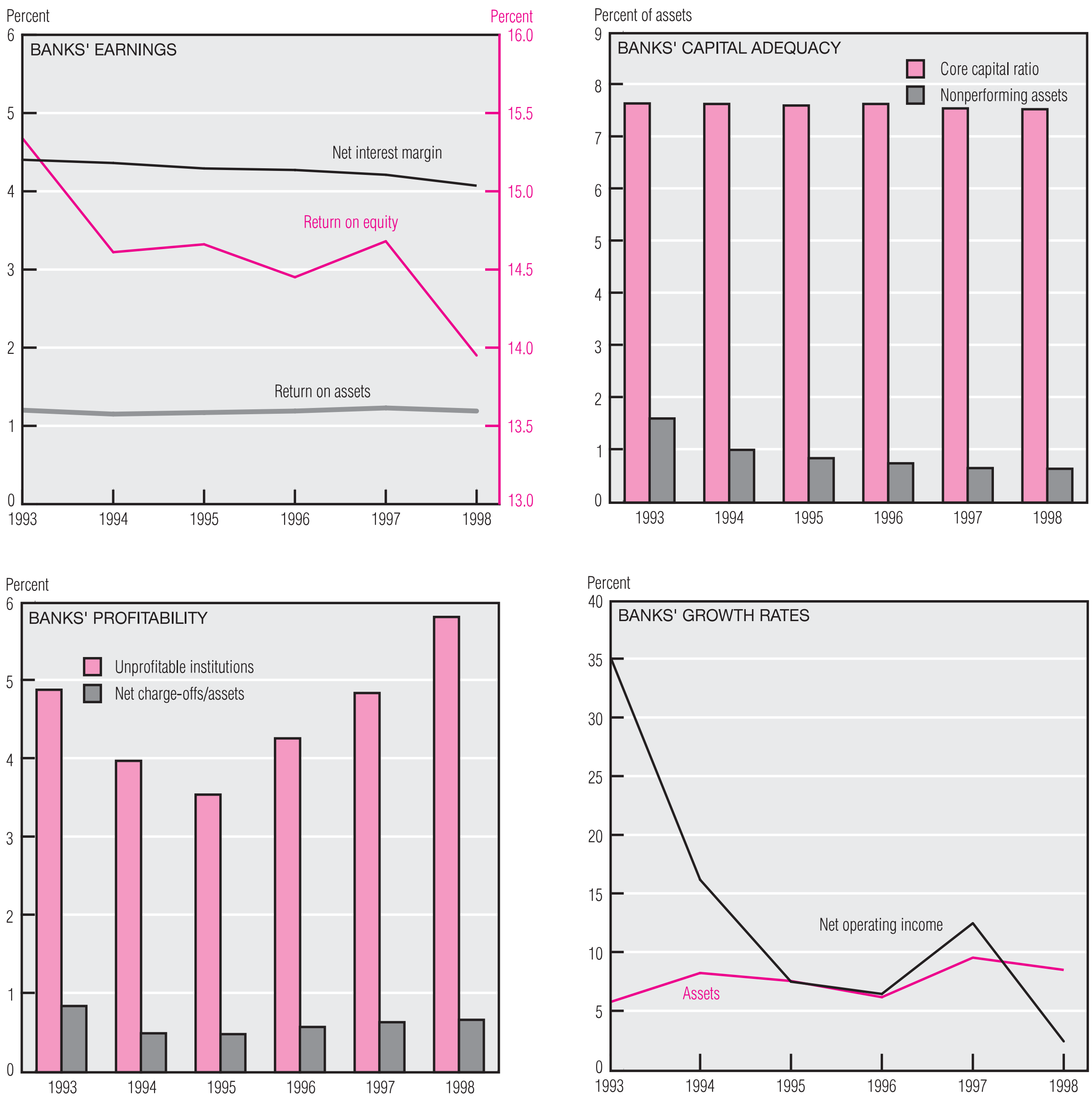
Banking Conditions



SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, December 1998.

Commercial banks' balance sheets showed continued signs of health through the fourth quarter of 1998. Despite a slowdown in profits relative to 1997, earnings were still strong, with the net interest margin remaining above 4%. Return on equity for the 1998 calendar year was 13.95%. Moreover, nearly 95% of all commercial banks posted positive profits for all of 1998.

Strong bank balance sheets are reflected in core bank capital which, at 7.54% of assets, is high by historical standards. In addition, asset-quality problems are not yet evident, as nonperforming assets fell to 0.65% of total assets.

One sign of potential weakness is the increased level of net charge-offs (0.67% of total loans). However, while net charge-offs have reached their highest level in five years, they remain well below 1% of total loans; hence, from a historical perspective, the current charge-off rate still appears favorable.

The formerly brisk pace of growth in the banking sector slowed substantially in 1998. Net operating income growth fell below 5% to 2.39%, its lowest level in six years. Bank asset growth, however, remained strong at levels above 8%. Taken together, despite recent signs of a slowdown, the banking sector should continue to grow steadily without compromising profitability or, more importantly, the quality of its assets.

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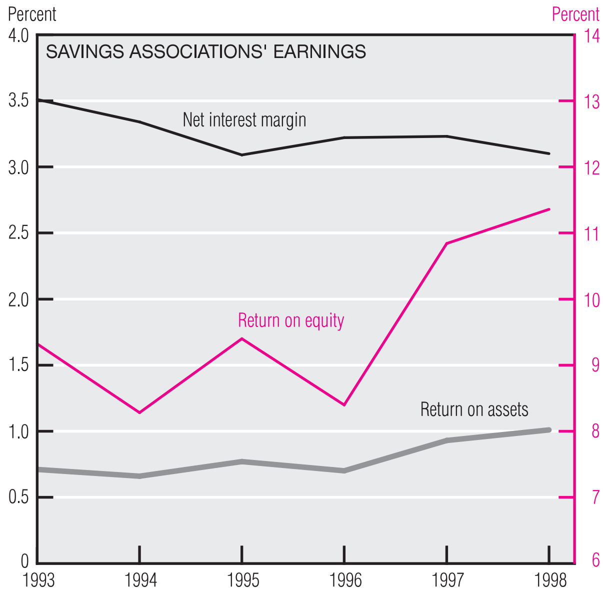
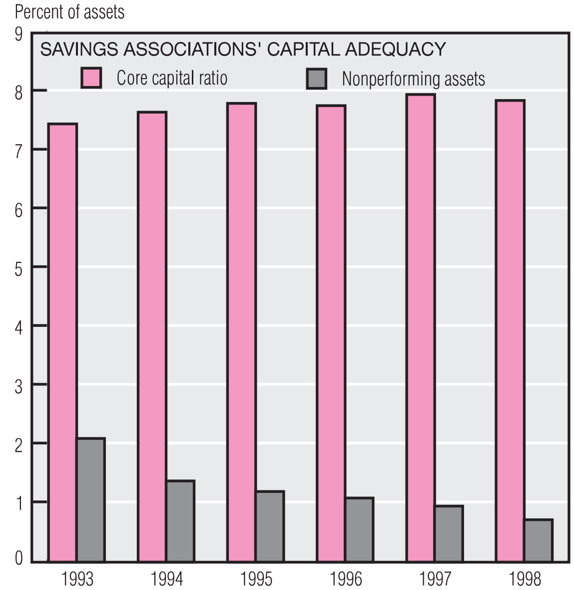
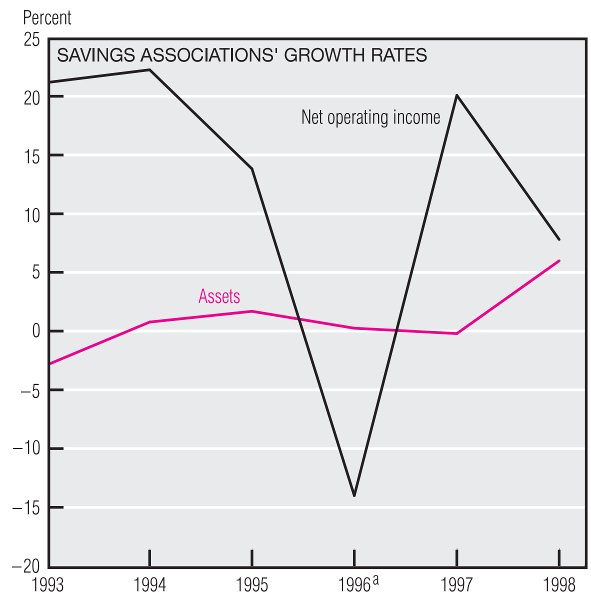
Banking Conditions (cont.)







a. A sharp decline in operating income growth in 1996 was partly due to a special deposit insurance assessment on the deposits of savings associations.
NOTE: All data are for FDIC-insured savings associations.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, December 1998.

The performance of savings associations continued to be strong throughout 1998, with full-year earnings for the industry reaching a record $10.2 billion. Despite some unexpected weakness in the fourth quarter of 1998, return on assets for the full year stood at its highest level since 1946 (higher than 1%). Furthermore, at 11.36%, return on equity was at its highest level since 1985. Unlike 1985, however, 1998's return on equity was generated by the robust return on assets and by a steady net interest margin of 3.1%. Finally, savings associations' balance sheets strengthened, with fewer than 5½% reporting losses through 1998:IVQ.

Asset quality also continued to improve, as nonperforming assets fell to 0.72% of total assets and net charge-offs fell to 0.21% of total loans. Core capital in 1998 remained a healthy 7.85% of total assets, a small decrease from the previous year. The decline in this financial ratio was driven by strong asset growth (nearly 6%) in 1998. This contrasts sharply with recent trends, in which savings associations' assets were either flat or declining. The year's strong asset growth was accompanied by an increase in operating income of just under 8%, suggesting that growth did not come at the expense of profit margins.

Overall, recent industry performance suggests that savings associations will continue to play an important role in the economy, though perhaps a smaller one than in the past.

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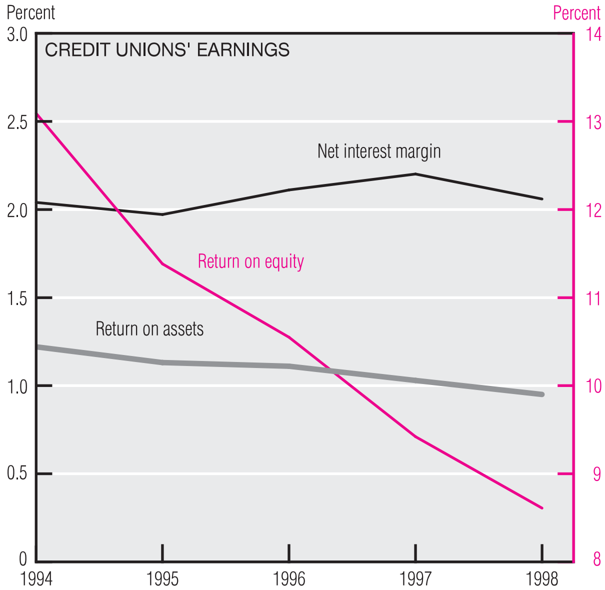

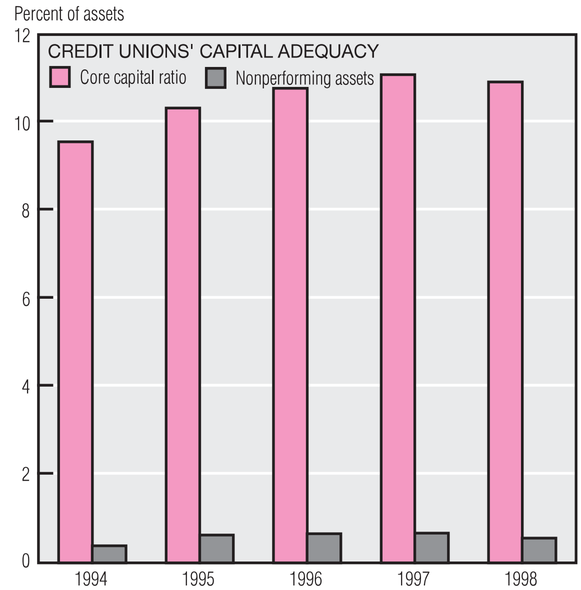

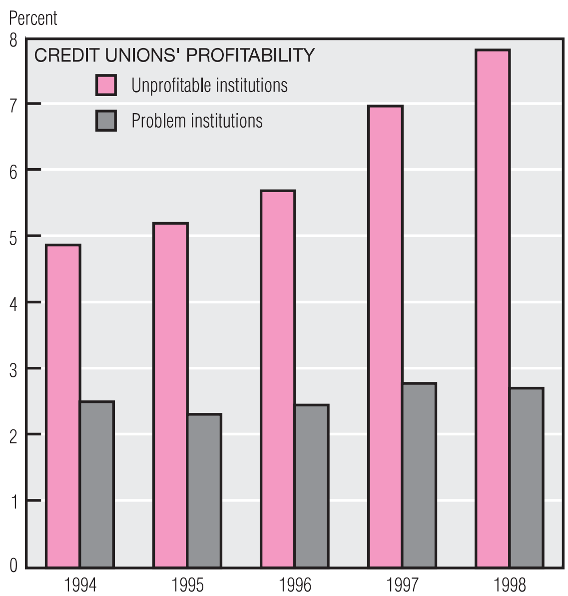

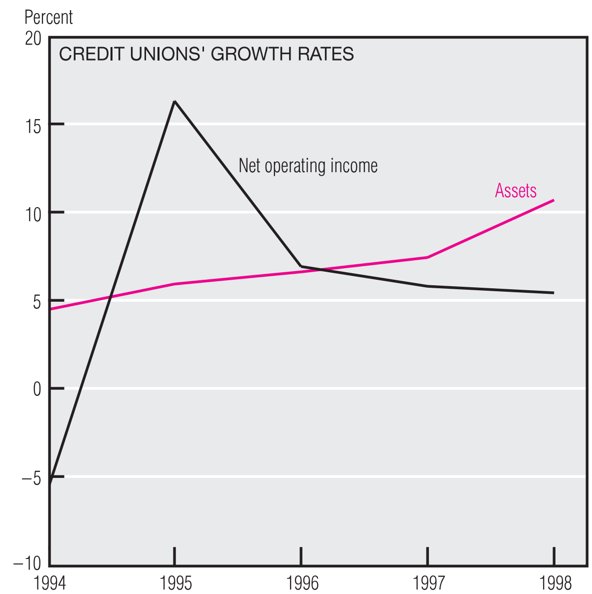

SOURCE: National Credit Union Administration.

Federally insured credit unions showed some weakness through the end of 1998. Profitability continued its steady decline over the latter half of the decade, as the return on assets (ROA) for the industry dropped to 0.95%. Falling ROA, coupled with an increase in core capital from 9.56% in 1994 to 10.92% in 1998, led to a sharp decline in return on equity (from 13.09% to 8.61%) over the same period.

A closer look at the components of earnings suggests that the deterioration of industry profits has resulted from shifting asset allocation rather than shrinking margins. While the industry's net interest margin has remained relatively flat, hovering around 2%, credit unions have nonetheless increased the proportion of their assets in investments other than higher-yielding loans.

Even as profitability has slipped, however, the overall condition of credit unions' balance sheets appears unchanged. The core capital ratio declined somewhat between 1997 and 1998, but it remains high relative to the previous few years at a healthy 10.92%. The percentage of the industry's problem assets relative to total assets has remained relatively flat since 1994, though the percent of unprofitable institutions has risen from nearly 5% in 1994 to nearly 8% today. Despite this, however, the number of credit unions assigned unsatisfactory ratings by their regulator fell slightly in 1998 (to 2.72%). While credit unions' present condition is mixed, over the long term there seems to be little cause for concern.