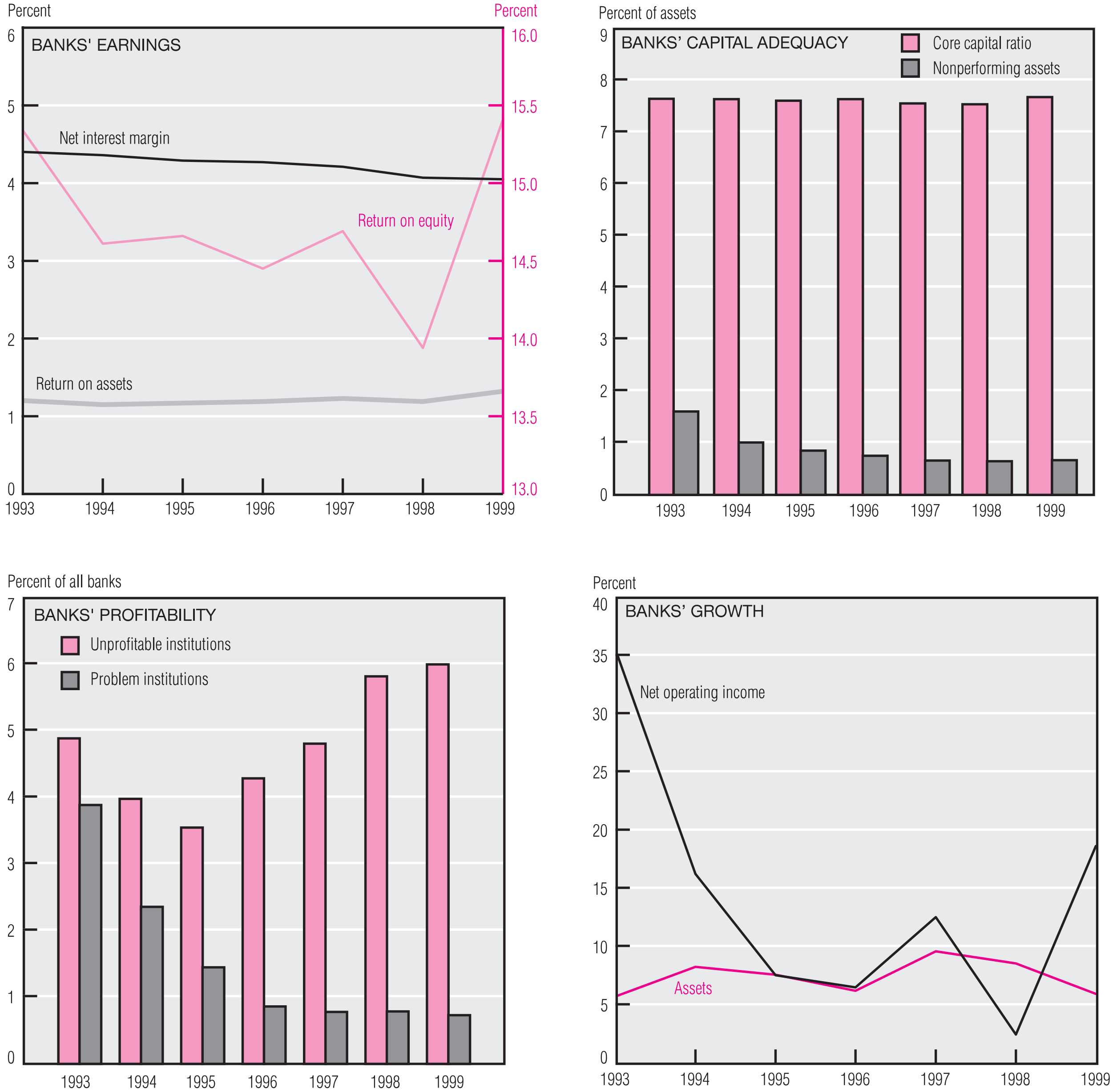
Banking Conditions



NOTE: All data are for FDIC-insured commercial banks. 1999 data are for the first quarter.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile,* March 1999.

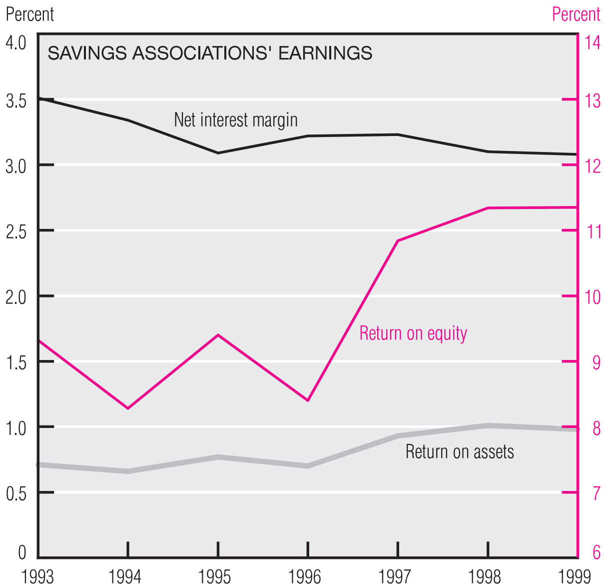
Commercial banks' balance sheets showed continued signs of health through the first quarter of 1999. After slowing down in 1998, profits picked up again in 1999:IQ, with a return on assets of 1.32% and a return on equity of 15.41%. Core earnings stayed strong as the net interest margin remained above 4%. Moreover, 94% of all commercial banks posted positive profits.

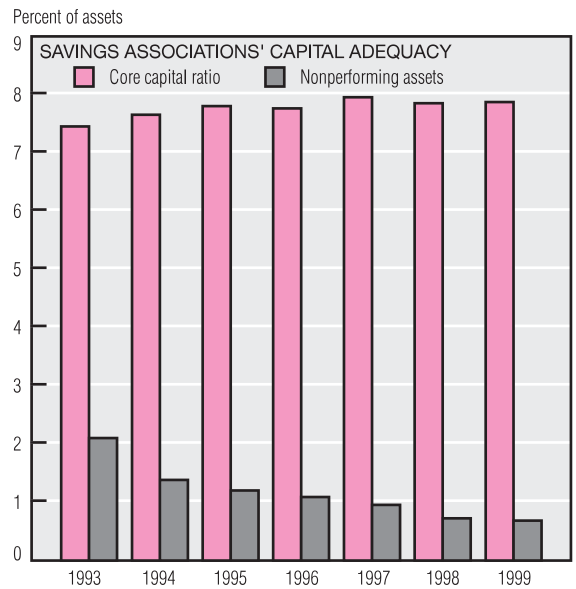
Banks' strong balance sheets are reflected in core bank capital, which, at 7.68% of assets, is high by historical standards. In addition, asset-quality problems are not yet evident; nonperforming assets, having increased very slightly from 1998, are only 0.67% of total assets. Further evidence of strength in the banking sector is the continued downward trend in the percent of banks rated as problem institutions—from 3.89% in 1993 to 0.73% in 1999:IQ. Finally, banks' asset growth over the last 12 months slowed to 5.88%. During the same period, however, net operating income grew 18.58%, sharply higher than the 2.39% growth rate for 1998. Overall, the banking sector has exhibited steady growth without compromising its profitability or, more importantly, the quality of its assets.

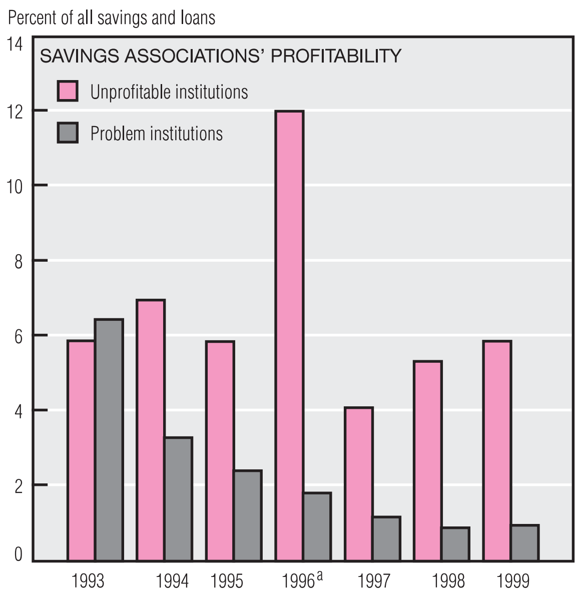
Savings associations performed steadily throughout 1999:IQ, and the industry posted quarterly earnings of $2.7 billion. Return on assets for the quarter was 0.98%, down slightly from its 1998 historical high of 1.01%. Further, at 11.35%, return on equity was at its highest level since 1985. Unlike the 1985 peak, however, return on equity in 1999 was generated by the robust return on assets just mentioned and by a steady net interest margin of 3.08%. However, the increase in the percent of savings associations reporting losses—from 4.1% in 1997 to 5.87%

(continued on next page)

Banking Conditions (cont.)







NOTE: All data are for FDIC-insured savings associations. 1999 data are for the first quarter.
a. The sharp decline in operating income growth in 1996 was partly due to a special deposit insurance assessment on savings and loans.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile,* March 1999.

in 1999:IQ—shows the need for caution in interpreting the otherwise positive earnings trends.

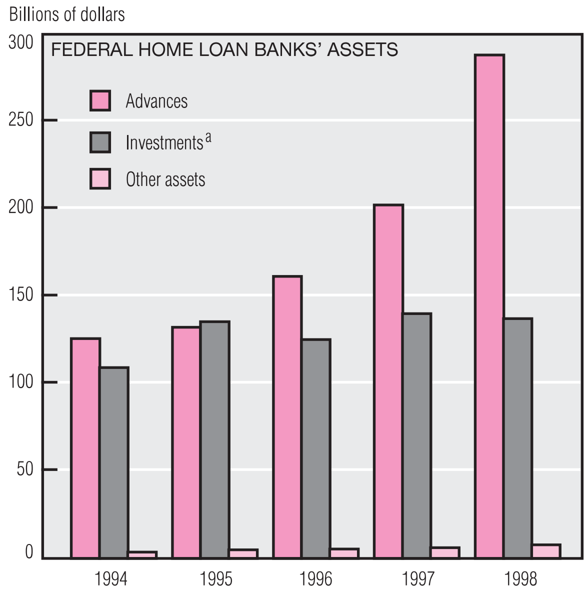
The asset quality of savings associations' balance sheets improved, as nonperforming assets fell to 0.68% of total assets, the lowest level in the last six years. Core capital remained a healthy 7.87% of total assets, a slight increase from 1998. Moreover, despite a small rise in the number of savings associations that had substandard examination ratings, problem institutions remained less than 1% of the total.

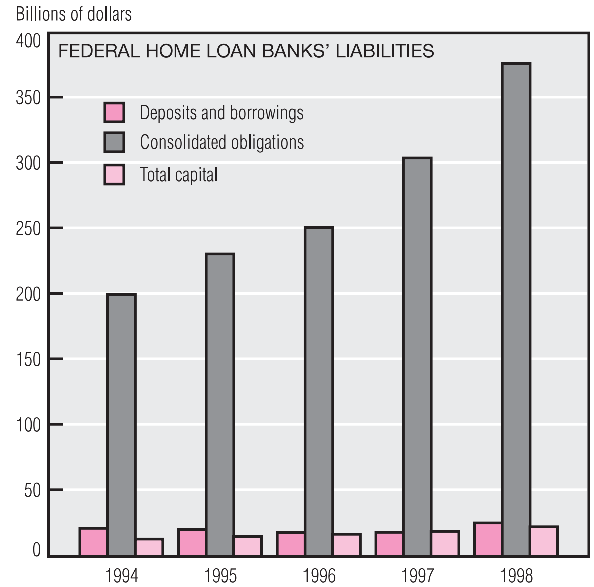
Twelve-month asset growth through 1999:IQ was 6.7%, slightly higher than 1998's rate of 6.05%. The increase of just less than 8% in operating income during the same period suggests that assets did not grow at the expense of profit margins in 1999. Overall, recent industry performance suggests that specialized housing lenders, such as savings associations, will continue to thrive, although their economic role is likely to be less important than it was in the past.

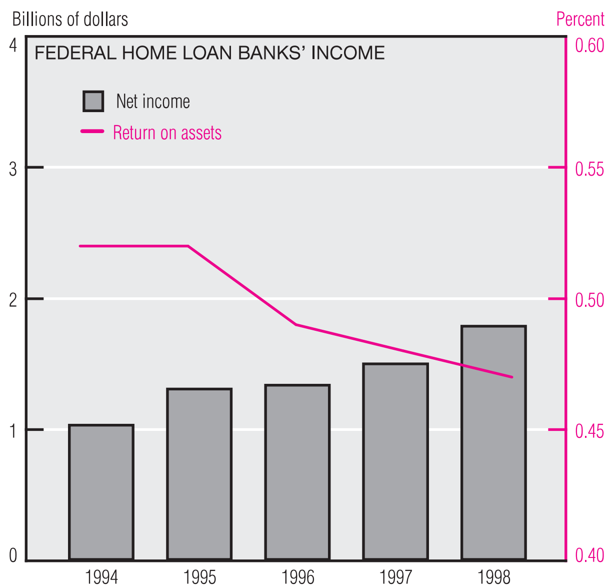
The 12 Federal Home Loan Banks are stock-chartered, government-sponsored enterprises; their main purpose is to provide liquidity to specialized housing finance lenders. Federal Home Loan Bank advances, which represent an important source of funding for member institutions' mortgage portfolios, increased from $202.3 billion at the end of 1997 to $288.2 billion at the end of 1998. This record increase in advances reflects the favorable funding costs afforded members as the result of the low long-term interest

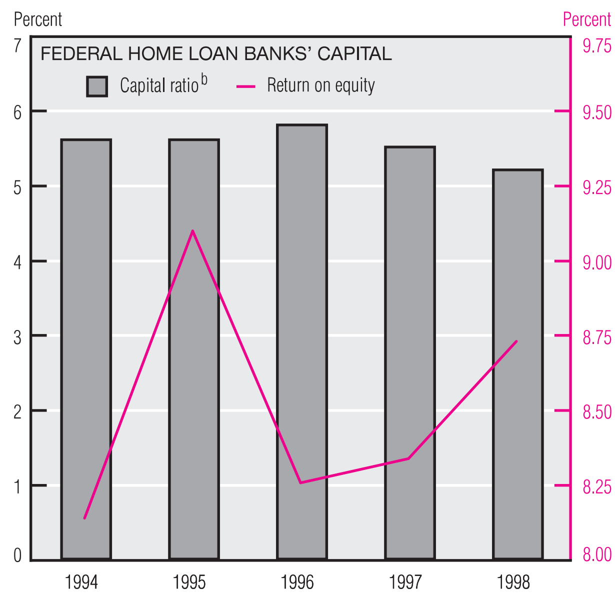
(continued on next page)

Banking Conditions *(cont.)*









a. Investments include federal funds sold.
b. Total capital ratio is capital stock plus retained earnings as a percentage of total assets at year end.
SOURCE: Federal Home Loan Bank System, *1998 Financial Report.*

rates that prevailed in 1998. It also reflects housing lenders' perception that the Federal Home Loan Bank advances are a more stable source of funding than money markets, which were disrupted by the 1998 financial troubles in Asia, Latin America, and Russia and by the highly publicized problems of Long Term Capital Management.

Collectively, the Federal Home Loan Banks reduced their investment portfolios by $2.9 billion in 1998, an indication of their increased lending opportunities during the year. The lion's share of funding for Federal Home Loan Bank assets is the $376.7 billion in consolidated obligations of the Federal Home Loan Bank System—bonds issued on behalf of the 12 Federal Home Loan Banks collectively. Member institutions' deposits and short-term borrowings provided another $25.8 billion in funding and equity capital supplied $22.8 billion, both figures up slightly over previous years.

The tremendous growth in Federal Home Loan Banks' assets has had a negative impact on profitability. Despite steady increases in net income from 1994 to 1998, return on assets has fallen steadily—from 52 basis points in 1995 to 47 basis points in 1998. Moreover, asset growth has led to a decrease in the capital-to-assets ratio from 5.8% in 1996 to 5.2% at the end of 1998. This increase in leverage is responsible for the rise in return on equity from 8.26% in 1996 to 8.73% in 1998. Overall, the Federal Home Loan Banks' performance last year suggests that they remain an important source of funding for the housing finance industry.