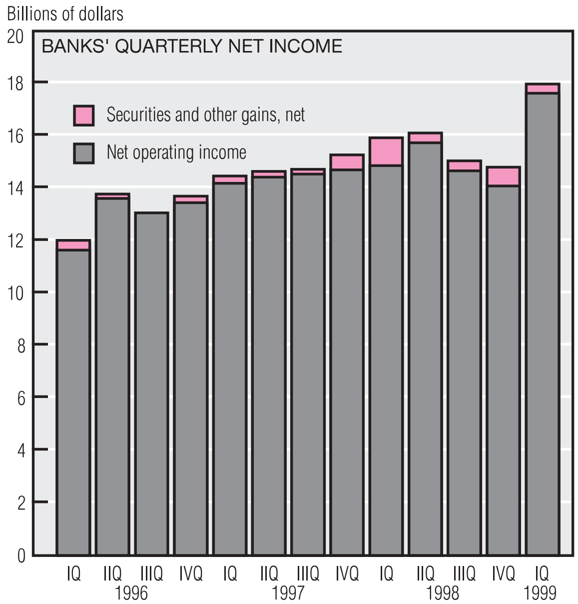
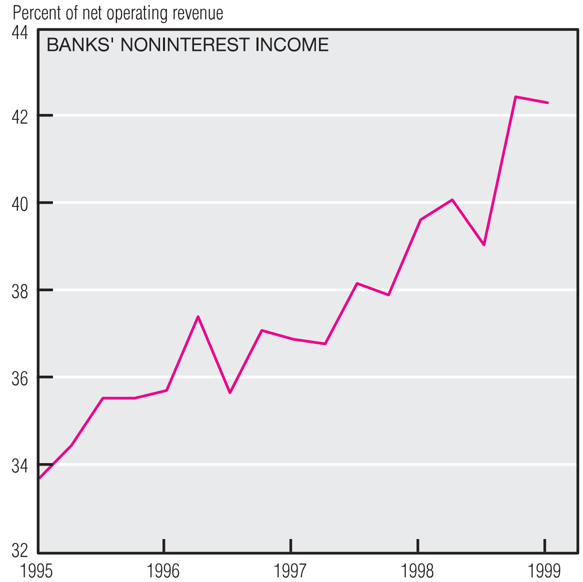
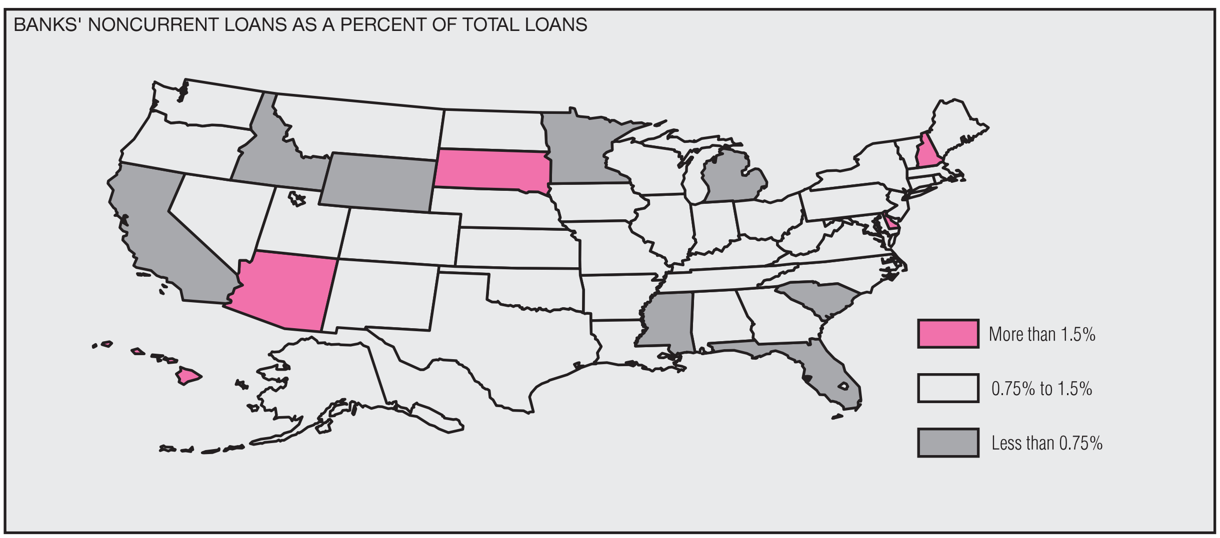
Banking Conditions







SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile,* March 1999.

Net income at insured commercial banks surged to $18.0 billion in 1999:IQ, easily surpassing the previous record of $16.1 billion set in 1998:IIQ. Bankers were cheered by the rise in average return on assets (ROA) to 1.32%, equaling the previous high that was set in 1995:IIIQ. There was a small dark cloud: A majority of banks with less than $100 million in assets reported lower earnings than a year ago.

These generally rosy results stem from increases in net operating income. The strongest-growing component of operating income over the last year remained noninterest income, which has jumped 19.5% since 1998:IQ. Growth in the share of this component continues a long trend that has accelerated in recent years. Another source of improvement is the rebound in international operations' contribution to bank earnings, which has held close to pre–Asia crisis levels in percentage terms over the last two quarters.

Both the cost of funding and the yield on earning assets declined over the last two quarters, yet the industry's net interest margin remained roughly constant at 4.05%. Again, this seeming stability in the industry average masked divergent trends in the margins of larger and smaller banks. Average margins at banks with less than $100 million in assets fell 26 basis points over the last year, reaching their lowest level in eight years. By contrast, margins at banks with assets of more than $100 million remained virtually unchanged. Average asset yields declined faster at smaller banks than large ones, while the decline in their average funding costs was more gradual. Because net interest income represents

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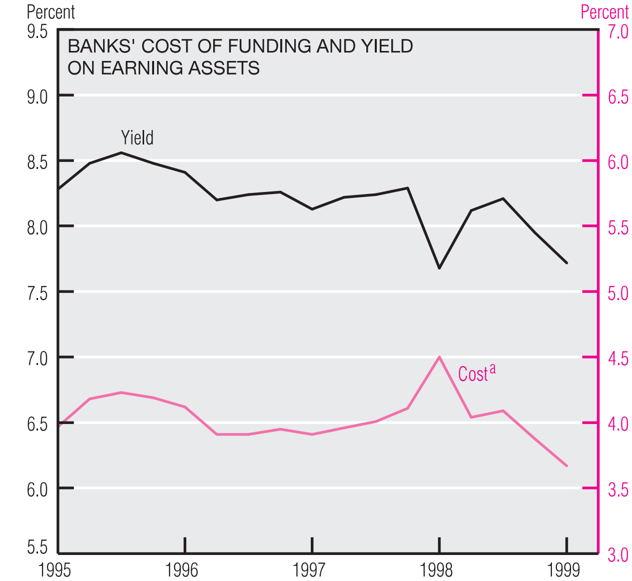

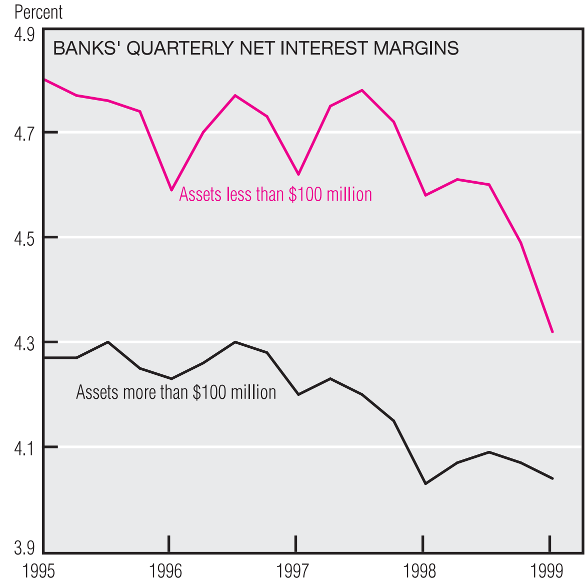

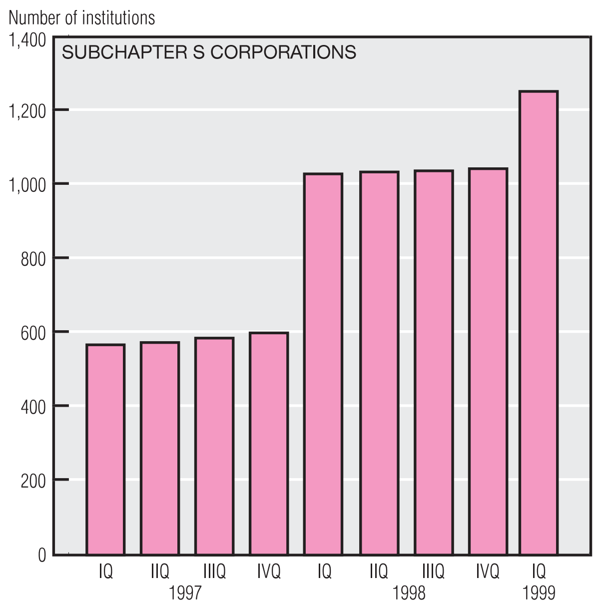

a. The cost of funding on earning assets is defined as the total interest paid on deposits and other borrowed money as a percent of average earning assets.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile,* March 1999.

a larger share of revenues at smaller banks, margin erosion causes these banks relatively more pain.

The geographic distribution of noncurrent loan rates now shows no distinct regional pattern. Most states have rates well below 1.5%, and eight have rates below 1%. These high-performing states were scattered across the country. Only five states, Arizona (2.0%), Hawaii (2.0%), South Dakota (1.5%), New Hampshire (1.8%), and Delaware (2.1%) had noncurrent loan rates at or above 1.5%. This lack of geographic pattern indicates that, at least by this measure, broad regions of the U.S. are experiencing good economic times.

Banking industry observers should note one developing trend. By changing the Internal Revenue code to allow financial institutions to elect Subchapter S corporation status, the Small Business Job Protection Act of 1996 makes comparing large and small banks difficult. Since 1997, 18% of banks with less than $100 million in assets have elected Subchapter S status. Like partnerships, these pass-through entities are not generally subject to any federal income taxes at the corporate level. Taxable income flows through them to their shareholders in proportion to their stock ownership. As a result, banks that do elect Subchapter S status report earnings as much as one-third higher than comparable banks that do not. If Subchapter S corporations are excluded, the return-on-assets gap between smaller and larger banks in 1999:IQ increases from 22 basis points to 33 basis points.

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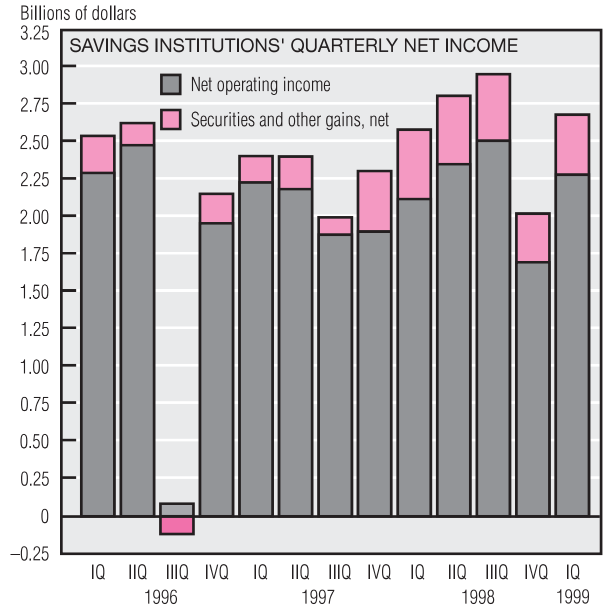

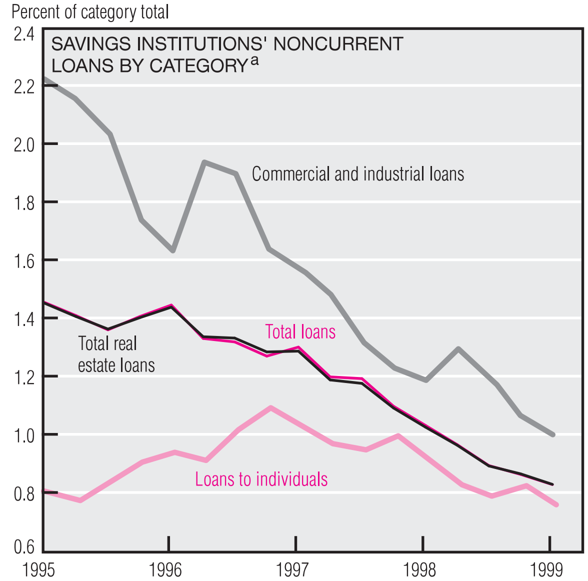

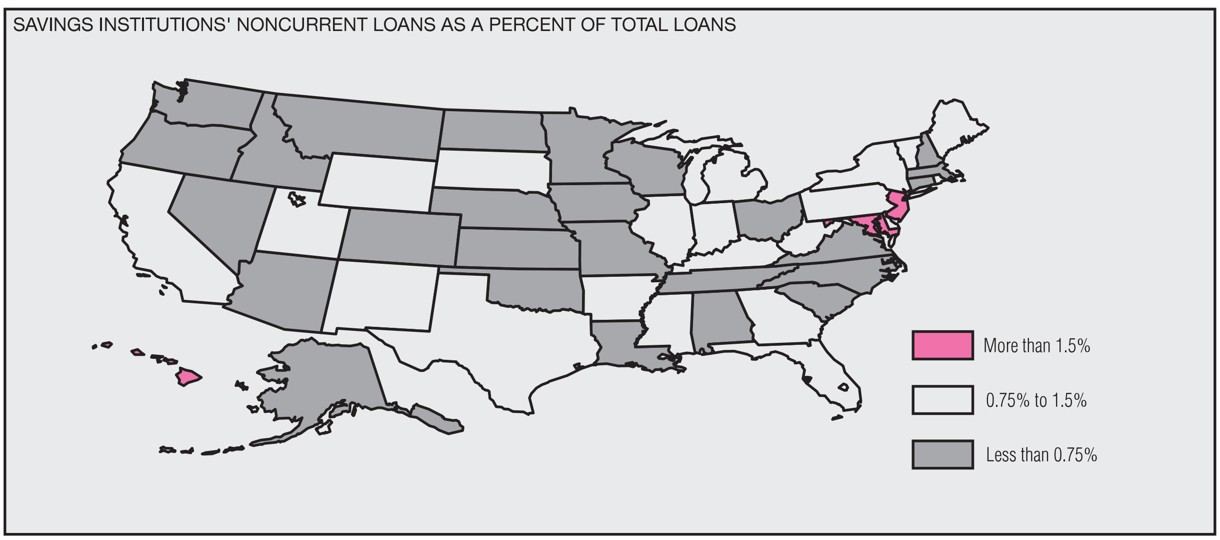

a. Noncurrent loans as a percent of category totals.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile,* March 1999.

Savings institutions also saw strong earnings growth in 1999:IQ, up $661 million from 1998:IVQ to $2.7 billion. Not quite a record, but still the third-highest quarterly earnings reported by the industry. Unlike banks, where securities and other gains made up less than 2% of industry net income, for savings institutions the share was 8%.

Asset quality, as measured by noncurrent loans, continued to improve from already healthy levels. Overall, noncurrent loans declined 3.5 percentage points to 0.83% from 1998:IVQ. Since 1998:IQ, these loans have fallen nearly 20 percentage points. The improvement is broad-based: It has occurred for all loan types, commercial and industrial, loans to individuals, and real estate loans.

For savings institutions, as for banking institutions, noncurrent loan rates display no striking geographic pattern. Even more puzzling, they do not seem to be closely related to noncurrent loan rates for banks. Few banks had rates over 1.5%. Only Hawaii (2.1%) had the misfortune to make both the bank and savings institution lists. Given its weak economy in recent years, Hawaii's status is not too surprising. In other states with poorly performing savings institutions, New Jersey (2.8%), Maryland (2.4%), and the District of Columbia (1.8%), banks had relatively healthy noncurrent loan rates. By this measure, savings institutions were healthier than banking institutions: 27 states had savings institutions with noncurrent loan rates of less than 0.75%, but only eight states had banks with such rates. Once more, the lack of geographic pattern suggests that broad regions of the country are enjoying robust economic conditions.