Solid Performance at Tenth District Banks

By William R. Keeton and Anne D. McKibbin

Commercial banks in Tenth District states performed well in the first half of 1997. Profitability and loan quality remained high, while loans continued to grow at a healthy pace. The only negative was that deposits grew sluggishly, adding to liquidity pressures. Banks in district states slightly outperformed banks nationwide in profitability and loan quality, while matching them in loan growth and deposit growth.

Performance of district banks

Banking performance in a particular state or group of states has traditionally been measured by the performance of all banks headquartered in that area. The rapid growth of interstate branching during the last year has made this measure of local banking performance somewhat less reliable, as banks in many states have been merged into banks headquartered in other states (see box). Banks headquartered in Tenth District states continue to account for a substantial majority of district banking operations, however, making it worthwhile to examine the change in their performance over the previous year. In looking at changes in performance, it is essential to control for changes in the sample due to local banks becoming branches of nonlocal banks and to nonlocal banks becoming branches of local banks. Accordingly, this article focuses on merger-adjusted changes in performance at a constant sample of banks—those that were headquartered in the district in mid-1997 and in operation during both 1996 and 1997

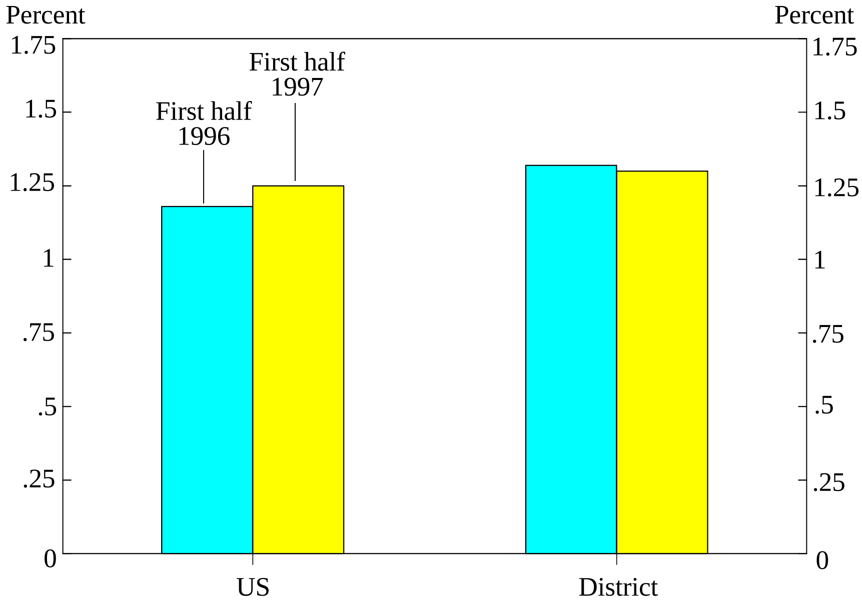
Profits at district banks remained high in the first half of 1997 (Chart 1). Profits are measured by return on assets (ROA), the ratio of after-tax profits to average assets. The roughly 1,780 banks headquartered in the district last June earned an average ROA of 1.30 percent in the first half, two basis points less than the same banks earned in the first half of 1996. District banks also maintained a narrow lead over banks in the nation, where ROA edged up to 1.25 percent.

Profits remained high at district banks because all major components held steady (Table 1). Net interest income was stable, as interest income and interest expense edged down by similar amounts. Noninterest income and noninterest expense also declined by roughly the same amount, leaving net noninterest expense little changed. Banks had to set aside more funds to cover loan chargeoffs, which rose five basis points from the first half of 1996. But banks added somewhat less to their loan loss reserves than the year before. As a result, loan loss provisions were unchanged at 0.27 percent of assets. Net security gains remained small, and for the second year in a row, extraordinary gains were negligible.

Loan quality at district banks was strong in the first half of 1997, showing a slight improvement over the first half of 1996. Loan quality can be measured by noncurrent loans, which include loans at least 90 days overdue and not accruing interest. At the end of June, these noncurrent loans were 0.95 percent of total loans, seven basis points lower than a year earlier. Delinquency rates remained high on credit card loans but fell sharply on farm operating loans, reflecting the turnaround in the cattle industry and improved growing conditions for crop producers. Delinquency rates were little changed for real estate loans, business loans and consumer loans other than credit card loans. The district delinquency rate remained slightly below the national delinquency rate, which edged down to 1.00 percent.

District bank loans continued to grow at a healthy pace in the first half of 1997. Loans at district banks rose at an annual rate of 8.1 percent in

Chart 1
Return on Assets
Commercial banks



the first half, one and a half percentage points faster than a year earlier and about the same rate as in the nation. Solid economic growth helped sustain loan demand, especially among business borrowers. And banks remained eager to lend, competing aggressively for customers.

District bank deposits rose a modest 1.7 percent in the first half of the year. This pace was down slightly from a year ago and about the same as in the nation. The sluggish deposit growth helped boost the district loan-deposit ratio to 71.1 percent, almost two percentage points higher than a year ago. Loan-deposit ratios rose at banks of all size but especially at small banks—those with less than $100 million in assets. During the last couple of years, these banks have experienced much faster loan growth than larger banks, but only moderately faster deposit growth. The higher loan-deposit ratios have strained liquidity, making banks more vulnerable to a sudden outflow of funds or slowdown in loan payments.

Performance by state

While Tenth District banks performed well on average during the first half of the year, performance varied across the seven district states. Compared with a year ago, profitability increased modestly in Wyoming and Kansas. Profitability was flat in Nebraska, Colorado, and Oklahoma and fell somewhat in Missouri and New Mexico (Chart 2). Loan quality improved in Kansas, Oklahoma, and Wyoming and was stable in other states (Table 1). Loan growth was moderate to strong in all states except Wyoming, while deposit growth was weak in all states except Kansas.

Wyoming. Average profitability rose modestly in Wyoming in the first half of 1997. ROA increased 10 basis points to 2.39 percent, increasing the state's already sizable lead over the rest of the district. Most of this gap in profitability has been due to exceptionally high earnings at a large bank. But other Wyoming banks have also been highly profitable,

Table 1
Bank Performance Measures
Tenth District states (constant sample)

	Tenth District States		Colorado		Kansas		Missouri	
	1996	1997	1996	1997	1996	1997	1996	1997
Profits (ROA)	1.32	1.30	1.39	1.37	1.13	1.23	1.37	1.28
Net interest income	4.28	4.25	4.87	4.84	4.09	4.21	4.06	4.01
- Loan loss provisions	.27	.27	.20	.25	.31	.22	.20	.23
- Net noninterest expense	1.97	1.96	2.53	2.50	2.01	2.08	1.71	1.76
+ Net securities gains	.02	.01	.05	-.02	.00	.00	.01	.00
+ Extraordinary gains	.00	.00	.00	.00	.00	.00	.00	.00
- Total taxes	.74	.72	.79	.71	.64	.69	.79	.74
Net chargeoffs	.19	.24	.14	.21	.26	.23	.14	.20
Noncurrent loans	1.02	.95	.60	.60	1.25	.98	.85	.88
Loan growth	6.7	8.1	12.7	8.2	6.0	14.6	7.1	8.4
Deposit growth	2.6	1.7	4.7	2.6	0.4	6.3	.6	.2

	Nebraska		New Mexico		Oklahoma		Wyoming	
	1996	1997	1996	1997	1996	1997	1996	1997
Profits (ROA)	1.28	1.27	1.43	1.25	1.12	1.10	2.29	2.39
Net interest income	4.27	4.38	4.65	4.37	3.98	3.76	4.97	5.36
- Loan loss provisions	.64	.69	.09	.13	.23	.22	.17	.16
- Net noninterest expense	1.68	1.74	2.37	2.26	2.06	1.85	1.44	1.56
+ Net securities gains	.02	.00	.05	.06	.00	.03	.15	.00
+ Extraordinary gains	.00	.00	.00	.00	.00	.00	.00	.00
- Total taxes	.69	.69	.81	.79	.57	.62	1.22	1.26
Net chargeoffs	.45	.61	.06	.12	.16	.14	.09	.12
Noncurrent loans	1.16	1.11	.99	1.03	1.42	1.32	.74	.60
Loan growth	6.0	5.2	3.9	5.8	4.1	7.4	4.8	.1
Deposit growth	.9	1.5	2.5	3.8	4.6	.8	13.1	-6.6

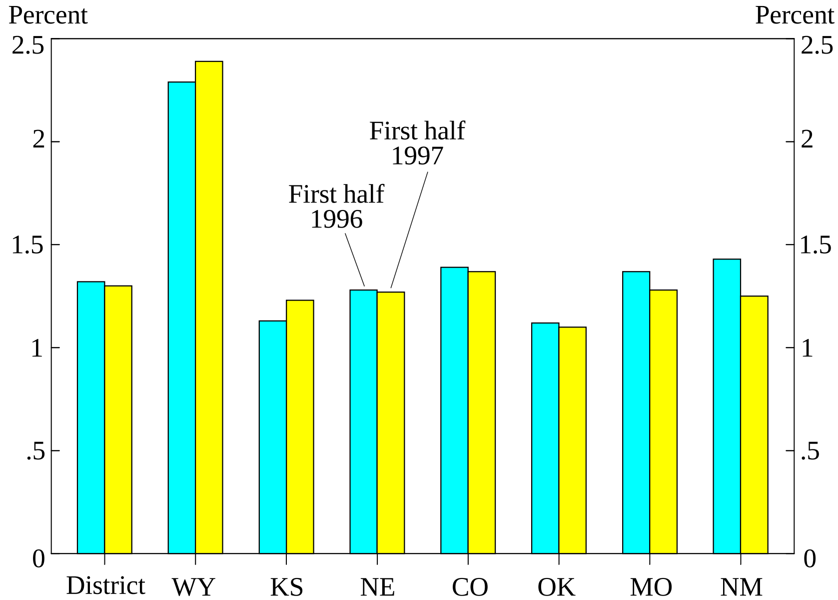
Note: Data are for the first half of the year. For each area, data for 1996 exclude those local banks that later became branches of nonlocal banks and include those nonlocal banks that later became branches of local banks. ROA, components of ROA, and net chargeoffs are a percent of average assets. Noncurrent loans are a percent of total loans. Loan and deposit growth rates are annualized percent changes from the end of the prior year to the middle of the current year. Loans are net of unearned income and deposits are for domestic offices only.

Source: "The Consolidated Reports of Condition and Income" for all FDIC insured commercial banks headquartered in the seven states of the Tenth Federal Reserve District.

Chart 2

Return on Assets by State

Commercial banks



earning an average ROA of 1.47 percent in the first half of 1997. That profit rate was up moderately from a year ago, helped by an improvement in net interest income and stable loan loss provisions.

Loan quality strengthened, while loan and deposit growth were held down by sharp declines at large banks. Noncurrent loans declined from 0.74 percent of total loans in mid-1996 to 0.60 percent in mid-1997, as the recovery in the state's cattle industry helped speed repayments on farm operating loans. Loans were flat and deposits plummeted 6.6 percent during the first half of 1997. Excluding the state's two largest banks, however, loans grew at a double-digit pace and deposits fell more modestly.

Kansas. Average profitability increased moderately in Kansas. ROA rose 10 basis points to 1.23 percent, bringing Kansas closer to the district average. Net interest income increased and loan loss provisions fell, outweighing an increase in net noninterest expense.

Loan quality improved, loan growth was very strong, and deposit growth was healthy. Noncurrent loans fell 27 basis points to 0.98 percent of total loans. Delinquencies were down sharply on farm loans and down moderately on commercial real estate loans. Loans increased a strong 14.6 percent, with banks of all sizes sharing in the growth. Deposits rose a solid 6.3 percent due to double-digit growth at medium-size banks—those with $100 million to $1 billion in assets.

Nebraska. Bank profitability was virtually unchanged in Nebraska. ROA slipped one basis point to 1.27 percent, a shade below the district average. Net interest income rose 11 basis points, making up for small increases in loan loss provisions and net noninterest expense.

Loan quality was stable and loan growth was healthy, while deposit growth remained sluggish. Noncurrent loans edged down five basis points to 1.11 percent, slightly above the district average. Delinquencies eased on farm loans and commercial real estate loans but rose on credit card loans, which are more important in Nebraska than in the rest of the district. Loans grew a solid 5.2 percent, as strong growth at banks under $1 billion in size compensated for weak growth at larger banks. Deposits increased a sluggish 1.5 percent, only marginally faster than the year before. As a result, the loan-deposit ratio rose further to 75.4 percent, well above the district average.

Colorado. Bank profits were little changed in Colorado, as ROA fell two basis points to 1.37 percent. Loan loss provisions edged up, while net security gains and net interest income both fell. Taxes also fell, however, limiting the decline in profits.

Loan quality stayed high, loan growth slowed to a more sustainable pace, and deposit growth remained sluggish. Noncurrent loans were 0.60 percent of total loans, the same as a year ago and well below the district average. Delinquencies edged up on farm operating loans but were little changed on other loans. Loan growth fell from 12.7 percent in the first half of 1996 to 8.2 percent in the first half of 1997. Deposits grew only 2.6 percent, half as fast as a year earlier.

Oklahoma. Profits were stable in Oklahoma. ROA slipped two basis points to 1.10 percent, the lowest profit rate in the district. Net noninterest expense fell sharply at the state's large banks, just offsetting a steep decline in their net interest income. At smaller banks, all major components of profits held steady.

Loan quality improved, loans grew at a health pace, and deposits were flat. Noncurrent loans fell ten basis points to 1.32 percent, as faster repayments on farm operating loans made up for slower repayments on business loans. Loans grew 7.4 percent, three percentage points faster than a year ago. Deposits increased a mere 0.8 percent, however, considerably slower than the year before.

Missouri. Profitability edged down at Missouri banks, as ROA declined nine basis points to 1.28 percent. Net interest income, loan loss provisions, and net noninterest expense all deteriorated slightly, contributing to the decline in earnings.

Loan quality was little changed, loan growth was healthy, and deposit growth was weak. Noncurrent loans were virtually unchanged at 0.88 percent of total loans. Loans grew a healthy 8.4 percent, slightly faster than the year before. Deposits barely increased at all, however, as solid growth at banks under $100 million in size failed to make up for weak growth at larger banks.

New Mexico. Bank profitability declined in New Mexico, but from a high level. ROA fell 18 points to 1.25 percent, slightly below the district average. A sharp drop in net interest income accounted for most of the earnings decline.

Loan quality was stable, while loan growth and deposit growth both improved slightly. Noncurrent loans were little changed at 1.03 percent, as lower delinquencies on farm operating loans made up for higher delinquencies on real estate loans. Loans grew a solid 5.8 percent, up a couple of percentage points from a year ago. Deposits increased a modest 3.8 percent.

Conclusion

Banks in Tenth District states continued to do well in the first half of 1997. Profitability was high and little changed from a year ago. Loan quality improved, and loans continued to grow at a healthy pace. The only unfavorable news was that deposit growth stayed sluggish, adding to liquidity pressures on district banks. On balance, district banks outperformed banks nationwide by a small margin, earning higher profits, holding fewer delinquent loans, and enjoying similar loan and deposit growth.

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Impact of Interstate Branching on Measures of Local Banking Performance

Assessing the performance of district banks has been complicated this year by a surge in interstate branching. Some out-of-state branches had been established previously in the district under a provision in federal banking law allowing national banks to move their headquarters a short distance across the state line. Interstate branching did not take off until this year, however, when the interstate branching provisions of the Reigle-Neal Act went into effect. A number of large bank holding companies have taken advantage of the new authority to consolidate their banks in different states under one charter, operating the merged banks as out-of-state branches. As a result, the amount of interstate branching has increased sharply, with many of the branches reporting to head offices in distant states and not just neighboring states.

The reason interstate branching makes it harder to assess local banking performance is that most banking data are reported at the bank level rather than the branch level. The reporting of data at the bank level creates two potential problems. The first is that measures of local banking performance may *include* some outside banking operations. This problem arises when banks in an area acquire branches in other areas, causing their performance to reflect nonlocal as well as local operations. The second problem is that measures of local banking performance may *exclude* some local banking operations. This problem arises when local banks are converted to branches of outside banks, causing the remaining banks to account for a smaller percentage of local banking operations.

Table A1 shows that the spread of interstate branching in the district has not yet led to the first problem—the inclusion of nonlocal banking operations in measures of local banking performance. For each state and the district as a whole, the first two columns shows the percent of deposits at local banks held in nonlocal branches in mid-1996 and mid-1997. Last June, only four states had any banks with out-of-state branches (Missouri, Kansas, Nebraska, and Oklahoma), and the amount of deposits in such branches was 10 percent or less in all four cases. Furthermore, most of the out-of-state branches owned by district banks were in other district states. As a result, district banks as a group held only 1.9 percent of their deposits in branches outside the district, virtually unchanged from a year ago.

The table shows, however, that the recent surge in interstate branching has significantly exacerbated the second problem—the exclusion of some local banking operations from measures of local banking performance. For each state and the district as a whole, the last two columns show the percent of local deposits held in branches of nonlocal banks. All but one district state were host to branches of out-of-state banks last June. In three of those states, the proportion of deposits in such branches was also up sharply from a year ago, surpassing 20 percent in each case (Missouri, Colorado, and Kansas). Many of the new branches report to head offices in other parts of the country, such as Minnesota or North Carolina. As a result, the percent of district deposits held in branches of banks based outside the district also jumped sharply, from 0.1 percent in mid-1996 to 17.5 percent in mid-1997.

While nonlocal banks account for an increased share of local banking operations in the district, local banks are still important

Table A1
Deposits at Local Banks and Branches
Tenth District states, midyear

	Percent of deposits at local banks held in nonlocal branches		Percent of deposits in local branches held by nonlocal banks	
	1996	1997*	1996	1997*
Colorado	0	0	.1	22.5
Kansas	4.3	5.9	3.1	21.4
Missouri	6.4	10.2	1.9	32.0
Nebraska	.3	.1	0	13.2
New Mexico	0	0	.8	7.6
Oklahoma	†	†	0	.3
Wyoming	0	0	0	0
Tenth District states	1.7	1.9	.1	17.5

* Estimated from data on mid-1996 deposits and subsequent mergers.

† Less than 0.5 percent.

Note: Local banks consist of all banks headquartered in the area, while local branches consist of all branches operating in the area.

Source: Summary of Deposits and National Information Center database.

enough for their overall performance to serve as a good measure of local banking performance. As indicated in the text, however, interstate branching has made it essential to focus on a constant sample of banks when looking at changes in performance over time. Otherwise, changes in measured performance could reflect changes in the mix of banks—for example, because the banks that convert to out-of-state branches have higher or lower profits than the banks that retain their charters.