SIXTH DISTRICT BANKING NOTES

DISTRICT BANK EARNINGS REBOUND

District member bank earnings, collectively in the doldrums since 1974, rebounded smartly during 1977.* Profitability, as measured by income after taxes but before security transactions as a percentage of equity capital, advanced to 8.9 percent in 1977 from 6.8 percent in 1976 (see Table 1). Last year's rebound allowed banks to recover nearly one-half the ground they lost when earnings dropped from an average of roughly 12 percent during the peak earnings years of 1972 and 1973.

TABLE 1

PROFITABILITY

(income after taxes and before securities gains or losses as a percentage of equity capital, including all reserves)

	1975	1976	1977
Alabama	9.5	10.9	11.3
Florida	3.7	3.4	6.4
Georgia	6.2	8.2	10.5
Louisiana*	11.6	11.3	12.0
Mississippi*	8.7	10.2	11.0
Tennessee*	8.3	10.5	10.7
All District Banks	6.3	6.8	8.9

*Sixth District portion only.

Wide Variations. District bank earnings continue to vary considerably by bank size and by state. The smallest member banks, for example, had average earnings equal to only 2.5 percent of equity capital in 1977. Even this meager return marked a significant gain from the previous year's weak performance, when earnings averaged a dismal 0.05 percent. However, there remained a large number of small unprofitable banks. Of the 48 banks with deposits of less than $10 million, less than two-thirds operated profitably last year. In 1976, however, only one-half of the small banks (then numbering 87) were profitable. Despite this improvement, the small banks' 1977 earnings rate was only 28 percent of the average for all District banks, compared to 60 percent during the early 1970s. These banks have not recovered as much as the intermediate and larger banks.

As a group, banks with over $50 million in assets generated the highest earnings of all District banks. They realized a 10.3-percent rate of return, up from 8.3 percent in 1976. The larger banks were able to achieve better results because of lower operating expenses rather than higher operating income, however. These banks average less income per dollar of assets and lower average rates of return on loans and securities than the smaller District banks. But the medium and large banks can spread some relatively large and fixed expenses, like salaries, occupancy expenses, and various "other" operating costs, over a larger asset base, reducing their operating expenses per dollar of assets.

Banks in the Sixth District portion of Louisiana continued to report the highest earnings—12 percent. However, member banks in Alabama and Mississippi generated earnings of 11 percent or more. Florida banks lag the rest of the District by a considerable margin despite an improvement in 1977. Much of their advance may have been technical, however, since a number of the smaller and least profitable banks were merged into larger banks during the year. The mergers also explain the drop in the number of member banks in Florida, from 331 at the end of 1976 to 286 a year later.

Sources of Higher Earnings. Last year's advance in District bank earnings resulted from both higher income and lower expenses, measured as percentages of total assets. Contributing most to the income growth was interest from loans. Loan income rose as total loans increased from 51.3 percent of total assets in 1976 to 53.7 percent in 1977. The largest lending gains occurred in real estate loans and loans to finance personal consumption expenditures. The average rate of return on loans moved up from 9.36 percent to 9.45 percent.

Interest income from securities was a much less important source of income last year. With loan demand strong, District banks increased their lending more than their acquisitions of securities. The slower growth in investments, especially municipal obligations and U. S. Treasury

*Information is based upon "1977 Operating Ratios, Sixth District Member Banks," available upon request.

securities, and generally lower returns on these assets reduced the relative importance of this income source.

Overall, banks' expenses rose less rapidly than income. During 1977, total operating expenses averaged 89.3 percent of total operating income, down from 91.9 percent in the previous year. Smaller provisions for loan losses accounted for the largest portion of the decrease and marked the second annual decline in these costs. While the largest expense item—interest expenses for deposits—dropped slightly, District banks paid more for borrowed funds. Higher borrowing costs were most noticeable at banks with over $500 million in assets. These expenses typically rise as the larger banks borrow to meet stronger loan demands. The second large expense category—wages and salaries—dipped after consuming an increasing portion of operating income in previous years.

A Long Way to Go. Despite last year's improvements, District bank earnings are still considerably below their 1973 peak (see Table 2). Since 1973, banks as well as businesses have felt the impact of higher and changing interest rates, inflation, and economic and financial problems lingering from the recession. A comparison of District banks' 1973 performance with their 1977 records reveals the specific changes that these conditions have induced. For example, total operating income increased from 6.9 percent of total assets in 1973 to 7.6 percent in 1977, but total operating expenses rose more rapidly (from 5.6 percent to 6.8 percent) and, therefore, reduced earnings.

Bank operating income has clearly been boosted by higher returns on loans and securities (together, this interest income comprised slightly more than 90 percent of total operating income in 1977) and by a shift of assets into loans and securities. But higher interest rates are a two-edged sword for banks, since their single largest expense is for interest on deposits and borrowed funds. Such interest expenses advanced from 2.62 percent of total assets in 1973 to 3.11 percent in 1977. As a result, three-quarters of the rise in interest income was offset by larger interest expenses. Even so, if higher interest rates had been the only factor impacting bank earnings since 1973, returns would have been much higher last year. Increased provisions for loan losses have also reduced the return on loans. Even though it declined during 1977, this expense was still about double its 1973 level. When the rise in loan loss provisions is subtracted from the net interest gain, last year's return on loans was no better than in 1973. The revenue gains from higher interest income were consumed by higher interest expenses and provisions for loan losses.

Increases in banks' noninterest expenses have contributed to the erosion of peak returns on assets as well. Clearly, District banks as a group will not surpass 1973 earnings rates until they increase their net return on loans and securities, reduce expenses as a percent of total assets, or both. The prospects for profitability approaching previous peak levels, however, appear brighter at this time than at any time since earnings began to recover in 1976.

John M. Godfrey

TABLE 2

PERFORMANCE: 1973 VS. 1977
SIXTH DISTRICT MEMBER BANKS

	1973	1977
PROFITABILITY		
Percentage of Equity Capital, including All Reserves		
Income after taxes and before securities gains (losses)	12.60	8.89
SOURCES AND DISPOSITION OF INCOME		
Percentage of Total Assets		
Total operating income	6.86	7.60
Salaries, wages, and fringe benefits	1.42	1.58
Interest on deposits	2.50	3.01
Net occupancy expense of bank premises	.21	.29
All other operating expenses	1.45	1.80
Total operating expense	5.58	6.78
Income after taxes and before securities gains (losses)	.98	.70
RATES OF RETURN ON SECURITIES AND LOANS		
Return on Securities		
Interest on U. S. Treasury securities	6.01	6.73
Return on Loans		
Interest and fees on loans	8.52	9.45
Net losses (-) or recoveries (+) on loans	-.28	-.57