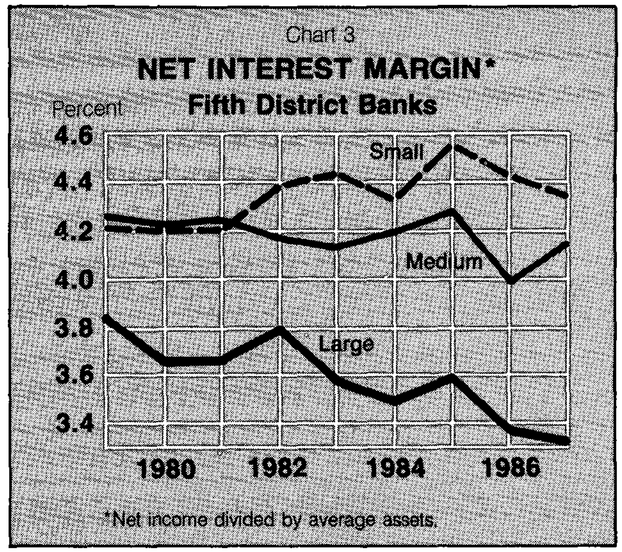
INCOME AND EXPENSE AS A PERCENT OF AVERAGE ASSETS[1]
ALL U.S. COMMERCIAL BANKS, 1979-87

Item	1979	1980	1981	1982	1983	1984	1985	1986	1987
Gross interest revenue	8.62	9.87	11.81	11.19	9.50	10.11	9.23	8.15	7.99
Gross interest expense	5.50	6.78	8.75	8.02	6.36	6.95	5.98	5.02	4.87
Net interest margin	3.12	3.09	3.07	3.17	3.15	3.16	3.25	3.13	3.12
Noninterest income	0.78	0.89	0.99	1.05	1.12	1.27	1.39	1.46	1.63
Loan and lease loss provision	0.24	0.25	0.26	0.39	0.47	0.55	0.66	0.76	1.24
Securities gains[2]						-0.01	0.06	0.13	0.05
Noninterest expense	2.54	2.63	2.76	2.91	2.95	3.05	3.15	3.17	3.26
Income before tax	1.12	1.10	1.04	0.91	0.84	0.82	0.89	0.81	0.29
Taxes	0.28	0.28	0.24	0.17	0.18	0.19	0.21	0.19	0.18
Other[3]	-0.04	-0.03	-0.04	-0.03	0.00	0.01	0.01	0.01	0.01
Return on assets[4]	0.80	0.79	0.76	0.71	0.67	0.64	0.70	0.63	0.11
Cash dividends declared	0.28	0.29	0.30	0.31	0.33	0.31	0.33	0.33	0.36
Net retained earnings	0.52	0.50	0.46	0.40	0.34	0.33	0.37	0.31	-0.24
Return on equity[5]	13.90	13.70	13.20	12.20	11.24	10.63	11.33	10.22	1.88
Average assets ($ billions)	1,593	1,768	1,940	2,100	2,253	2,398	2,604	2,799	2,926

Notes: Discrepancies due to rounding error.
For footnotes see Table I.

Sources: *Federal Reserve Bulletin,* 1981, 1984 (1979-83 data); Consolidated Reports of Condition and Income (1984-87 data).





deducted from total assets when calculating ROA, the income stream from the asset portfolio should yield a higher return in succeeding years. Because the increased provisions move bank assets closer to their true market values, one might expect, other things remaining the same, higher returns in 1988.

Interest Margin

Net interest margin fell to its lowest level in the years covered by Table I. Market interest rates rose throughout 1987, yet rates were on average below their levels during 1986 in many of the markets where commercial banks operate. Interest income declined by more than interest expense for District banks as a group. Some banks fared better, however. For example, while net margin fell for both small and large Fifth District banks, medium Fifth District banks increased their average net margin by 17 basis points (Chart 3). At the national level, the average net interest margin fell by only one basis point.

Fifth District banks continued to earn a much higher interest margin than their counterparts nationwide. Interest income relative to assets was higher at Fifth District banks than for all U.S. banks because earning assets constituted a higher percentage of District banks' assets. Interest expense was lower at Fifth District banks because those institutions paid lower rates on average for comparable liabilities. Further, lower cost liabilities made up a larger percentage of their total funding. That is, District banks derived a higher percentage of their liability base from relatively low-cost consumer deposits and a much lower percentage from higher-cost foreign office deposits. Tables III and IV show that both the rates earned and the rates paid by Fifth District banks declined in 1987 as compared with 1986.

Noninterest Revenue and Expense

Fifth District noninterest income, including service charges on deposit accounts, leasing income, trust activities income, credit card fees, mortgage servicing fees, and safe deposit box rentals, was unchanged from 1986 to 1987 (Table I). Noninterest expense, however, fell from 3.29 percent of average assets to 3.17 percent.

The decline in noninterest expense stemmed largely from falling salaries expense relative to average assets indicating that employee productivity in generating assets more than offset rising salaries per employee. Actually, large Fifth District banks accounted for virtually all the improvement in the noninterest expense figure since small and medium banks experienced little change. While the average number of employees at large Fifth District banks declined by less than 1 percent, the number of employees per million dollars of assets at these banks fell by 12 percent. Similarly salaries per employee rose by 7 percent at large banks.

Nationwide the rise in noninterest income was partially offset by increased noninterest expense. Here is a continuing difference between Fifth District banks and their peers at the national level. A comparison of Tables I and II shows that noninterest income has remained flat in the Fifth District while continuing to increase nationwide over the last several years. By contrast, noninterest expense has risen persistently for all U.S. banks while the trend has been downward in the Fifth District. Last year (1987) was

Table III

AVERAGE RATES OF RETURN ON SELECTED INTEREST-EARNING ASSETS
FIFTH DISTRICT COMMERCIAL BANKS, 1979-87

Item	1979	1980	1981	1982	1983	1984[2]	1985[2]	1986[2]	1987[2]
Total interest-earning assets	10.09	11.28	13.18	12.68	11.11	11.77	11.06	9.78	9.25
Total loans and leases	11.25	12.50	14.48	14.14	12.38	12.59	11.92	10.63	10.05
Net loans and leases[1]	11.37	12.63	14.64	14.30	12.53	12.74	12.08	10.77	10.19
Total securities	6.43	7.15	8.57	9.27	9.20	9.68	9.01	8.30	7.61

[1] Net loans are: total loans net of allowance for loan losses for 1979-83; total loans and leases net of the sum of allowance for loan and lease losses and allocated transfer risk reserve for 1984-87.

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

Table IV

AVERAGE COST OF FUNDS FOR SELECTED LIABILITIES
FIFTH DISTRICT COMMERCIAL BANKS, 1979-87

Item	1979	1980	1981	1982	1983	1984	1985	1986	1987
Interest-bearing deposit accounts	7.15	8.68	10.63	9.91	8.19	8.72	7.89	6.77	6.12
Large certificates of deposit	9.96	11.33	14.35	12.05	7.62	9.47	7.91	7.07	6.65
Deposits in foreign offices	10.28	13.17	15.18	12.79	7.73	9.19	7.92	6.40	6.69
Other deposits	6.16	7.54	9.23	9.12	8.34	8.55	7.97	6.74	5.97
Subordinated notes and debentures	8.19	8.20	8.11	8.34	8.32	8.03	9.64	8.48	9.21
Fed funds	11.94	13.34	15.54	11.21	8.52	9.58	7.67	6.92	5.87
Other	6.98	8.65	13.49	11.29	8.75	9.18	6.73	5.19	7.34
Total	7.60	9.13	11.23	10.10	8.24	8.84	7.90	6.76	6.13

the first in which Fifth District noninterest expense dropped below the national average as a percent of assets.

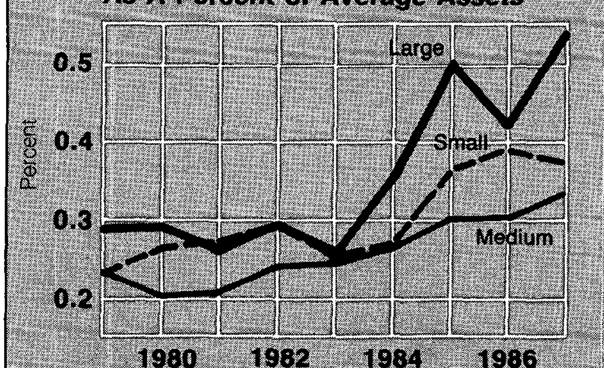
Loss Reserves

Fifth District banks on average increased provision for loan and lease losses[3] to .50 percent of average assets, the highest provision in the years covered by Table I. The 10 basis point increase during 1987 occurred mainly at large banks, while at small and medium-sized banks loan and lease loss provision relative to assets changed little compared with 1986 (see Chart 4). Increases occurred during the second and fourth quarters of 1987 and were greatest at banks with significant foreign loan exposures. The large increase in provision for loan and lease losses raised the allowance for loan and lease losses relative to total loans from 1.35 percent in 1986 to 1.41 percent in 1987 for all Fifth District banks on average. For large Fifth District banks the ratio grew from 1.40 percent in 1986 to 1.48 percent in 1987. Allowance declined at medium-sized banks from 1.2 percent to 1.15 percent, and rose slightly at small banks from 1.13 percent to 1.15 percent.

Net charge-offs relative to total loans at medium and large banks rose to .38 percent and .59 percent,

Chart 4

LOAN AND LEASE LOSS PROVISIONS
As A Percent of Average Assets



[3] Provision for loan and lease losses is the income statement flow magnitude that adds to the balance sheet stock item known as allowance for loan and lease losses.

respectively, while small banks' charge-offs declined to .42 percent. Charge-offs for the average of all Fifth District banks increased from .47 percent in 1986 to .55 percent in 1987. Loans classified as past due 90 days or more and those not accruing interest fell as a percent of total loans from 1.12 in 1986 to 1.11 in 1987.

At the national level, loan and lease loss provision relative to average assets increased by 48 basis points. Large banks were responsible for the increase. Allowance for loan and lease losses relative to total loans grew significantly from 1.64 percent in 1986 to 2.70 percent in 1987. Charge-offs relative to total loans declined for all U.S. banks, from .94 percent to .89 percent on average. Relative to total loans, loans past due 90 or more days or not accruing interest increased for U.S. banks from 2.77 percent to 3.49 percent, more than three times the average for the Fifth District.

Capital

Fifth District banks increased average regulatory capital ratios during 1987 (Table V). Both primary and total capital ratios grew for all three size groups. Increases at small District banks occurred in spite of a large decline in undivided profits, and were the result of additions to common stock, surplus,[4] and allowance for loan and lease losses. Medium District banks increased capital ratios with additions to common stock and undivided profits. Large Fifth District banks' capital ratios increased because of minor changes in several of the items counted as regulatory capital. In fact, without a six basis point increase in allowance for loan and lease losses, the average total capital ratio of large District banks would have actually declined by three basis points. The effect of loss reserves on regulatory capital ratios is especially significant since their inclusion as capital has been questioned by many observers.[5]

At the national level the regulatory capital ratios grew much more quickly than for the Fifth District and were higher on average than those for Fifth District banks. Growth occurred in all size groupings in both primary and total capital. Far more than in the Fifth District, the nationwide increase in large banks' primary and total capital ratios was the result of higher allowance for loan and lease losses. Without the increase, the total capital ratio for large U.S. banks would have declined by 63 basis points. For small U.S. banks the majority of the increase came from increased allowance for loan and lease losses and surplus. For the average of all medium banks in the nation the increase in regulatory capital came from growth in common stock, surplus, allowance for loan and lease losses, and subordinated notes.

As an alternative to either primary or total capital, equity capital may be preferred as a capital measure because it does not include loss reserves. Rather, it consists only of common stock, surplus, undivided profits, capital reserves, and perpetual preferred stock. Using ratios of equity capital to total assets shows a different picture of how Fifth District banks performed relative to all banks. Specifically, Fifth District banks raised equity capital ratios from 6.31 percent in 1986 to 6.41 in 1987. As shown in

Table V

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

1987	Small	Medium	Large	Total
Fifth District				
Primary ratio	10.39	8.83	6.98	7.53
Total ratio	10.43	8.85	7.27	7.76
Equity ratio	9.65	8.17	5.76	6.41
All U.S. Banks				
Primary ratio	9.46	8.19	7.33	7.75
Total ratio	9.50	8.36	7.74	8.07
Equity ratio	8.57	7.27	5.24	6.02

1986	Small	Medium	Large	Total
Fifth District				
Primary ratio	10.23	8.75	6.91	7.49
Total ratio	10.27	8.77	7.24	7.75
Equity ratio	9.40	7.93	5.63	6.31
All U.S. Banks				
Primary ratio	9.26	8.01	7.03	7.52
Total ratio	9.30	8.15	7.51	7.88
Equity ratio	8.32	7.00	5.53	6.17

Note: Primary capital here is common stock, perpetual preferred stock, surplus, undivided profits, capital reserves, mandatory convertible instruments,allowance for loan and lease losses, and minority interest in consolidated subsidaries, less intangible assets. Total capital includes primary capital plus limited life preferred stock and those subordinated notes and debentures not eligible for primary capital. Equity capital is common stock, perpetual preferred stock, surplus, undivided profits, and capital reserves. Primary capital and total capital are divided by quarterly average assets plus allowance for loan and lease losses less intangible assets to produce primary ratio and total ratio. Equity capital ratio is equity capital divided by total assets. The primary capital and total capital ratios used here correspond closely but not exactly to the different measures used by the federal bank regulatory agencies.

[4] Surplus is the amount received from the sale of common or preferred stock in excess of par or stated value.

[5] See for example David C. Cates, "Self-Review Is Answer to Unrealistic Capital Policy," *American Banker*, April 16, 1987.

Table V, all three size classes increased equity capital. In contrast, for the average of all U.S. banks equity capital decreased, although the overall decrease conceals increases for both small- and medium-sized banks. Further, equity capital ratios for all three size classes remained higher in the Fifth District than at the national level. Thus, once loss allowance is removed from the capital measure the performance of Fifth District banks relative to their peers nationwide appears more favorable.

Change in retained earnings may have influenced capital levels through its effect on undivided profits. Specifically, retained earnings fell relative to average assets at Fifth District banks because of increased dividends and lower ROA. For example, large Fifth District banks increased dividends relative to assets from .33 to .48 percent. As a result, large banks' average retained earnings declined relative to assets by 29 basis points to reach a level of .35. Medium-sized Fifth District banks increased dividends relative to assets from .40 to .45 percent but only lowered retained earnings by 4 basis points. Small banks increased dividends relative to assets from .39 to .44 percent but had a 17 basis point decline in retained earnings. At the national level banks raised dividends relative to assets from .33 to .36 percent. Since income relative to assets was only .11 percent, banks nationwide paid out more in dividends than they earned. Consequently, retained earnings on average were negative.

The behavior of retained earnings in 1987 exemplifies a dilemma facing bankers seeking to build up capital. On the one hand, increases in retained earnings add to equity. On the other hand, higher payouts may seem necessary to attract new equity investment. But current payouts are not investors' only consideration; also relevant are a bank's future prospects. Since retained earnings can be used to purchase income producing assets which augment the value of the bank, it is not clear that investors will invariably insist on receiving their income as current dividends rather than as capital gains or enhanced payouts in the future.

APPENDIX

BANK PERFORMANCE MEASURES BY FIFTH DISTRICT STATE—1987

(Percent)

	DC	MD	NC	SC	VA	WV
		SMALL BANKS				
ROA	0.09	1.12	0.66	1.02	1.21	1.03
ROE	0.89	12.47	6.43	9.41	13.35	11.36
Nonperforming loans & leases	1.17	0.78	1.02	1.28	1.01	2.00
Net charge-offs	0.82	0.22	0.30	0.41	0.43	0.53
Number of banks	8	47	34	54	122	145
		MEDIUM BANKS				
ROA	0.75	1.12	1.14	0.99	1.24	1.07
ROE	12.12	14.03	12.40	13.12	16.68	12.22
Nonperforming loans & leases	0.56	0.50	1.01	1.15	0.73	2.12
Net charge-offs	0.37	0.12	0.59	0.33	0.42	0.52
Number of banks	7	31	17	9	36	34
		LARGE BANKS				
ROA	0.23	0.73	0.96	0.91	0.88	1.12
ROE	4.70	11.76	16.99	14.66	15.98	16.18
Nonperforming loans & leases	1.70	1.22	1.00	1.44	0.87	1.02
Net charge-offs	0.50	0.64	0.53	0.59	0.66	0.38
Number of banks	5	11	10	5	9	1
		TOTAL				
ROA	0.28	0.80	0.96	0.93	0.97	1.06
ROE	5.43	12.21	16.24	13.48	15.71	12.00
Nonperforming loans & leases	1.54	1.09	1.00	1.39	0.86	2.00
Net charge-offs	0.49	0.55	0.53	0.54	0.60	0.51
Number of banks	20	89	61	68	167	180

Notes: Banks not operating at the beginning of 1987 are excluded from these totals. Nonperforming loans & leases are loans and leases past due 90 days or more and those not accruing interest, as a percent of total loans. Net charge-offs are loan and lease charge-offs, net of recoveries, as a percent of total loans.