Bank Profits Rebound as Loss Set-Asides Ease

By Kelly Klemme and Kenneth J. Robinson

Banks across the U.S., including the Eleventh Federal Reserve District, appear to be recovering from the financial crisis that began in mid-2007. The news is welcome because a healthy banking sector spurs economic growth by providing financing for businesses to expand investment spending and for consumers to purchase goods and services.

Data for 2010 show strong profit growth, with banks across the nation rebounding from a net loss in 2009 and those in the Dallas-based Eleventh District almost doubling their profits. There was also good news regarding asset quality: Problem loans are starting to moderate. And there are indications that the banking industry has grown more efficient, supporting more operations at lower cost.

However, concerns linger about the sustainability of profits because the recent improvement can be attributed almost entirely to a reduction in what banks set aside to cover future loan losses. Banks refer to this as their provision expense, and it usually falls as asset quality improves. But there is a limit to how far it can decline and contribute to profitability.

Table 1 shows the major components of profitability for U.S. and Eleventh District banks and their contribution to earnings in 2009 and 2010. Among banks nationally, the 76-basis-point improvement in profitability, as measured by ROAA, can be traced almost entirely to a drop in provision expense. A basis point equals one one-hundredth of a percentage point.

By Kelly Klemme and Kenneth J. Robinson

Last year, the banking industry both nationally and regionally recorded its highest net income since 2007.

Bank Profits Rebound
as Loss Set-Asides Ease

Last year, the banking industry both nationally and regionally recorded its highest net income since 2007.
a percentage point. For the district, profitability increased 41 basis points despite less revenue. For these banks, lower revenue was more than offset by declines of about 50 basis points in both noninterest expense and provision expense.

**Earnings Sustainability**

Banks’ improved profitability has been characterized as “a drastic reversal from 2009, when the prospect of widespread loan defaults forced them to set aside billions of dollars to cover losses.”

Interpreted this way, the upturn may seem less resilient. Lower provision expense means banks are setting aside less money for future loan losses. As the overall economy improves and asset-quality problems diminish, such a reduction is expected.

Given that there is a limit to how much provision expense can fall and thus contribute to profitability, and that revenue has recently increased little, if any, is bank profitability stagnating? Or will increased revenue, or perhaps efficiency gains, help sustain bank profitability?

**Provision Expense and Return on Assets**

Some historical perspective might shed light on these questions. While declining provision expense is a big contributor to recent bank profitability, that development is neither new nor unusual. Historically, provision expense changes have been important factors affecting movements in bank profitability.

In periods of relative banking prosperity, such as the 1990s, provision expense and profitability are fairly constant. But during times of stress, when banks must set aside additional funds to cover possible loan defaults, the associated provision expense increase coincides with declining bank profitability. This was true for U.S. banks in the recent financial crisis (Chart 1A), and it was also true for Eleventh District banks in the late 1980s, when the industry experienced severe difficulties (Chart 1B).

For U.S. banks, provision expense increased 169 basis points from 2006 to 2009 (Chart 2). This coincided with a decline in profitability of 147 basis points. In the district, provision expense increased 118 basis points in the mid-1980s. During this period, ROAA fell 206 basis points. Provision expense in both downturns was the single-biggest contributor to profitability movement, far outpacing other components.

During periods of recovery, though, this trend is reversed. As Chart 1 reveals, we are beginning to see a decline in provision expense at banks nationwide as the recovery takes hold. Similarly, provision expense fell sharply in the district in the late 1980s after banking difficulties subsided.

**Weakness in Revenue**

If banks are showing weakness in revenue measures, as seen in Table 1, how durable can the recent profitability upturn be? Again, historical perspective is useful. Revenue measures at both U.S. and district banks rose fairly steadily until peaking in the mid-to-late 1990s (Chart 3).

Since then, overall revenue has trended lower. Revenue sources differ somewhat, with banks in the district deriving a greater proportion of revenue from net interest income than banks nationally, and banks nationwide deriving a relatively larger proportion of revenue from noninterest income. However, despite this revenue decline, banks were able to earn a healthy return on assets of 1 percent or more, at least until the onset of the financial crisis. So a lack of recent revenue growth is not necessarily cause for concern. An increasingly competitive marketplace tends to pressure revenue and overall profitability.

Yet, banks have earned robust profits even in the face of a sustained revenue decline.

**Maintaining Profitability**

The banking industry has confronted significant competitive issues over the past
Lower provision expense means banks are setting aside less money for future loan losses. As the overall economy improves and asset-quality problems diminish, such a reduction is expected.

two decades. Interstate branching restrictions were eliminated with the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994, increasing industry consolidation. And entities such as hedge funds and money market funds lured customers away from banks.

Despite the pressures on revenue, banks were able to maintain profitability. One possible explanation may be that increased efficiency offset declining revenue, thus mitigating the pressure on profitability.

Noninterest expense, as a percent of average assets, can be used as a rough measure of bank efficiency.

Noninterest expense is a broad category that includes employee salaries and benefits, facility and equipment expenses, advertising and marketing costs and other types of overhead. If bank efficiency is improving, it is expected that noninterest expense would decline relative to assets. That ratio, after increasing fairly steadily, peaked in the mid-to-late 1990s at U.S. and Elev-
enth District banks and has since trended downward (Chart 4).

For banks in the U.S. and the district, falling salary and premises expense relative to assets accounted for roughly half of the overall decline. In other words, banks are now able to support more assets at a lower cost. That may reflect recent advances in information technology.8

Rebuilding Balance Sheets

Recent data suggest that the banking industry, with improved profitability and fewer problem assets, is in the early stages of recovery from the worst financial crisis since the Great Depression. Adjustments continue as banks strive to rebuild their balance sheets and position themselves for the future. These changes, coupled with declining revenue, could be contributing to a spate of mergers and acquisitions. In 2010, for example, 172 bank mergers were announced. Of this total, more than three-fourths involved sellers with fewer than $1 billion in assets. So far this year, 44 deals have been announced, and almost all involve sellers with assets below $1 billion.9

Concerns remain about the source of the industry’s profits, but these may be misplaced. Put in historical context, the recent rebound in profitability that has been driven almost entirely by a drop in provision expense is both welcome and expected. As the economic recovery advances and asset quality improves, the upturn in profitability should continue.

Klemme is a financial industry analyst and Robinson is a research officer in the Financial Industry Studies Department at the Federal Reserve Bank of Dallas.

Notes

1 The Eleventh Federal Reserve District consists of Texas, northern Louisiana and southern New Mexico.
2 Noncurrent loans are those 90 days or more past due or those with nonaccrual status (the stated interest rate was not being paid).
3 Data were obtained from the Federal Financial Institutions Examination Council’s Reports of Condition and Income. Data for the Eleventh District banking industry have been adjusted for structural changes involving recent relocations of banks into the district.
4 Technically, the loan-loss reserve is known as the Allowance for Loan and Lease Losses (ALLL). There are no formal numerical requirements for banks’ ALLL. However, banks are responsible for “developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL.” See Board of Governors of the Federal Reserve System, SR 06-17, Dec. 13, 2006, www.federalreserve.gov/boarddocs/srletters/2006/SR0617.htm.
6 For more on the 1980s banking difficulties in the Eleventh District and how district banks have fared relatively better in the current crisis, see “Eleventh District Banking Industry Weathers Financial Storms,” by Kenneth J. Robinson, Southwest Economy, Second Quarter 2010.

Recent data suggest that the banking industry, with improved profitability and fewer problem assets, is in the early stages of recovery.

Chart 4
Lower Noninterest Expense Points to Improved Efficiency

Percent of average assets

<table>
<thead>
<tr>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>'10'</td>
</tr>
<tr>
<td>'09'</td>
</tr>
<tr>
<td>'08'</td>
</tr>
<tr>
<td>'07'</td>
</tr>
<tr>
<td>'06'</td>
</tr>
<tr>
<td>'05'</td>
</tr>
<tr>
<td>'04'</td>
</tr>
<tr>
<td>'03'</td>
</tr>
<tr>
<td>'02'</td>
</tr>
<tr>
<td>'01'</td>
</tr>
<tr>
<td>'00'</td>
</tr>
<tr>
<td>'99'</td>
</tr>
<tr>
<td>'98'</td>
</tr>
<tr>
<td>'97'</td>
</tr>
<tr>
<td>'96'</td>
</tr>
<tr>
<td>'95'</td>
</tr>
<tr>
<td>'94'</td>
</tr>
<tr>
<td>'93'</td>
</tr>
<tr>
<td>'92'</td>
</tr>
<tr>
<td>'91'</td>
</tr>
<tr>
<td>'90'</td>
</tr>
<tr>
<td>'89'</td>
</tr>
<tr>
<td>'88'</td>
</tr>
<tr>
<td>'87'</td>
</tr>
<tr>
<td>'86'</td>
</tr>
<tr>
<td>'85'</td>
</tr>
</tbody>
</table>

U.S.

Eleventh District
