Banking & Finance

AN EIGHTH DISTRICT PERSPECTIVE

SPRING 1986

Eighth District Bank Performance in 1985

For many Eighth District banks, 1985 was a strong year for reported earnings, as the positive impact of lower interest rates and profitable investment decisions more than offset the negative effects of steadily increasing loan losses. For some Eighth District banks, however, 1985 was characterized by loan problems that depressed earnings as well as return on assets. This article examines the recent Eighth District banking experience and highlights profitability distinctions among District states.

Earnings

In assessing earnings performance, both the size and the composition of items in a bank's portfolio must be appraised. The quantitative aspect of earnings is evaluated through an analysis of a bank's return on assets (ROA) and return on shareholders' equity (ROE). The ROA ratio, calculated by dividing a bank's net income by its assets, gauges how well a bank's management is employing its assets. The ROE ratio, obtained by dividing a bank's net income by its total equity capital, indicates to shareholders the earnings on their investment.

As indicated in table 1 on the next page, Eighth District banks earned a 0.89 percent ROA and an 11.05 percent ROE in 1985, compared with 1984 averages of 0.87 percent and 10.93 percent, respectively. The higher profitability ratios are due, in large measure, to a wider spread between interest income and interest expense. With a decline in interest expense as a percent of bank assets, net interest margins improved. In general, banks benefit from periods of declining interest rates because their cost of funds declines more rapidly than the interest rates they charge borrowers.

Returns on assets and on equity were up in all Eighth District states except Illinois, where lower reported earnings by banks with less than $100 million in assets, hampered the profitability ratios. It should be noted, however, that only banks in southern Illinois are within the Eighth District's borders so that the performance of small agricultural banks primarily accounts for the declining returns on assets and equity. Banks in Kentucky and Mississippi, on the other hand, outranked the other District states, posting the highest returns on assets and equity.

Asset Quality

Because the quality of an institution's assets eventually is reflected in its earnings stream, the composition of the asset portfolio is an indicator of the future earnings of an organization. Asset quality is sensitive to both national and international conditions and particular regional trends that affect the quality of a bank's loan portfolio. As the financial strength of certain borrowers deteriorates, their ability to satisfy loan obligations is impaired.

Changes in asset quality can be monitored by two indicators. The first, loan loss rates, have direct impact on bank profitability since they represent actual charge-offs against income. As loan loss rates rise, banks increase their loan loss provision account, thereby reducing profitability. The second indicator, loan delinquency (nonperforming) rates, indicate the potential for loan losses and, therefore, provide a rough indication of future losses.

Credit or loan quality, as measured by the loan loss ratio, deteriorated during 1985. As indicated in table 2, data for the Eighth District and individual states reveal increases in the ratio of loan losses to total loans. Illinois banks, with the agricultural loan problems experienced during 1985, posted a significant increase in their average loan loss ratio.

Nonperforming loans as a percent of total loans increased slightly at the District level during 1985. Arkansas, Illinois and Mississippi experienced rising delinquency rates in 1985. The remaining District states saw lower nonperforming loan ratios last year and, as a result, may realize lower loan loss rates in 1986.

Because of deteriorating average loan quality experienced during the past several years, most banks in the Eighth District have increased their loan loss reserves as a share of their total loans. This action has been taken

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as a precautionary measure to absorb potential future loan losses. As a percent of total loans, Eighth District banks' loan loss reserves increased from 1.20 percent in 1984 to 1.30 percent in 1985.

Summary

While some Eighth District banks continue to experience a variety of difficulties, such as rising loan loss rates, state data generally point to improved average performance. Returns on assets and equity increased in 1985 in most District states. In terms of returns on assets and equity, Kentucky and Mississippi posted the highest ratios for the seven states examined. Reported earnings were retarded somewhat, however, by larger provisions for loan losses.

—Lynn M. Barry

Table 1
Percentage Returns on Assets and Equity at Insured Commercial Banks (by state)

	Return on Assets		Return on Equity	
	1984	1985	1984	1985
Eighth District	0.87%	0.89%	10.93%	11.05%
Arkansas[1]	0.78	0.85	9.55	10.29
Illinois	0.89	0.77	10.43	9.06
Indiana	0.93	0.98	10.87	11.22
Kentucky	1.04	1.12	12.35	13.37
Mississippi	1.01	1.21	12.28	14.41
Missouri	0.84	0.90	11.07	11.72
Tennessee	0.73	0.90	10.27	12.77

[1] Certain 1985 ratios for Arkansas have been adjusted to negate the effects of substantial losses which occurred when a now defunct government securities group was unable to honor obligations of a large commercial bank. The unadjusted 1985 ratios for Arkansas are as follows:

Return on Assets 0.52%
Return on Equity 6.36

SOURCE: Federal Deposit Insurance Corporation, "Consolidated Reports of Condition and Income for Insured Commercial Banks," 1984-85.

Table 2
Indicators of Asset Quality at Insured Commercial Banks (by state)

	Net Loan Loss ÷ Total Loans		Nonperforming Loans ÷ Total Loans		Loan Loss Reserve ÷ Total Loans	
	1984	1985	1984	1985	1984	1985
Eighth District	0.60%	0.88%	2.49%	2.50%	1.20%	1.30%
Arkansas[1]	0.69	0.97	2.57	3.30	1.10	1.40
Illinois	0.80	1.55	2.88	3.19	1.04	1.23
Indiana	0.51	0.79	2.05	1.78	1.11	1.15
Kentucky	0.52	0.66	2.35	2.06	1.37	1.34
Mississippi	0.75	0.89	1.89	2.02	1.11	1.28
Missouri	0.53	0.69	2.42	2.35	1.25	1.27
Tennessee	0.61	0.93	2.99	2.47	1.23	1.31

[1] Loan losses for Arkansas in 1985 have been adjusted to negate the effects of substantial losses which occurred when a now defunct government securities group was unable to honor obligations of a large commercial bank. The 1985 unadjusted loan loss ratio for Arkansas is 1.05 percent.

SOURCE: Federal Deposit Insurance Corporation, "Consolidated Reports of Condition and Income for Insured Commercial Banks," 1984-85.

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EIGHTH DISTRICT BANKING DATA

LARGE WEEKLY REPORTING BANKS[1]

Selected Assets & Liabilities	Level I/1986 ($ millions)	Rates of Change: Current Quarter IV/1985-I/1986	Current Year I/1985-I/1986	Same Periods Previous Year IV/1984-I/1985	I/1984-I/1985
Total Loans & Leases	$16,028	9.7%	7.8%	19.3%	13.8%
Commercial Loans	5,434	6.6	0.3	8.6	12.2
Consumer Loans	3,749	15.8	22.7	24.1	13.8
Real Estate Loans	3,570	13.9	7.0	14.5	11.3
Loans to Financial Institutions	796	−38.8	−23.4	−15.4	8.4
All Other Loans	2,479	25.0	22.8	90.3	26.5
Total Securities	3,836	6.7	5.6	3.5	−2.0
U.S. Treasury & Agency Securities	2,113	−16.2	−3.8	−4.7	−9.3
Other Securities	1,721	46.9	19.9	17.8	11.6
Total Deposits	18,905	−0.8	2.7	4.1	7.4
Non-Transaction Balances	11,765	1.2	0.8	6.6	12.0
MMDAs	2,442	29.6	13.5	32.1	11.4
$100,000 CDs	3,718	−1.3	−4.4	4.3	17.0
Demand Deposits	5,393	−7.4	2.7	−5.7	−2.2
Other Transaction Balances[2]	1,733	21.9	16.1	22.8	9.4

SMALL WEEKLY REPORTING BANKS[3]

Selected Assets & Liabilities	Level I/1986 ($ millions)	Rates of Change: Current Quarter IV/1985-I/1986	Current Year I/1985-I/1986	Previous Year IV/1984-I/1985
Total Loans & Leases	$5,060	0.7%	4.4%	8.2%
Commercial Loans	1,509	−5.5	−3.2	9.5
Consumer Loans	1,001	−13.4	−0.4	10.3
Real Estate Loans	2,077	8.1	8.4	8.2
All Other Loans	473	25.8	29.1	−2.2
U.S. Treasury & Agency Securities	1,951	−3.0	−0.6	13.3
Other Securities	742	22.5	8.4	3.0
Total Deposits	7,671	−23.3	−0.2	10.2

[1] A sample of commercial banks with total assets greater than $750 million. Historical data have been revised to incorporate adjustment factors that offset the cumulative effects of mergers and other changes involving weekly reporting banks during 1985. These adjustment factors, which are computed each year, are used to construct a consistent time series for which year-to-year growth rates can be calculated. Adjustment factors are available upon request from the Statistics Section of the Research and Public Information Department. Rates of change are compounded annual rates.

[2] Includes NOW, Super NOW, ATS and accounts permitting telephone or pre-authorized transfers.

[3] A sample of commercial banks with total assets less than $300 million as of January 1984.

EIGHTH DISTRICT BANKING DATA

Bank Performance Ratios

RATIOS	IV/1985	IV/1984	IV/1983
Loans to Deposits			
Large Banks[4]	77.32%	73.82%	66.02%
Small Banks[5]	58.55	59.11	57.10
Loan Loss Reserves to Total Loans			
Large Banks	1.45	1.39	1.48
Small Banks	1.22	1.12	1.04
Delinquent Loans to Total Loans			
Large Banks	3.80	3.87	5.21
Small Banks	5.13	4.95	4.68
Net Loan Losses to Total Loans			
Large Banks	0.64	0.42	0.43
Small Banks	1.03	0.70	0.68

EIGHTH DISTRICT INTEREST RATES[6]

	March 1986	February 1986	January 1986	Year Ago March 1985
Super NOWs	5.52%	5.70%	5.72%	6.89%
MMDAs	6.53	6.83	6.85	7.76
Time CDS				
92 — 182 days	6.96	7.30	7.32	8.79
1 — 2½ years	7.65	8.08	8.10	9.50
2½ years and over	7.99	8.43	8.49	9.77

[4] All Eighth District banks with total assets greater than $750 million. Ratios are derived from Call Reports.

[5] All Eighth District banks with total assets less than $300 million.

[6] Average interest rates paid on new deposits by a sample of District commercial banks.