Record Earnings...Lower Profits

IN MANY respects 1966 was a difficult year for banks. They experienced reduced deposit flows, partly because of severe competition for individual and corporate funds from other financial institutions, and partly because of rising money market rates, which after mid-year exceeded the maximum rates payable on large-denomination time certificates, and thereby attracted funds to other money market instruments. Meanwhile, monetary policy in 1966 dragged against the expansion of bank reserve positions during most of the year. In addition, high loan-deposit ratios continued to be a restrictive factor in bank-credit expansion.

Despite all this, however, the nation's member banks recorded a 14-percent increase in net current earnings and a 5-percent gain in net income after taxes. Member banks in the Twelfth District meanwhile turned in a somewhat mixed performance. Their net current operating earnings rose nearly 8 percent to a record $594 million. Yet, because of relatively heavy capital losses on sales of securities and higher loan losses, their net income after taxes was only $291 million—6 percent below their 1965 profits figure. Thus, District banks in1966 achieved just the opposite of their 1965 performance —when, in the face of a reduction in current operating earnings, they obtained record profits because of reduced non-operating costs.

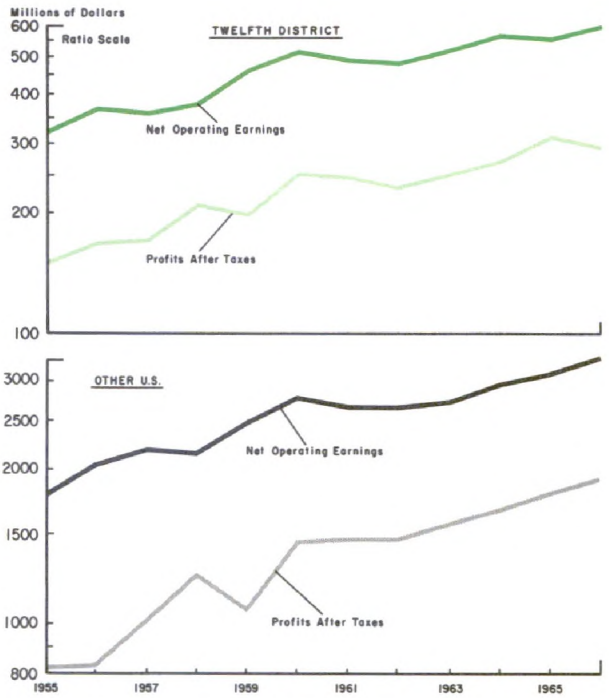
In 1966, unlike other recent years, the increase in Western banks' revenues—a result of substantially higher returns on both loans and securities — outstripped the increase in their expenses. A slight deceleration in the rate of increase in interest expense on time deposits was another factor contributing to the more favorable relationship between revenues and expenses.

Paradoxically, the factors that contributed to record revenues in 1966—strong loan demand and higher yields on loans and securities—were largely responsible for the decline in net profits. Many District banks sold securities at a capital loss to obtain additional funds with which to meet heavy loan demand or to reinvest in higher-yielding securities. This type of response was a calculated acceptance of non-operating losses as a means of increasing current and future operating income.

New factors in 1967

Banks in the West, as elsewhere in the nation, now face the possibility of some leveling off in the rate of increase in revenue from loans and securities. In late January, major banks reduced the prime rate on busi-

District bank profits decline but current earnings reach new high



ness loans, and action of this type normally signals a scaling down of loan rates generally. Yields on both short-and long-term securities also trended downward in the early months of the year.

These declines in the rates of return on bank assets were not matched by any commensurate reduction on the expense side. Interest on passbook savings—the principal cost item for Western banks—remained unchanged at the 4-percent ceiling rate. Rates paid on consumer-type savings and time certificates also remained unchanged, although Western banks, along with their colleagues elsewhere, reduced the rates offered on large-denomination CD's. Borrowing costs of Federal funds eased in the first part of the year, but increased net purchases by major Western banks probably more than offset the lower interest charges on such borrowed reserves. Thus, banks started out the new year with some doubt that their revenues will again rise substantially faster than their expenses.

EARNINGS AND EXPENSES OF TWELFTH DISTRICT MEMBER BANKS

(millions of dollars)

	1966p	1965
Earnings on loans	2,025.0	1,771.4
Interest and dividends on		
U.S. Government securities	219.2	236.1
Other securities	196.5	157.7
Service charges on deposit accounts	188.0	175.9
Trust Department earnings	79.6	73.3
Other earnings	104.8	85.3
Total earnings	2,813.2	2,499.7
Salaries and wages	626.2	581.0
Interest in time deposits	1,043.6	885.3
Other expenses	549.1	480.3
Total expenses	2,218.9	1,946.7
Net current earnings	594.3	553.0
Net recoveries and profits (—losses)[1]		
On securities	— 46.4	+ 18.0
On loans	— 105.8	— 102.2
Other	— 17.0	— 10.7
Total net recoveries and profits (—losses)[1]	— 169.2	— 94.7
Net profits before income taxes	425.1	458.3
Taxes on net income	133.9	147.7
Net profits after taxes	291.2	310.6
Cash dividends declared	175.0	174.2

p—Preliminary.
[1]Includes transfers to (—) and from (+) valuation reserves
Note: Details may not add to totals due to rounding.
Source: Federal Reserve Bank of San Francisco.

Higher loan rates

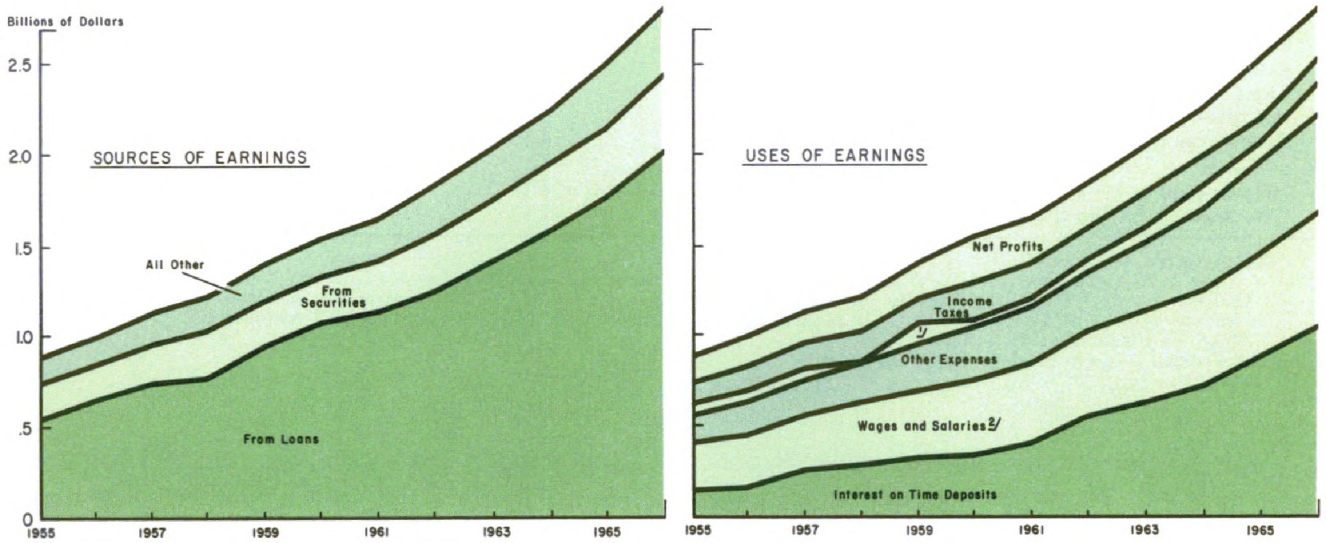
On the income side of the ledger, revenues totaled $2,813 million at District banks in 1966. Loan revenue accounted for 80 percent of the $314-million increase in total operating income. The growth in outstanding loans was only 6 percent, but income from loans jumped 14 percent over the year-earlier level as the average rate of return rose to 6.73 percent—32 basis points above the 1965 average rate.

The first major move toward higher loan rates came in early December 1965, when large banks increased the rate they charged prime business borrowers from 4½ percent (in effect since August 1960) to 5 percent. This was followed in 1966 by three prime-rate increases—in March, June, and August—which finally brought this pivotal rate to 6 percent. Since business loans generally are tied in some way to that rate, these changes resulted in sharply increased revenues from the ebullient business-loan sector. Rates on other loan categories also moved up during the year in line with the prime-rate increase and the rise in money-market rates generally.

Higher security yields

Revenue from security holdings increased $22 million in 1966, but the gain did not apply to all categories of securities. A reduction of over $600 million in District-bank portfolios of U.S. Treasury securities more than offset the effect of a 16-basis point in-

Revenue gains exceed increases in bank expenses . . . profits reduced by losses on loans and securities



crease in the average rate of return on Treasury issues, and income from this source therefore decreased by $17 million. On the other hand, bank holdings of other securities, mainly tax-exempt municipals, rose by $500 million, while their average rate of return on municipals increased 17 basis points. The combination of larger volume and higher yields produced a $39-million increase in income from other securities, and this more than offset the lower revenue received from Treasury issues.

As in other recent years, income from sources other than loans and securities continued to rise in 1966. Revenue from service charges on deposits increased 7 percent, a lower rate of gain than in 1965 because of a somewhat smaller growth in demand deposits. The largest revenue gains were from "other charges and fees" and from "other" current revenue, which rose 21 and 24 percent respectively. These increases developed mainly from the wide range of computer services now being offered by District banks and an increase in business fees from expanded credit-card programs.

Trust department income reached $80 million in 1966 as revenue rose 9 percent, almost double the 1965 rate of increase. Greater emphasis on trust activities by District banks, particularly some of the medium-sized banks, substantially enhanced trust business as a source of District bank revenue in this as in other recent years.

Slower time-deposit growth

Total bank expenses reached a record $2,219 million in 1966, a 14-percent increase over 1965. This rate of gain was slightly below the 1965 increase, primarily because the major expense item—interest on time deposits—rose "only" 18 percent compared with a record rise of 25 percent in the preceding year. This dampening of the interest-cost spiral reflected a slowdown in the rate of growth of time-and-savings deposits

SELECTED OPERATING RATIOS OF TWELFTH DISTRICT MEMBER BANKS

(Percent Ratios)

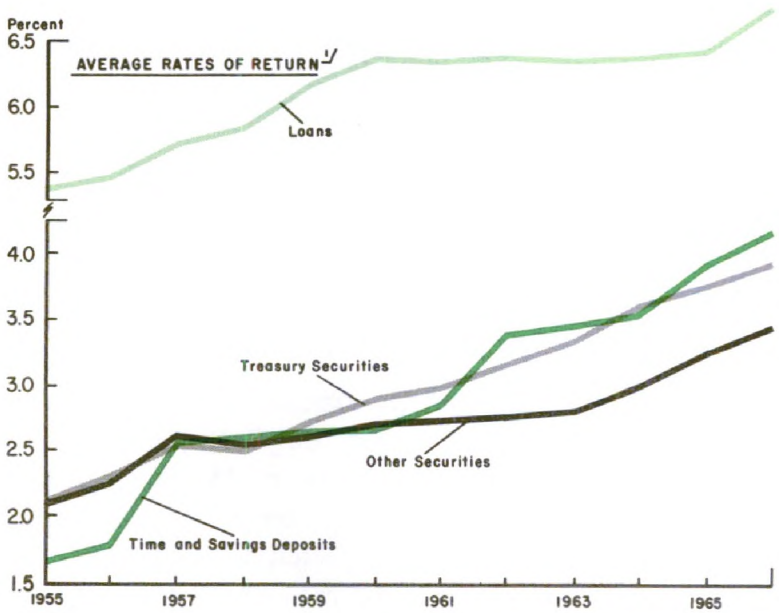
	1966p	1965	Increase or Decrease
Earnings ratios:			
Return on loans	6.73	6.41	+0.32
Return on U. S. Government securities	3.91	3.75	+0.16
Return on other securities	3.43	3.26	+0.17
Current earnings to capital accounts	16.48	16.05	+0.43
Net profits after taxes to capital accounts	8.08	9.01	—0.93
Cash dividends to capital accounts	4.85	5.06	—0.21
Other ratios:			
Interest paid on time deposits to time deposits	4.18	3.92	+0.26
Time deposits to total deposits	55.64	53.33	+2.31

p—Preliminary.
Note: These ratios are computed from aggregate dollar amounts of earnings and expense items of Twelfth District member banks. Capital accounts, deposits, loans, and securities items on which these ratios are based are averages of Call Report data as of December 31, 1964, June 30, 1965, and December 31, 1965; and as of December 31, 1965, June 30, 1966, and December 31, 1966.
Source: Federal Reserve Bank of San Francisco.

—from 13 percent in 1965 to under 8 percent in 1966. Partially offsetting this factor was a rise of 26 basis points in the average rate of interest paid on deposits.

Several factors were responsible for the further upward movement in deposit rates.

Spread widens between average rate charged on loans and average rate paid on time deposits



Beginning in the second quarter of 1966 and continuing throughout the year, bank depositors shifted substantial amounts from their passbook savings (which paid a maximum rate of 4 percent) to various types of consumer savings certificates and other time certificates (which paid rates substantially above 4 percent). In addition, during much of the year, District banks paid the ceiling rate of 5½ percent on the large-denomination negotiable CD's that they issued to corporations and other large depositors.

District member banks paid $36 million in interest on borrowed money in 1966 — up 59 percent over the 1965 figure. This increase took place despite a lower volume of discounting with the Federal Reserve Bank of San Francisco and despite an unchanged (4½ percent) discount rate. Most borrowing by District banks in 1966 was through the purchase of Federal funds (idle balances of banks on deposit with a Federal Reserve Bank). Moreover, rates on these funds were substantially above

the level prevailing in 1965 — and remained, generally, well above the discount rate.

Higher-paid employees

Despite an almost complete cessation of new bank openings and a substantial reduction in new branch-office openings, wage and salary expenses (including fringe benefits) rose 8 percent in 1966—slightly more than the 1965 increase. The effects of bank automation continued to be apparent in the structuring of bank employment. The number of employees expanded by 4.5 percent, in contrast to a 1965 gain of 2.8 percent. The rate of increase in employee wages continued to outstrip the increase in numbers, as the type of jobs created through automation demanded skills drawing higher rates of pay.

However, 1966's most dramatic change was a sharp 10-percent increase in the number of bank officers. This increase in numbers was a major factor behind a 13-percent increase in officer salaries. In just five years the proportion of officers to total employees at District banks has risen from 19 percent to 23 percent.

Loan and security losses

In 1966, District member banks had net income of $425 million before taxes—$33 million less than in the previous year—as larger loan and security losses more than offset the increase in net operating earnings. Net loan losses (including those charged to bad debts and other loan reserves) rose to $71 million in line with a rising trend in the loan-loss ratio. Yet, despite relatively higher loan losses, banks transferred about the same amount to their bad-debt reserves as in 1965 —a year in which many banks substantially increased such reserves under the new (and for them more advantageous) Internal Revenue formula on computing bad debt reserves.

District banks also had net losses of $47 million on securities in 1966. Higher yields on securities reflected a drop in prices below original purchase-price levels; thus, as banks liquidated securities to obtain additional loan

SELECTED RESOURCE AND LIABILITY ITEMS OF ALL MEMBER BANKS TWELFTH DISTRICT, DECEMBER 31, 1966

(millions of dollars)

	As of Dec. 31, 1966p	Change from December 31, 1965 Dollars	Percent
Net loans and investments[1]	42,249	+1,708	+ 4.2
Loans and discounts, net[1]	30,931	+1,831	+ 6.3
Commercial and industrial loans	11,280	+1,220	+12.1
Agricultural loans[2]	1,272	+ 687	+ 5.7
Real estate loans	9,536	+ 244	+ 2.6
Loans to individuals	6,074	+ 303	+ 5.3
U. S. Government obligations	5,545	− 632	−10.2
Other securities[3]	5,773	+ 509	+ 9.7
Total assets	52,392	+3,299	+ 6.7
Total deposits	46,111	+2,333	+ 5.3
Demand deposits	20,298		
Total time and savings deposits	25,813	+1,862	+ 7.8
Savings	15,770	−1,418	− 8.3
Other Time, IPC	6,365	+3,119	+96.1
Capital accounts	3,664	+ 115	+ 3.2

p—Preliminary.
[1] Total loans, including Federal Funds sold, minus valuation reserves. Selected loan items which follow are reported gross.
[2] 1966 data excludes loans directly guaranteed by CCC.
[3] 1966 data includes Export-Import Bank participations and CCC loans previously reported under loan categories.
Note: Details may not add to totals due to rounding.
Source: Federal Reserve Bank of San Francisco.

funds or to effect a restructuring of their securities portfolios, they were faced with substantial capital losses. In 1965, by way of contrast, banks realized net profits of about $5 million from their security sales.

Total taxes paid by District member banks declined 9 percent in 1966. Lower Federal taxes more than offset an increase in state taxes, but the reduction in taxes was not great enough to bring after-tax profits to the year-ago level. Thus, District banks ended 1966 with net profits of $291 million—$20 million less than in 1965. Banks meanwhile declared cash dividends of $175 million—almost the exact amount declared in 1965. Since capital accounts increased during the year, the ratio of cash dividends to capital accounts was reduced.

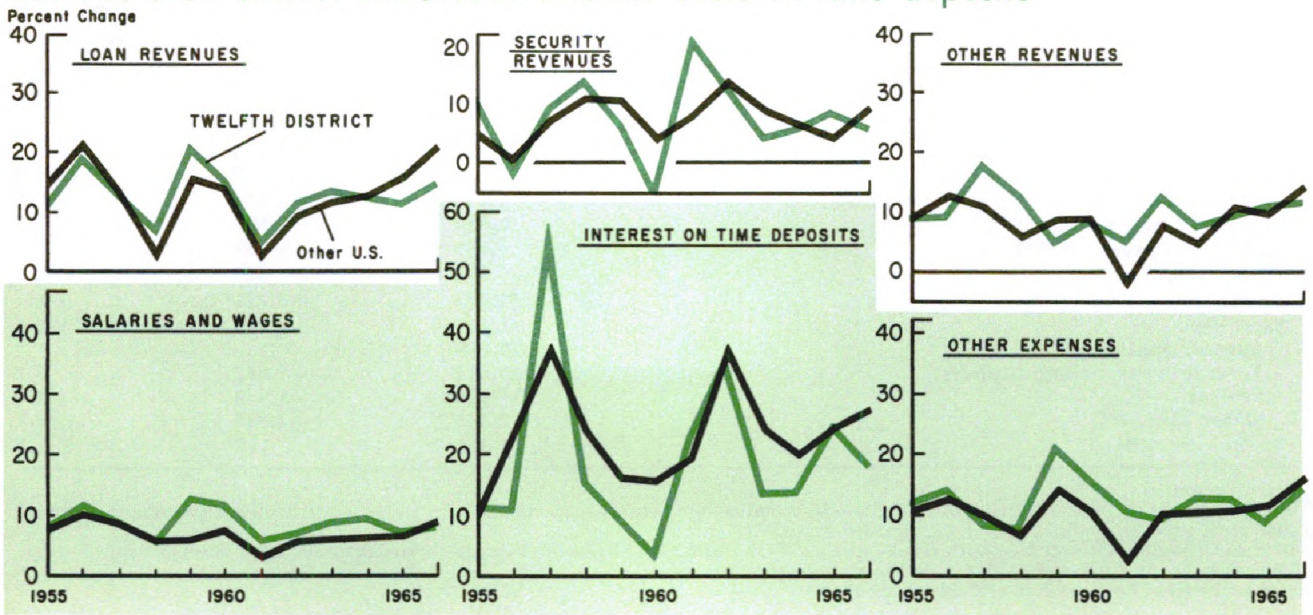
Similar earnings pattern

The thirteen largest District member banks (those with deposits of $500 million and over) had a somewhat similar earnings pattern as other District member banks in 1966. Nonetheless, the "other" bank group had a greater percentage increase in net current earnings, as well as in net income before and after taxes, than did the largest-bank group. On the revenue side, the "other" group's interest income from both U.S. Government securities and other securities exceeded that of the preceding year. Although the percentage gain in direct loan revenue was approximately the same for both groups, the "other" group had a greater gain in charges and fees from loans, and it also enjoyed a relatively larger increase in trust revenues.

Interest costs on time deposits rose more for the "other" bank group, partly because these banks had a steadier deposit growth than the largest banks, many of which experienced large fluctuations in CD's during the year. First-time issuance of consumer-type savings and time certificates also boosted interest costs for many smaller banks. The "other" bank group had relatively greater increases in employee salaries and in fringe benefits than the largest banks.

Non-operating expenses rose sharply for both bank groups. However, "other" banks had a higher rate of increase in loan losses

District banks exhibit smaller gains in revenues than other banks, but also show smaller increase in interest costs on time deposits



PERCENT CHANGES IN SELECTED EARNINGS AND EXPENSE ITEMS OF TWELFTH DISTRICT MEMBER BANKS

	All		13 Largest[1]		Other	
	1965-66	1964-1965	1965-66	1964-1965	1965-66	1964-65
Earnings on loans	+14.3	+11.2	+14.3	+10.9	+14.3	+12.9
Int. and dividends on securities	+ 5.6	+ 8.2	+ 4.0	+ 8.6	+12.1	+ 6.7
U. S. Government	− 7.2	− 1.8	−10.3	− 2.3	+ 3.9	+ 0.2
Other	+24.6	+27.7	+23.8	+28.7	+28.8	+23.0
Service charges on deposit accounts	+ 6.9	+ 9.3	+ 5.9	+ 9.5	+11.0	+ 8.7
Trust Department earnings	+ 8.6	+ 4.0	+ 7.5	+ 2.6	+15.5	+14.1
Other earnings	+22.9	+21.3	+26.3	+15.6	+10.9	+46.6
Total earnings	+12.5	+10.7	+12.3	+10.3	+13.6	+12.6
Salaries and wages	+ 7.8	+ 6.8	+ 7.8	+ 6.4	+ 8.0	+ 8.6
Interest on time deposits	+17.9	+24.9	+17.6	+25.1	+19.4	+23.9
Other expenses	+14.3	+ 8.6	+14.0	+ 7.9	+15.6	+11.0
Total expenses	+14.0	+14.9	+13.9	+14.8	+14.6	+15.3
Net current earnings	+ 7.5	− 1.8	+ 6.9	− 2.6	+10.0	+ 2.0
Net profits before income taxes	− 7.2	+ 4.3	− 7.8	+ 5.4	− 4.5	0
Taxes on net income	− 9.3	−12.9	− 9.3	−12.3	− 9.5	−15.4
Net profit after taxes	− 6.2	+15.2	− 7.2	+16.4	− 1.8	+ 9.8
Cash dividends declared	+ 0.5	+ 7.7	− 0.2	+ 6.8	+ 3.9	+12.5

[1]Includes all District member banks with total deposits of $500 million and over as of December 31, 1966.
Source: Federal Reserve Bank of San Francisco.

than the thirteen largest banks, as well as a lower rate of loss from securities sales.

1967?

As mentioned earlier, reductions in loan rates and security yields took place in the opening months of 1967. Even so, banks now have a large portion of their loan and security portfolios yielding rates of return well above the levels existing in the first quarter of a year ago.

Some lessening in loan demand has recently occurred, particularly from the business sector, which accounted for the largest part of 1966's credit expansion. At the same time, there are indications that mortgage lending may recover somewhat from the depressed levels prevailing last year. Moreover, through expanded use of credit cards, District banks may enlarge their share of the retail consumer-loan market in 1967, and this could serve to offset some of the effects of a lower projected volume of automobile financing. And, under the present somewhat easier monetary policy, including the recent reduction in reserve requirements on savings and certain other time deposits, and the current accelerated inflow of time deposits, District banks should be in a better position to expand their loan portfolios during coming months—which in turn should mean higher operating revenues.

On the other hand, District banks may experience mounting interest costs on their time deposits if the net inflow of time-and-savings deposits continues at the somewhat faster recent pace—and if rates on consumer type certificates are not cut. Besides, the inexorable rise in wage and salary expense can be expected to continue. In addition, the expansion of credit-card programs could have a marked effect on banks' expenses this year. A large number of both large and medium-size District banks initiated credit-card programs in late 1966, or plan to start issuing credit cards this year. As the early stages of such programs normally entail heavy start-up costs, these programs may result in significant increases in bank operating expenses in 1967.

—*Ruth Wilson*