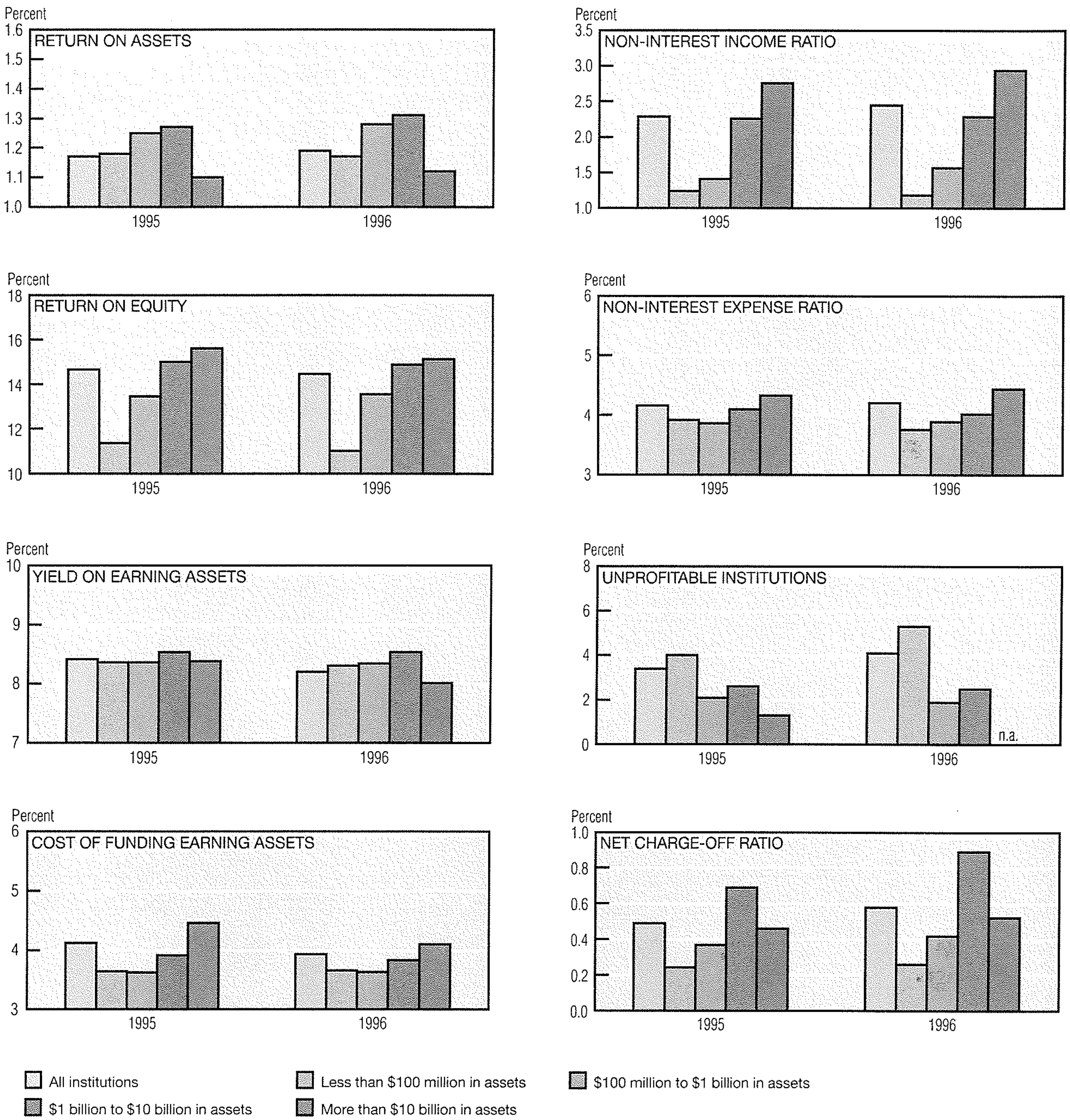
Banking Conditions



SOURCE: Federal Deposit Insurance Corporation.

The latest statistics on insured U.S. commercial banks confirm the industry's strength. In 1996, banks' $52.4 billion earnings produced a 1.19% return on assets (ROA), the second-highest annual posting ever and just below 1993's record high 1.20%. In 1995, banks earned $48.8 billion, which resulted in a 1.17% ROA. The improvement in banks' profitability can be traced mainly to non-interest income. Between 1995 and 1996, the ratio of non-interest income to total assets increased from 2.29% to 2.45%. Banks' profits were affected only slightly by the lower yield on earning assets because their cost of funding fell by nearly an equal amount.

The improved profitability statistics, however, hide two potential problems—the first in the small bank community and the second in the industry's asset quality. From 1995 to 1996, the number of unprofitable banks rose significantly—the result of a deteriorating performance by the nation's small banks (those with assets below $100 million). Of the 6,659 small banks in existence in 1995, 4.0% were unprofitable. By 1996, the number of these institutions had fallen to 6,205, but the unprofitable share had ballooned to 5.3%.

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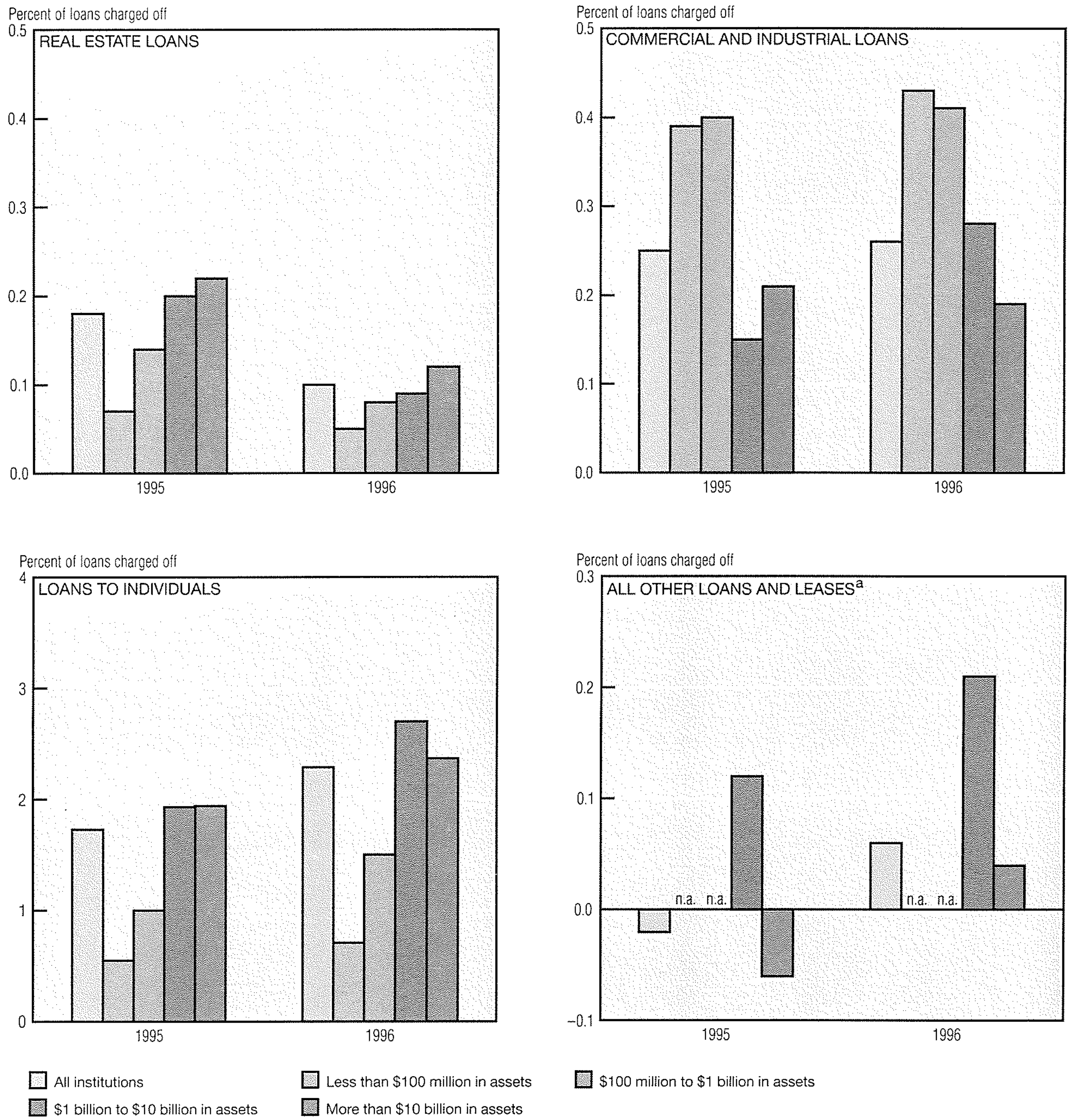
Banking Conditions (cont.)



a. Includes farm loans.
SOURCE: Federal Deposit Insurance Corporation.

The number of unprofitable small institutions was reflected in the group's ROA, which dropped from 1.18% in 1995 to 1.17% in 1996. This reduction, though negligible, becomes more meaningful when compared with the increase in ROAs posted by the three categories of larger banks. Non-interest income and the cost of funding earning assets were the primary contributors to small banks' poorer performance.

Last year also saw a deterioration in one important indicator of bank asset quality—the ratio of net charge-offs to loans and leases. Net loan charge-offs were $3.3 billion higher in 1996 than in 1995, growing from 0.49% to 0.58%. Although all four bank size groups reported higher ratios, the largest uptick occurred in banks with assets between $1 billion and $10 billion. Small banks posted the lowest increase.

The deterioration in loan quality was largely concentrated in loans to individuals. The ratio of consumer loans charged off to total assets climbed from 1.73% in 1995 to 2.29% in 1996. Again, the largest increase was reported by the group of banks with assets between $1 billion and $10 billion.

Worsening consumer loan quality stems mainly from problems with credit card loans. Between 1995 and 1996, net charge-offs of these loans grew by $2.7 billion. As a result, they accounted for 61.1% of all loans charged off last year.