provided by Research Papers in Economics

PERFORMANCE CHARACTERISTICS OF HIGH-EARNING MINORITY BANKS

*Bruce J. Summers and James F. Tucker**

One of the interesting developments on the American banking scene during the post-World War II era has been the increased interest shown by minority groups in the ownership and operation of commercial banks. Of the 81 minority banks in existence at year-end 1975, only 8 were operating in 1945. Fifteen more opened between 1946 and 1969, while 58 date from 1970. Although there were only 81 minority banks among the 14,600 commercial banks in operation at the close of 1975, the net increase in minority banks since the beginning of this decade amounts to over 250 percent, while the increase for nonminority banks amounts to only 12 percent. Of the 81 banks identified as minority institutions, 47 were owned by blacks and 27 were classified as Hispanic-American, with the remainder being distributed among Chinese-American (3), American Indian (2), Asian-American (1), and Multiracial (1) minority groups. Two of these 81 banks were actually organized as nonminority banks, but were later taken over by minority interests.[1]

The sudden proliferation in minority-owned banking institutions has attracted considerable attention, largely because the financial and economic aspects of minority banking are recognized as unique in the industry. These organizations provide banking services primarily to the nation's minority population, and the special business circumstances they face are related to the special position occupied by minority groups in the national economy. The close tie between the economic position of blacks and the operation of black banks, for example, is made by Brimmer [7; p. 382]. Nevertheless, it is also true that a great deal of variability exists *within* the ranks of minority banks when it comes to successfully dealing with these unique business circumstances. The primary objective of this study is to analyze those factors that lie behind the successful operation of minority banks.

There are, no doubt, many reasons for the sharp acceleration in the establishment of minority banks during the 1970's. Based on interviews with persons instrumental in organizing a number of these banks, however, three factors emerge as being central to the decision-making process leading to application for a bank charter. The first of these involves an increased awareness by minority group entrepreneurs of the profitability of commercial banking. Indeed, the success of existing minority banks became widely publicized during the late 1960's and early 1970's, and there was reason to believe that economic advances being made by minorities provided an even more advantageous market for banking services. The second factor concerns the improved environment for seeking and obtaining bank charters. Doubtlessly a part of the change in this environment reflected the momentum of civil rights legislation passed during the middle and late 1960's. Likewise, this was the period when minority groups began to achieve greater political influence at both the state and national levels, and this influence, at times, proved effective in "opening the door" to the chartering agencies and breaking bottlenecks for charter applications previously submitted. The third factor focuses on the then growing belief that locally-owned commercial banks could provide a stimulus to economic development in the minority community. Although some have questioned the ability of minority banks to perform this function successfully (see Brimmer [7; p. 399]), organizers of minority banks did in fact envision a significant role for their institutions in the development of minority business enterprise.

---

* The authors are grateful to Richard Rosenbloom and Peggy Nuckols for computational assistance. Jacqueline McDaniel, Data Base Analyst in the Division of Research and Statistics, Board of Governors of the Federal Reserve System, coordinated and supplied source data.

[1] A bank is recognized as minority-owned when 50 percent or more of its common stock is owned or controlled by individuals belonging to racial minority groups. OMBE of the Commerce Department, and the Treasury Department, which is responsible for administration of the Government's Minority Bank Deposit Program, officially designate minority banks. A recent amendment to the rules governing the Minority Bank Deposit Program allows a bank to qualify if: more than 50 percent of the bank's stock is owned by women; a majority of the bank's board consists of women; and women hold a significant number of management positions.

The operating characteristics of minority-owned banks have been the focus of a number of studies [2, 3, 4, 5, 6, 7, 8, 11, 13, 14]. Most studies of minority bank financial performance have considered bank operating characteristics in a comparative context. Using this methodology, minority banks have usually been compared to some other group of banks consisting of nonminority institutions, sometimes taking the form of all commercial banks or all nonminority banks. Brimmer [7], for example, compares the performance of black banks with that of all insured commercial banks and all member banks of the Federal Reserve System.

Other studies have also followed the relative performance methodology but have been more selective in choosing comparative sample groups of banks. In a companion to the Brimmer article mentioned above, Irons [11] views the operating characteristics of 18 black banks against a paired sample of 20 nonminority banks and a national average of similarly sized banks. Kohn [13] compares the performance of 6 minority banks (5 of which are located in the Tenth and 1 in the Eighth Federal Reserve District) with that of two groups of nonminority banks: 43 established member banks and 32 new commercial banks, all located in the Tenth Federal Reserve District. Boorman [2] and Boorman and Kwast [4] compare 8 minority banks established between 1963 and 1965 with a paired sample of nonminority banks. These two articles isolate the behavior of newly formed banks.

There are, of course, widely recognized problems with aggregating together all minority banks, or for that matter all commercial banks, for comparative purposes. Even when adjusted by size, age of operation, and location, it is difficult to get a meaningful sample group for comparing the operating characteristics of minority and nonminority banks. This is due to minority and nonminority banks serving communities that are quite different in terms of their social and economic makeup. It would seem, therefore, that there is something to be said for *intragroup* comparisons of minority banks.

Limited intragroup comparisons of minority banks have been made, notably as part of studies by Leavitt [14] and Boorman [3]. In these studies, both authors attempt to distinguish between newly formed and mature minority banks. Leavitt deals exclusively with black banks and constructs test groups on the basis of age (all black banks three years old versus all black banks over three years old) and charter classification (national and state-insured black banks). Boorman makes the most serious attempt at overcoming the problems associated with intergroup bank comparisons, but his discussion is limited to citing the differences between the newer and older minority banks. Perhaps most importantly, Boorman explicitly recognizes [3; p. 278] that ". . . other factors indicate that there may be significant differences in performance among the minority banks themselves." It is this central idea—that performance comparisons of minority banks can be most useful when made with other minority banks—that lies at the base of this study.

Segmenting Minority Banks For Comparison

This article undertakes an intragroup comparison of minority bank performance characteristics. Groups are identified for comparison from all minority-owned commercial banks in existence as of December 31, 1975, i.e., the universe of minority banks. The key advantage of an intragroup comparison is that uncontrollable differences between groups are neutralized to the greatest extent possible. At points in the analysis where a benchmark would be useful, however, reference will be made to standards maintained by commercial banks generally.

There are a number of possible ways to segment minority banks into groups for comparative purposes. As already mentioned, several previous studies [3, 14] have emphasized age of operation and type of charter. Other possible selection criteria include location, size, and perhaps even racial composition. Using nonfinancial criteria as a basis for sample selection, however, involves inherent bias. The problem is that the use of such nonfinancial criteria involves a *presupposition* that the chosen basis for sample selection is in fact a critical determinant of operating performance. The dangers inherent in this approach are avoided here by concentrating on strictly financial characteristics as a guide to selecting minority bank groups for comparison.

Two groups of banks are selected from the universe, with a four-year consolidated return on investment (CROI) as the critical selection factor. Return on investment is used because of its importance as a basic performance index in the eyes of both financial analysts and private investors. A four-year consolidation procedure is followed in order to insure that the banks selected for the comparison groups, hereafter re-

ferred to as the "high-earning" and the "residual" groups, have demonstrated earnings performance that can be considered sustainable over time.[2] The period of consolidation includes the years 1972-75.

Of the 81 minority banks in existence as of December 31, 1975, 45 had been in operation at least four years or longer. Thus, the universe of banks available for selection based on a four-year consolidation automatically is reduced from 81 to 45. In addition, one of the 45 banks is further eliminated due to its basic lack of conformity with the rest of the banks making up the universe.[3] The comparison groups, therefore, are chosen from among these 44 remaining minority banks.

[2] Sustainability implies some degree of stability, too. A coefficient of variation (i.e., the standard deviation of ROI divided by the mean) has been computed for each of the 11 banks in the high-earning group, with a resulting range of 0.11 to 0.67. Based on only four years of performance data, these coefficients are not suspiciously large. In addition, the variation is being measured around high mean values of ROI.

[3] This bank has been owned by minority stockholders for only 5 of its 20 years of existence. It had total assets at December 31, 1975, of $133 million, placing it far beyond the normal size range of the remaining minority banks.

The cutoff point for a CROI that places a bank in the high-earning category is set at 10 percent, a commonly used rule for evaluating business performance. On this basis, 11 of the 44 banks are selected for the high-earning group. These banks are listed in Table I. The remaining 33 banks constitute the residual group.

Nonfinancial Characteristics As Table I shows, the high-earning banks constitute a fairly diverse group. Nine of the eleven (82 percent) are black-owned, while 25 of the 33 residual banks (76 percent) are black-owned. As is also the case for the residual banks, most of the high-earning banks are located in large metropolitan areas, although the Northeast is conspicuously absent (three of the banks in the residual group are located in the New York City area, while one is located in Boston). Three of the high-earning banks, however, are located in cities with populations less than 100,000. In terms of total assets at year-end 1975, the high-earning banks range in size from $8.3 million to $56.3 million, the mean size being $26.5 million. The residual banks have a smaller

Table I

ELEVEN HIGH-EARNING MINORITY BANKS[1]

Bank Name	Location	Charter Class and Federal Reserve Membership Status	Establishment Date	Total Assets 12-31-75 $ Thousands	Minority Type
Industrial Bank of Washington	Washington, D. C.	State nonmember	8-18-34	40,082	Black
United National Bank of Washington	Washington, D. C.	National	8-31-64	30,846	Black
Mechanics & Farmers Bank	Durham, N. C.	State nonmember	3-1-08	41,199	Black
First State Bank	Danville, Va.	State nonmember	9-8-18	8,340	Black
Highland Community Bank	Chicago, Ill.	State nonmember	11-9-70	21,063	Black
South Side Bank[2]	Chicago, Ill.	State member	1-1-72	20,024	Black
Centinel Bank	Taos, N. M.	State nonmember	1-5-69	11,636	Hispanic-American
Riverside National Bank	Houston, Tex.	National	8-16-63	12,974	Black
Bank of Finance	Los Angeles, Calif.	State nonmember	11-16-64	39,032	Black
Cathay Bank	Los Angeles, Calif.	State nonmember	4-19-62	56,317	Chinese-American
Liberty Bank of Seattle	Seattle, Wash.	State nonmember	5-31-68	10,485	Black

[1] Banks with four-year consolidated return on investment of 10 percent or better.

[2] Minority shareholders gained controlling interest 5-1-72.

mean size of $18.7 million, with a range of $4.5 million to $62.4 million. While the average size high-earning group bank is about 40 percent larger than the average size residual group bank, there is nonetheless no simple association between larger size and higher profits. Indeed, 4 of the 11 high-earning banks fall below the average size of the residual group banks, and the operating economies enjoyed by a $26 million bank over an $18 million bank are certainly not great.

Eight of the high-earning banks (73 percent) are state nonmember banks, 2 are national banks, and only 1 is a state member bank. Among the residual banks, on the other hand, 19 (57 percent) are state nonmember banks, 13 (41 percent) are national banks, and, again, there is but one state member bank. This breakdown seems particularly interesting in view of the well-known argument that membership in the Federal Reserve System is a relatively costly alternative to nonmembership, inasmuch as reserve balances held with the Federal Reserve Banks are noninterest bearing. Although the high-earning banks, and to a lesser extent the residual banks, favor state charters and nonmember status in the Federal Reserve System, it should be pointed out that this pattern is changing somewhat. It will be recalled that 36 of the 81 minority banks in existence at year-end 1975 were not included in the final selection process, inasmuch as they were not in operation for four years or more. Of these 36 newer banks, 23 have national charters, 12 are state nonmembers, and 1 is a state member.[4] The shift in interest to national bank charters is probably related to the liberalized application procedure toward minority banks adopted by the Comptroller of the Currency in the early 1970's.

With respect to age, the high-earning and residual banks are quite similar. The mean ages for the two groups are, respectively, 21 and 16 years. Both groups can be considered mature from the standpoint of experience and market representation. As Table I shows, the variation in age among the high-earning banks is considerable; 2 of the banks date from 1970, while 3 were established prior to World War II.

Financial Characteristics Both the high-earning group and the residual group have an eclectic makeup, but their overall nonfinancial characteristics are not that dissimilar. Inasmuch as this is the case, it would seem that there is a good possibility that earnings differentials are essentially the result of management differences. Such differences would appear on bank balance sheets and income statements, and it is the purpose of this section to examine and compare important financial ratios for the two groups. As will become clear below, balance sheet management does indeed explain the success of the high-earning group.

Capital Position Table II provides a summary of the capital positions of the high-earning and residual minority bank groups. The high-earning group, as the table illustrates, is somewhat less heavily capitalized than the residual group for each of the two measures shown. Interestingly, the same measures computed for all commercial banks in the U. S. on a four-year consolidated basis fall above the summary ratios for equity capital and reserves and between the summary ratios for total capital accounts. For all commercial banks, equity capital and reserves as a percent of risk assets is 8.4, while total capital accounts as a percent of risk assets is 9.0.

The comparison group of 11 high-earning minority banks has been selected on the basis of return on investment, and the possibility exists that some of these banks could have achieved a high return by sacrificing capital adequacy. For the group, this is not necessarily the case. At 7.5, the ratio of equity capital and reserves to risk assets is below that of all commercial banks and the residual minority bank group, but is not extremely different. As the capital adequacy ranges show, there is a great deal of variability between banks within groups; this is especially

Table II

CAPITAL POSITION

Four-Year Consolidation

Measure	Eleven High-Earning	Thirty-three Residual
Equity capital and reserves/ Risk assets[1]		
Group	7.5	8.2
Range within group	4.3 to 11.7	2.6 to 29.6
Total capital account/Risk assets[1]		
Group	8.0	9.7
Range within group	5.0 to 11.7	2.0 to 29.6

[1] Risk assets = total assets — cash and due from banks — U. S. Treasury securities.

[4] One of these 36 banks, a Mexican-American nationally chartered institution, failed in 1976.

true within the residual group. Only one bank in the high-earning group, whose capital ratios show up as the bottom end of the ranges in Table II, is seriously undercapitalized. Conversely, none of the high-earning banks is seriously overcapitalized. There are several overcapitalized banks within the residual group, however.

Sources of Funds At first glance, there appears to be a great deal of similarity regarding the types of deposits that provide the minority banks in the two groups with their major source of funds. As Table III indicates, total demand deposits as a percent of total liabilities for the high-earning and residual groups equals, respectively, 41.3 and 43.3. The respective percentages for total time and savings deposits to total liabilities are 55.7 and 51.7. These ratios suggest that the residual group is in a relatively more advantageous position than the high-earning group, inasmuch as low-cost demand deposits comprise a larger proportion of the balance sheet and high-cost time and savings deposits comprise a smaller proportion. A closer inspection, however, suggests that this apparent relative advantage in favor of the residual bank group is more than outweighed by other adverse factors.

While the residual group does enjoy a slightly greater proportion of demand deposits to total liabilities than the high-earning group, a fairly large share of these demand deposits is in the form of liabilities to governmental bodies. Only 63.4 percent of the demand deposits of the residual group is due to private accounts, as compared to 77.0 percent for the high-earning group. This has several implications. First, government deposits are encumbered in the sense that they limit a bank's ability to allocate funds to the various available uses; these deposits must be secured by holdings of U. S. Treasury, or municipal, securities. Second, large holdings of governmental deposits relative to private deposits may reflect a special dependence on such a source of funds. To the extent that it does, it means that a bank may be overly protected and less inclined to compete for private business. This, clearly, is an undesirable long-run situation. The residual group is a heavier holder of U. S. Government (20.4 versus 15.0 percent) demand deposits, and of state and local (8.4 versus 3.6) demand deposits, as a proportion of total demand deposits.

The advantage to the residual group evidenced by its lower dependence on time and savings deposits is, again, more apparent than real. As in

Table III

SOURCES OF FUNDS

Selected Categories, Four-Year Consolidation

Measure	Eleven High-Earning	Thirty-three Residual
Total demand deposits/ Total liabilities	41.3	43.3
IPC demand deposits/ Total demand deposits	77.0	63.4
U. S. Government demand deposits/ Total demand deposits	15.0	20.4
Demand deposits of states and local gov./Total demand deposits	3.6	8.4
Total time and savings deposits/ Total liabilities	55.7	51.7
IPC time deposits/ Total time and savings deposits	30.7	34.9
Savings deposits/ Total time and savings deposits	56.8	43.0
U. S. Government time deposits/ Total time and savings deposits	2.1	4.0
Time deposits of states and local gov./Total time and savings deposits	9.8	18.8
Large denomination time deposits (over $100,000)/Total time and savings deposits	10.2	16.0
Federal funds purchases/ Total liabilities	0.6	0.9

the case of demand deposits, the residual bank group holds a greater proportion of U. S. Government, and state and local, time deposits to total time and savings deposits than does the high-earning group. More importantly, however, savings deposits account for a much lower proportion of total time and savings deposits for the residual group (43.0 percent) than for the high-earning group (56.8 percent). Savings accounts, of course, are traditionally viewed as being the most stable and, in the long run, relatively low cost, form of deposits. Their strength on a bank balance sheet also suggests a high degree of market penetration for consumer business. It could be argued that the benefits accruing from large savings deposit balances are offset to some degree by the higher activity levels, and thus higher costs, associated with these balances. These costs are largely recoverable, however, by the imposition of service charges tied to account activity levels.

The residual group does display a clear advantage over the high-earning group with respect to solicitation of private time deposits. Private time deposits as a percent of total time and savings deposits equals 34.9 for the residual group versus

30.7 for the high-earning group. This may reflect a greater aggressiveness on the part of banks within the residual group to bid for large denomination deposits. The ratio of such deposits (those greater than $100,000) to total time and savings deposits is 16.0 for the residual group and only 10.2 for the high-earning group.

Both comparison groups exhibit a very low dependence on purchases of Federal funds as a source of funds, as evidenced by their ratios of Federal funds purchased to total liabilities. Reliance on borrowed funds is also extremely low for both groups and is, therefore, not even shown in Table III.

Uses of Funds Table IV summarizes uses of funds for the two groups of minority banks. It is immediately evident that there exist a number of major differences between groups. To start with, it seems as if the residual group places a higher premium on portfolio liquidity than does the high-earning group. Cash balances and deposits at other commercial banks as a percent of total assets equals 11.9 and 10.1 for the residual and high-earning groups, respectively. Also, the residual group allocates a much greater share of funds to holdings of U. S. Treasury securities and a somewhat greater share to holdings of securities issued by U. S. Government agencies.

Table IV

USES OF FUNDS

Selected Categories, Four-Year Consolidation

Measure	Eleven High-Earning	Thirty-three Residual
Cash and due from banks/ Total assets	10.1	11.9
U. S. Treasury securities/ Total assets	9.9	12.6
Obligations of U. S. Government agencies/Total assets	12.0	12.4
Obligations of states and local government/Total assets	11.2	5.8
Federal funds sold/Total assets	5.6	7.0
Other loans/Total assets	45.4	42.4
Real estate loans/Other loans	48.8	29.9
Single-family real estate loans/ Real estate loans	61.1	65.4
Loans to financial institutions/ Other loans	0.5	2.8
Commercial and industrial loans/ Other loans	26.3	38.2
Loans to individuals/Other loans	22.7	27.5
Credit card loans/ Loans to individuals	1.9	1.0
Bank premises/Total assets	2.1	3.1

A very significant difference in the asset portfolios of the two groups arises in the case of municipal investments. At 11.2 percent, the ratio of state and local government securities to total assets for the high-earning group is almost double the 5.8 percent of the residual group. This suggests that the high-earning group is much more sensitive to the need for sheltering income and that, as is the case for commercial banks generally, tax-free municipal securities provide an important avenue for this.

Sales of Federal funds, as a percent of total assets, equal 5.6 for the high-earning group and 7.0 for the residual group. This probably is a further indication of the higher priority given liquidity and security by the residual group. It may also, however, reflect the attractiveness of higher Federal funds yields in recent years. A highly liquid bank is able to shift into Federal funds sales much more readily than the less liquid bank. Rates on Federal funds are very volatile, however, and ease of investment in Federal funds is hardly a good reason for maintaining an extremely liquid balance sheet. High earnings in one investment period can easily be offset in subsequent periods of generally increased banking system liquidity and lower interest rates.

The high-earning and residual groups devote about an equal amount of resources to loans; the ratio of other loans to total assets for the two groups is 45.4 and 42.4, respectively. These ratios lie in what may be considered a very conservative range, so far as bank performance generally is concerned, and provide evidence that both groups are essentially conservative users of available funds. Although the high-earning and residual groups seem to take roughly the same approach to managing total loans as a proportion of total assets, they are not at all similar regarding the types of loans made. While the high-earning group is much more heavily committed to real estate lending, the residual group is much more oriented to business and consumer lending.

Real estate loans (or all loans secured primarily by real estate), account for 48.8 percent of total other loans (i.e., all loans excluding Federal funds sold and securities purchased under agreements to resell) made by the high-earning group, but only 29.9 percent for the residual group. To the extent that they make real estate loans, both groups are heavily oriented to single-family mortgage loans, probably the most secure type of real estate loan that can be made. The high-earning group is generally in a better position to make

Table V

EXPENSES

Selected Categories, Four-Year Consolidation

Measure	Eleven High-Earning	Thirty-three Residual
As a percent of total operating expense:		
Employee salaries, wages, and benefits	27.3	27.2
Interest paid on deposits	41.3	34.8
Net occupancy expense	4.7	5.4
Furniture and equipment	2.7	2.9
Provisions for loan losses	5.3	9.2
Other operating expense	17.2	18.9
Total operating expense/Total assets	6.2	6.9

real estate loans, being able to match this long-term use of funds with a large base of stable savings deposits.

The residual bank group makes up for its much lower relative involvement in real estate lending by activity in other areas. The residual group, for example, makes 2.8 percent of total other loans to other financial institutions, versus 0.5 percent for the high-earning group. More important, however, is the heavy degree of involvement by the residual group in business lending, with 38.2 percent of total other loans falling in the commercial and industrial category, versus only 26.3 percent for the high-earning group. This is an especially important finding in view of the fact that minority banking has been thought of as a special source of capital to the minority business community [12]. Clearly, the high-earning group has decided that the risks inherent in minority business lending, which have been shown to be significant [15], are so great as to be avoided to a fairly extreme degree. The cautious approach taken by the high-earning group toward lending to minority businesses has recently been articulated by the president of one of the eleven banks within the group.[5] In this instance, it is pointed out that minority banks take a more cautious approach toward lending in the minority business community than many majority banks.

In the area of consumer lending, the residual group is again significantly more active than the high-earning group. The ratios of loans to individuals to total other loans for the two minority bank groups are 27.5 and 22.7, respectively. Again, the high-earning group seems to have adopted management policies designed to minimize its involvement in a more risky area of lending. While both groups have a low level of participation in revolving credit to consumers, the high-earning group is almost twice as active in this specialized area.

Before leaving the asset side of the balance sheet, it is interesting to note the extent to which bank funds are tied up in investment in bank premises. At 2.1 percent, the ratio of bank premises to total assets for the high-earning group is about one-third less than the 3.1 percent of the residual group. This means, in effect, that the high-earning group operates with considerably less overhead than does the residual group, and the funds freed up from investment in fixed assets can be applied to earning uses. Both groups, it might be mentioned, have a greater investment in fixed assets than is typically the case in the banking industry. All insured commercial banks, on a four-year consolidated basis, have a bank premises to total assets ratio of 1.6 percent, and all banks with less than $50 million in assets have a ratio of 1.7.

Expenses and Income Tables V and VI summarize, respectively, the expense and income characteristics of the high-earning and residual groups. In brief, the high-earning group is shown to be more efficient with regard to both control of

Table VI

INCOME

Selected Categories, Four-Year Consolidation

Measure	Eleven High-Earning	Thirty-three Residual
As a percent of total operating income:		
Interest and fees on loans	53.3	52.2
Income on Federal funds sold	7.5	8.3
Trust department income	1.5	1.4
Service charge income	7.8	8.5
Other operating income	1.2	2.1
Interest and dividends on investments	30.0	28.4
As a percent of interest and dividends on investments		
Income on U. S. Treasury securities	31.9	38.2
Income on obligations of U. S. Government agencies	35.8	42.0
Income on obligations of states and local governments	23.0	12.8
Total operating income/Total assets	7.0	6.8
Operating income — operating expense/Total assets	0.8	−0.1
Net income/Equity capital and reserves	12.6	−2.3

[5] Joseph D. Hutnyan, "Minority Banker Warns Some Banks Over-eager on Minority Lending," *American Banker*, May 12, 1976.

expenses and generation of income. This conclusion is based on the total operating expense to total asset and total operating income to total asset ratios shown in the tables. The high-earning group incurs expenses equal to 6.2 percent of total assets and generates income equal to 7.0 percent of total assets; its spread of gross income over expenses amounts to 0.8 percent of total assets. The residual group incurs expenses equal to 6.9 percent of total assets and generates income equal to 6.8 percent of total assets. In the case of the residual bank *group*, therefore, expenses exceed gross income, and an operating loss equal to 0.1 percent of total assets results. For comparative purposes it is interesting to note that for all insured commercial banks the spread of gross income over expenses, on a four-year consolidated basis, amounts to 1.0 percent of total assets. While generating less income in relation to total assets than the high-earning group, at 6.6 percent, expenses to total assets for all insured commercial banks is also much lower, at 5.6 percent.

These basic indexes of management performance ultimately, of course, affect the profitability of the two groups, as shown in Table VI. Consolidated return on investment for the high-earning group is a very respectable 12.6 percent, while that for the residual group is —2.3 percent.

An analysis of group expenses provides a way of determining the nature of the differences between the high-earning and residual groups on this important factor leading to CROI. Both groups devote an almost equal proportion of total operating expense (keeping in mind that their operating expense as a proportion of total assets differs) to employee remuneration; the percentages are 27.3 for the high-earning group and 27.2 for the residual group. This is the second most important expense item in the commercial banking industry, and the equality between groups suggests that the labor market conditions they face are about equal. Interest expense on deposits is the biggest banking industry expense and, as the source of funds analysis undertaken above would suggest, the high-earning group allocates a much greater proportion of total expense to this category. This is due to the high-earning group's heavier reliance on time and savings deposits as a source of funds.

Previous analysis also suggests that overhead expenses for the high-earning group should be less than those for the residual group, and this turns out to be the case. Net occupancy expense for the high-earning group is only 4.7 percent of total expenses, as compared to 5.4 percent for the residual group. Equipment expense for the high-earning group is also a somewhat lower proportion of total expenses than for the residual group, at 2.7 and 2.9 percent, respectively.

Loan loss provisions, which are treated as a current operating expense, are significantly different for the two groups. Such provisions amount to only 5.3 percent of total expenses for the high-earning group, but increase to 9.2 percent for the residual group. This one expense category is so high for the residual group as to almost eliminate the advantage it has due to low deposit costs. The high loan loss expense is, most likely, associated with the higher proportions of business and consumer loans made by the residual group. It is interesting to note that the four-year consolidated loan loss expense for all insured commercial banks is 4.2 percent, considerably below that of even the high-earning group.

Interest and fees on loans as a percent of total operating income for the two groups is roughly the same, at 53.3 percent for the high-earning group and 52.2 percent for the residual group. This, however, is not what one would expect given the composition of their loan portfolios. The high-earning group is relatively heavily invested in illiquid, but relatively low risk, real estate loans. Conversely, the residual group is relatively heavily invested in more risky business and consumer loans. If, as would be expected, the residual bank group were compensated for the increase in risk associated with its business and consumer lending, then such a premium would be reflected in higher interest income on loans. This is clearly not the case. Both groups have about the same proportion of income derived from loan interest and, while their total loan portfolios equal about the same percentage of assets, the risk distribution is quite different. The residual group should be charging higher interest rates on loans in order to compensate for the additional risk, which is reflected in its higher expense for loan losses. In practice, however, the rate of return on loan portfolio (computed from interest and fees on loans/total other loans) is almost identical for the two groups. The rates of return on loan portfolio for the high-earning and residual groups are, respectively, 8.26 percent and 8.33 percent.

In a number of other respects, the income sources for the two groups are similar. Both derive a fairly large share of income from Federal

funds sales, something characteristic of smaller banks generally. Likewise, their service charge income is fairly high, although it is more so for the residual group. Trust department income makes a very minor contribution to total income.

Interest and dividends earned on investments represents 30.0 percent of total operating income for the high-earning group and 28.4 percent for the residual group. These proportions are close but, as in the case of loans, disguise important differences of portfolio composition. The residual group is relatively heavily invested in U. S. Treasury securities and relatively under invested in municipal securities, while the converse is true for the high-earning group. Thus, the residual group derives 80.2 percent of its investment income from the taxable yields off U. S. Treasury and U. S. Government agency securities, and only 12.8 percent off nontaxable municipal securities. The high-earning group derives 67.7 percent of its investment income from U. S. Treasury and U. S. Government agency securities, and 23.0 percent from municipal securities.

The importance of tax management differences between the two groups cannot be overemphasized. The high-earning group has managed its tax position in such a way as to minimize applicable corporate income taxes; indeed, its applicable income taxes as a percent of gross income equals only 20.5 percent. For the residual group, an unusual result is obtained. It will be recalled that this *group* has sustained an income loss over the four-year consolidation; nonetheless, the group has still paid corporate income taxes equal to 30.4 percent of its losses. This contradictory situation is explained by the fact that the members of the group have had different tax and earning experiences, some earning no income and paying no tax and some paying tax on earned income. Also, the tax and earnings data are consolidated over a four-year period, allowing yearly income period fluctuations to show up in the final figures.

The high-earning group, incidentally, has been able to achieve its status without paying out an excessive proportion of net income in dividends. Cash dividends paid by the high-earning group amounts to a conservative 28.4 percent of net income. This means that a significant portion of earnings has been retained and added to reserve accounts. The residual group has paid cash dividends equal to 35.1 percent of its losses; this anomalous situation is explained by the consolidation process described above in the context of tax payments.

Summary and Conclusions In this study, minority-owned commercial banks with four years or more operating experience are divided into two comparison groups according to earnings performance. Those banks with a four-year consolidated return on investment of 10 percent or better constitute the high-earning group, while the remaining banks with a four-year consolidated return on investment of less than 10 percent are combined into a residual group. The performance of the high-earning group is compared with that of the residual group through an analysis of key operating ratios.

The findings indicate that the high-earning group is somewhat more adept at generating income than is the residual group; total operating income to total assets is 7.0 for the high-earning group and 6.8 for the residual group. On the other hand, the high-earning group is much more effective at controlling expenses than the residual group, the respective ratios of total operating expense to total assets being 6.2 and 6.9. Consequently, the high-earning group has an excess of operating income over operating expense equal to 0.8 percent of total assets, compared to an excess of operating expense over operating income of 0.1 percent for the residual group. Both groups invest a fairly low proportion of funds, about 45 percent, in loans. The types of loans made, however, are quite different between groups; real estate loans dominate the portfolio of the high-earning group, and commercial and industrial loans dominate the portfolio of the residual group. With respect to securities, the high-earning group favors tax-free municipals while the residual group favors U. S. Treasury securities. Employee remuneration accounts for 27 percent of total expenses for both groups. Interest paid on deposits is a much higher expense for the high-earning group, which relies to a greater extent on time and savings deposits than does the residual group. This higher expense item for the high-earning group is offset by lower occupancy and loan loss charges and by lower general operating expenses. The management practices followed allow the high-earning group to achieve a four-year consolidated return on investment of 12.6 percent, compared with a loss of 2.3 percent for the residual group.

These findings can be synthesized into two basic conclusions about minority banks. First, there exist a variety of circumstances under which minority banks can successfully operate; this is suggested by the heterogeneous nature of the high-earning group. Although such factors as size, location, type of charter, etc. may, and probably do influence bank operation, they do not dictate success or failure. Rather, quality of financial management appears to be the critical determinant of minority bank performance.

Second, there appears to be a direct conflict between market exigencies faced by minority banks generally, for example the need to correctly assess and balance risk and return on loans, and the idealized set of community service goals under which minority banks are often conceived. This conflict is most evident in the differences between the loan policies of the high-earning and residual groups. The high-earning group has clearly chosen to forego some lending opportunities, particularly in the business and consumer loan areas, due to what is evidently viewed as excessive risk. The residual group has been much more active in making business and consumer loans in the minority community but has suffered from unusually large losses. It is largely the relative success in limiting the expense of losses associated with bad loans that provides the high-earning group with its margin of performance over the residual group. While many minority banks choose to follow the typical path of success laid out by nonminority banks, particularly in making high proportions of business loans, the loan portfolio of the high-earning group definitely reflects a concern with the special risk that might be connected with this type of lending in the minority community. It would seem, therefore, that successful banking in the minority community requires very careful attention to asset quality and may not be wholly compatable with the capital demands of minority business.

The high-earning group is, in a number of important ways, more like majority-owned and operated commercial banks than like the residual group. For example, the high-earning group is more competitive and market oriented than the residual group, as evidenced by its deposit structure. It is more conscious of operating efficiency, as shown through key expense ratios. And, not least important, the high-earning group seems more adept at practicing the subtleties of financial management than the residual group; evidence of this is provided by the tax management practices of the two groups. More interesting, though, is the fact that the high-earning group does more than simply copy the portfolio behavior of successful nonminority banks. Rather, it applies the practice of accepted management patterns to fit the special environment in which it operates, thus achieving financial success.

References

1. Ang, James and Richard Willhour. "The Consumer Loan Supply Function of a Minority Bank: An Empirical Note." *Journal of Money, Credit and Banking*, (May 1976), pp. 255-9.
2. Boorman, John T. *New Minority-Owned Commercial Banks: A Comparative Analysis*. Washington, D. C.: Federal Deposit Insurance Corporation, 1973.
3. ————. "The Prospects for Minority-Owned Commercial Banks: A Comparative Performance Analysis." *Journal of Bank Research*, (Winter 1974), pp. 263-79.
4. ———— and Myron L. Kwast. "The Start-Up Experience of Minority-Owned Commercial Banks: A Comparative Analysis." *Journal of Finance*, (September 1974), pp. 1123-41.
5. Brimmer, Andrew F. "The Negro in the National Economy." *The American Negro Reference Book*. Edited by John P. Davis. Englewood Cliffs, New Jersey: Prentice Hall, Inc., 1966.
6. ————. "The Banking System and Urban Economic Development." Paper presented before a joint session of the 1968 Annual Meetings of the American Real Estate and Urban Economics Association and the American Finance Association, Chicago, Illinois, December 28, 1968.
7. ————. "The Black Banks: An Assessment of Performance and Prospects." *Journal of Finance*, (May 1971), pp. 379-405.
8. ————. "Recent Developments in Black Banking: 1970-1971," Washington, D. C., July 31, 1972. (Mimeographed.)
9. Corwin, R. D. *Racial Minorities in Banking: New Workers in the Banking Industry*. New Haven: College & University Press, 1971.
10. Emeka, Mauris Lee Porter. *Black Banks, Past and Present*. Kansas City: Mauris L. P. Emeka, 1971.
11. Irons, Edward D. "Black Banking—Problems and Prospects." *Journal of Finance*, (May 1971), pp. 407-25.
12. Knight, Kenneth E. and Terry Dorsey. "Capital Problems in Minority Business Development: A Critical Analysis." *American Economic Review*, (May 1976), pp. 328-31.
13. Kohn, Donald L. "Minority Owned Banks." *Monthly Review*, Federal Reserve Bank of Kansas City, (February 1972), pp. 11-20.
14. Leavitt, Brentin C. "Black Banks: A Review of Earnings Performance." Address before the First Annual Director-Senior Management Seminar of the National Bankers Association, Inc., Atlanta, Georgia, July 21, 1972.
15. Marsh, James. "Viewing the Loss Experience on Minority Enterprise Loans." *Bankers Magazine*, (Winter 1971), pp. 84-7.
16. Thieblot, Armond J., Jr. *The Negro in the Banking Industry*. Philadelphia: Industrial Research Unit, Wharton School of Finance and Commerce, University of Pennsylvania, 1970.
17. Walker, Charles E. Address before the 43rd Annual Convention of the National Bankers Association, St. Louis, Missouri, October 16, 1970. Reprinted in the Department of the Treasury *News*, Washington, D. C.