Earnings Rebound Continues for Eleventh District Banks

"While District banks have become much more profitable than they were in 1988, the profitability of banks elsewhere has declined substantially."

Banks in the Eleventh District, which comprises Texas, southern New Mexico and northern Louisiana, have extended the 1990 earnings rebound that reversed a four-year trend of losses. With a first-quarter net income of $325 million, District banks, as a group, were able to generate a return on assets of 0.74 percent, which compares favorably to a net income of $182 million and a return on assets of 0.41 percent during the same period last year. The proportion of profitable District banks also climbed substantially. In contrast, banks outside the District collectively reported lower returns and deteriorating asset quality.

National Comparisons

Preliminary data indicate that the continued rebound in bank earnings pushed the first-quarter return on assets at District banks slightly above the return generated at banks elsewhere in the nation, as shown in Chart 1. During the four most recent quarters, the pattern of returns for District banks closely resembles the pattern for their counterparts elsewhere in the nation. However, a longer-term comparison of earnings reveals that while District banks have become much more profitable than they were in 1988, the profitability of banks elsewhere has declined substantially.

The differing trends in returns at District banks and other U.S. banks can be attributed, in part, to differences in market conditions. While the nation entered a substantial recession in the third quarter of 1990, economic conditions in the District deteriorated only mildly. Chart 2 contrasts nonfarm employment growth in the three District states with employment growth in the rest of the nation. Employment growth outside the District began to fall appreciably during 1989 and eventually dropped below zero.
The comparative strength of District Year-over-year rate of growth (percent)

The Rest of the Nation

* Preliminary.

Taxes

Table 1

Major Profitability Components for Eleventh District Banks

<table>
<thead>
<tr>
<th></th>
<th>1990:1</th>
<th>1991:1*</th>
<th>Effect on Profitability (Basis Points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Interest Margin</td>
<td>2.70</td>
<td>3.22</td>
<td>+52</td>
</tr>
<tr>
<td>Noninterest Income</td>
<td>1.46</td>
<td>1.62</td>
<td>+16</td>
</tr>
<tr>
<td>Loss Provision</td>
<td>.45</td>
<td>.45</td>
<td>0</td>
</tr>
<tr>
<td>Other Noninterest Expense</td>
<td>3.23</td>
<td>3.64</td>
<td>-41</td>
</tr>
<tr>
<td>Gains on Securities</td>
<td>.02</td>
<td>.13</td>
<td>+11</td>
</tr>
<tr>
<td>Taxes</td>
<td>.12</td>
<td>.18</td>
<td>-6</td>
</tr>
<tr>
<td>Extraordinary Items</td>
<td>.03</td>
<td>.04</td>
<td>+1</td>
</tr>
<tr>
<td>Return on Assets</td>
<td>.41</td>
<td>.74</td>
<td>+33</td>
</tr>
</tbody>
</table>

* Preliminary.

NOTE: Data are annualized and adjusted for mergers and acquisitions. DATA SOURCE: Report of Condition and Income.

Anatomy of Eleventh District Improvement

The first-quarter return on assets for District banks compared favorably to the return for other U.S. banks and also exceeded, by a substantial margin, the return generated by District banks in the first quarter of 1990. Table 1 shows a comparison between the major components of District bank profitability for the first quarter of 1990 and the first quarter of 1991. An increase in noninterest expense worked to reduce the return on District banking assets but was more than offset by a sharply higher net interest margin. The rise in noninterest expense was influenced by an increase in both salary-related expenses and various unclassified expenses, while the wider net interest margin can be traced to a large reduction in interest expense.

One explanation for lower interest expense is the recent decline in market interest rates. Another contributing factor has been a movement away from the use of purchased funds and toward a reliance on less-expensive core deposits. The percentage of District banking assets funded by large certificates of deposit has declined steadily in recent years. District banks funded 13 percent of assets with large certificates of deposit in 1990, but only 8 percent of assets in the first quarter of 1991.
the first quarter of this year, compared to 16 percent in the first quarter of 1990 and 20 percent in the first quarter of 1989. This movement helped to lower interest expense on large certificates of deposit from 1.29 percent of assets in the first quarter of 1990 to 0.99 percent in the first quarter of 1991.

In addition to improved returns, the District also experienced a reduction in the proportion of banks with negative net income. Chart 6 shows frequency distributions for the return on assets at individual District banks. Each bar measures the proportion of District banks that had a return on assets within a specified range. Two distributions are drawn, one for the first quarter of 1990 and one for the first quarter of 1991. As shown by the height of the bars to the left of the vertical dividing line, the proportion of District banks within each range of negative returns was smaller for the first quarter of 1991 than for the first quarter of 1990. Correspondingly, the proportion of District banks with positive returns between zero and 2 percent increased substantially. In total, 86 percent of District banks were profitable in the first quarter of 1991, compared to only 78 percent in the same period last year.

The overall rightward shift of the 1991 distribution toward higher returns reflects both widespread improvement among the District's banks and the resolution of District bank failures. But despite the improvements that have already occurred, the District still has a relatively low proportion of banks with a positive net income compared to the rest of the nation, where 90 percent of all banks were profitable in the first quarter of 1991.

As banking conditions continue to improve in the District, the number of bank failures should also decrease. Experience this year has supported such a trend. During the first five months of 1991, 20 District banks failed, compared to 43 failures for the same period last year.

Concluding Remarks

Recent District banking trends have diverged from those in the rest of the nation. The earnings rebound that reversed a trend of losses and generated positive net income at District banks in 1990 continued into the first quarter of this year. The return on District banking assets surpassed year-
earlier levels, and the proportion of District banks that were profitable also climbed substantially. At the same time, the banking industry outside the District experienced lower returns and a deterioration in asset quality.

The boom-to-bust banking patterns witnessed in the South-west during the 1980s, once thought to be unique to this region, are now apparent, to varying degrees, in other areas of the country. This trend suggests that it is both the institutional framework of banking and regional characteristics that have contributed to current banking difficulties. In response to these developments, a consensus has now formed around the need for fundamental banking reform. Considerable disagreement persists, however, over which specific reform measures are required. Our next issue will explore perspectives on banking reform.

—Jeffery W. Gunther
Kelly Klemme