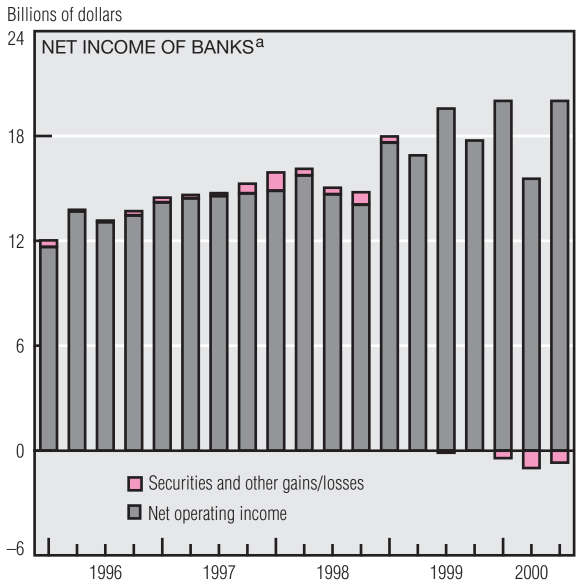
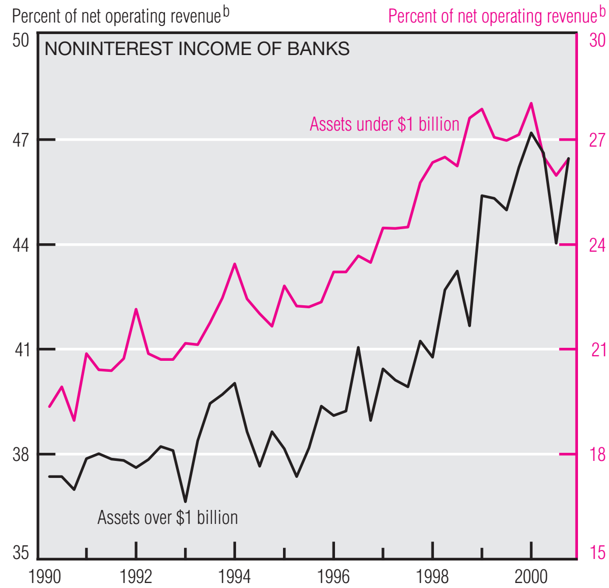
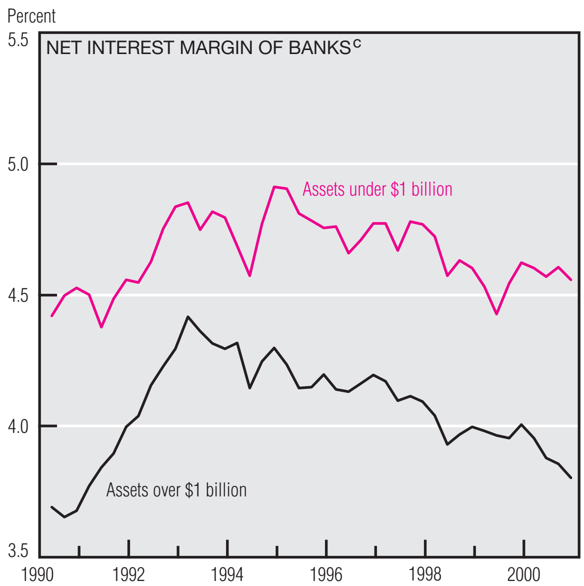
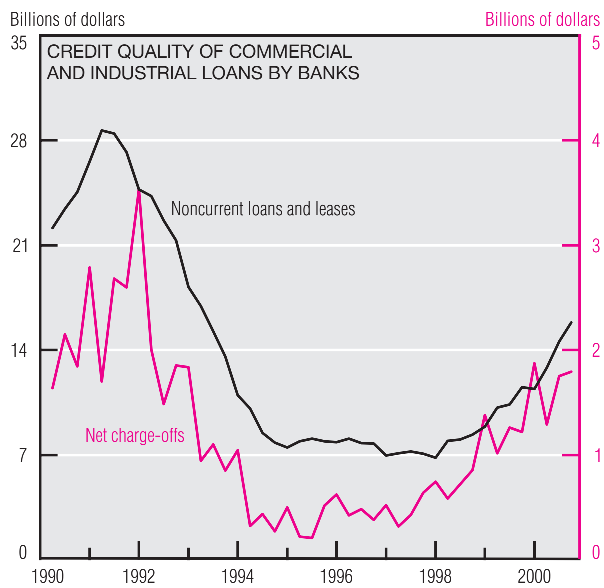
Banking Conditions









a. Net income equals net operating income plus securities and other gains and losses.
b. Net operating revenue equals net interest income plus noninterest income.
c. Interest and dividends earned on interest-bearing assets minus interest paid to creditors, expressed as a percent of average earning assets.
NOTE: All charts refer to FDIC-insured institutions.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile,* 2000:IIIQ.

Consistent with the slowing economy, conditions for the nation's FDIC-insured depository institutions remained mixed in the third quarter. After a disappointing second quarter, commercial banks' earnings rebounded in the third, approaching the record-setting levels reached in the first quarter. Third-quarter net income totaled $19.3 billion, up 31.6% from the second quarter, but still 1.32% off the $19.5 billion posted in the first. Gone were large banks' sizable restructuring and credit-related charges, which sapped the industry's second-quarter results.

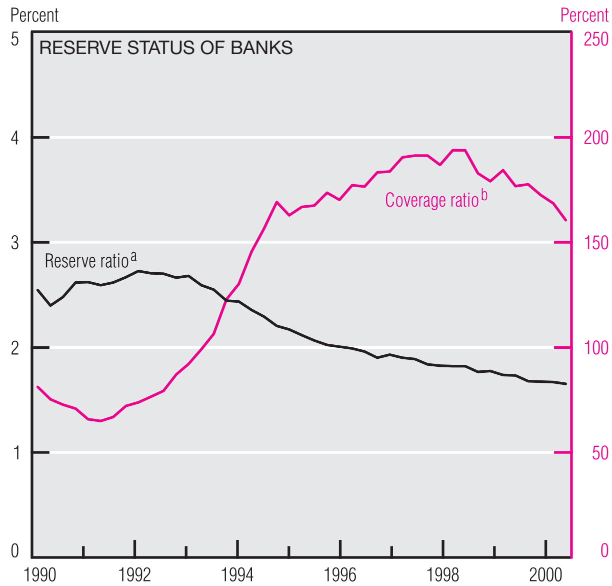
Average return on assets (ROA) tells a similar story. Third-quarter ROA recovered to 1.28%, following 0.99% in the second quarter, but remained significantly lower than the 1999:IIIQ peak of 1.41%. Higher short-term rates caused commercial banks' net income to slip 1.4% below that of a year ago. Earnings strength remained widespread, however, with 62.9% of commercial banks reporting an ROA of 1% or more for the third quarter.

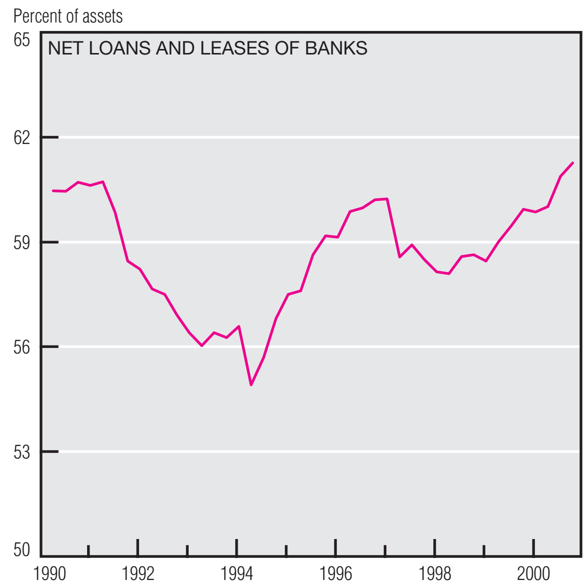
Although securities losses and other gains and losses narrowed, some signs pointed to the possibility of lower profits to come. Noninterest income as a percent of net operating revenue, which has grown robustly over much of the last four years, has stalled of late, particularly for small banks. Furthermore, net interest margins continued their long decline, which began in 1993.

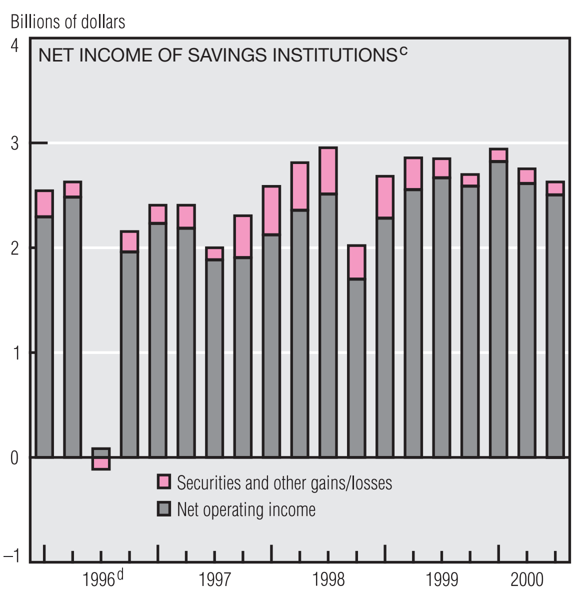
In addition, loan quality seems to be slipping. Noncurrent loans and leases and net charge-offs have

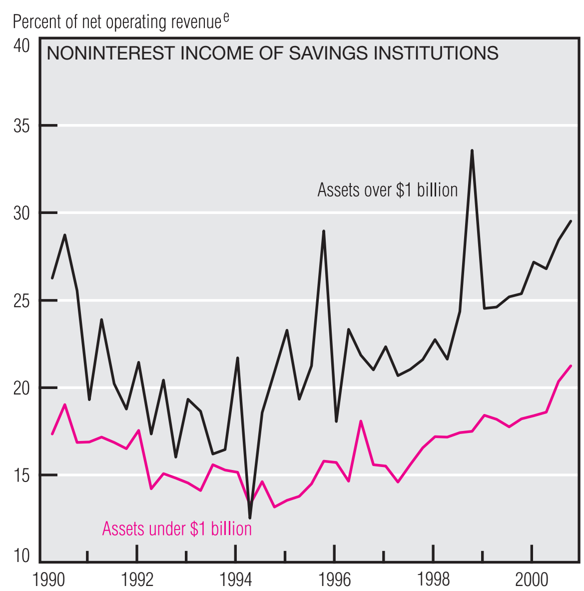
(*continued on next page*)

Banking Conditions (cont.)









a. Ratio of prudential reserves to total loans and leases.
b. Ratio of prudential reserves to noncurrent loans and leases.
c. Net income equals net operating income plus securities and other gains and losses.
d. A major cause of the sharp decline in 1996 was a special insurance assessment on savings institutions' deposits.
e. Net operating revenue equals net interest income plus noninterest income.
NOTE: All charts refer to FDIC-insured institutions.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, 2000:IIIQ.

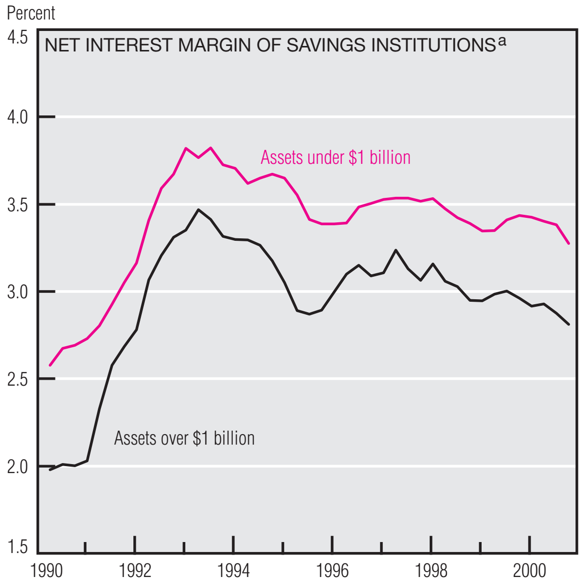
been rising since 1998, increasing $2.2 billion and $0.4 billion in 2000:IIIQ. Unfortunately, prudential reserves continue to grow more slowly than noncurrent loans and total loans. The reserve ratio (prudential reserves as a percent of total loans and leases) and the coverage ratio (those same reserves as a percent of noncurrent loans and leases) have edged downward. Net charge-offs of banks' credit-card loans caused the largest loan losses, with net charge-offs of $2.4 billion (4.27%) in the last quarter.

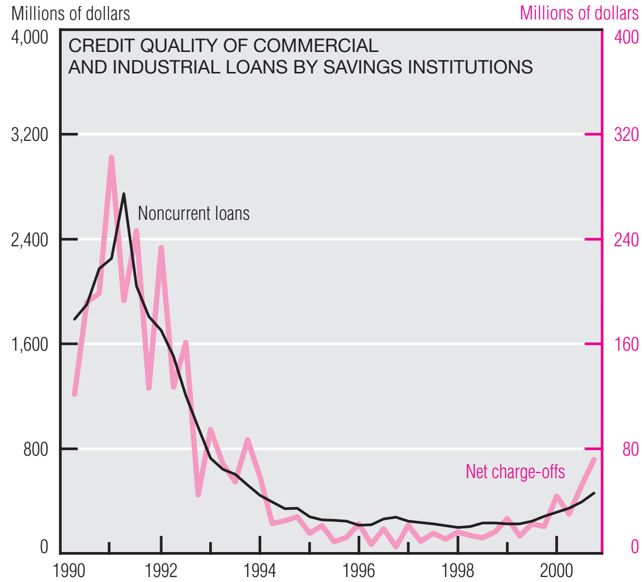
Banks have been able to offset some of the decline in loan quality by boosting the ratio of net loans and leases to total assets, thus generating more earnings per asset dollar. Also, assets rose $80.9 billion during the third quarter, topping $6 trillion for the first time and giving banks more to lend. They found willing borrowers for the additional capital, much of which has gone to depository institutions (up 12.5%), home equity lines of credit (up 5.8%), and real estate construction and development loans (up 4.6%). In sum, the nation's banks remained fairly healthy. This is reflected in their equity capital, which increased to 8.59% of assets because of profit retention arising from securities holdings' improved market value and higher retained earnings.

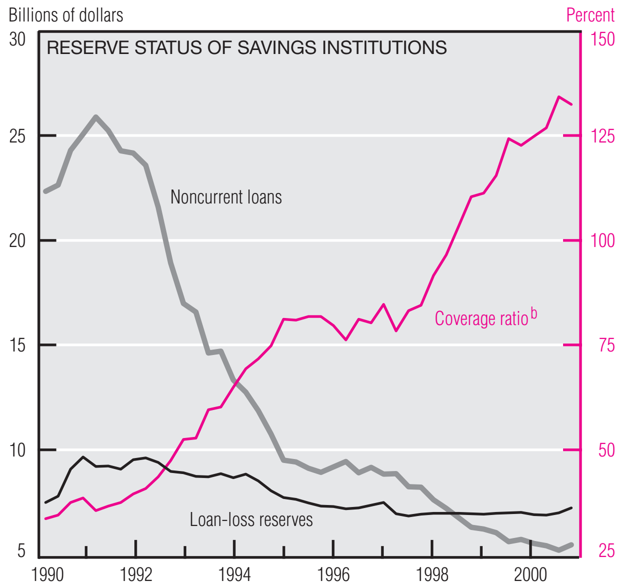
Conditions for FDIC-insured savings institutions weakened as earnings fell for the second consecutive quarter to $2.6 billion, down $186 million from the second quarter and

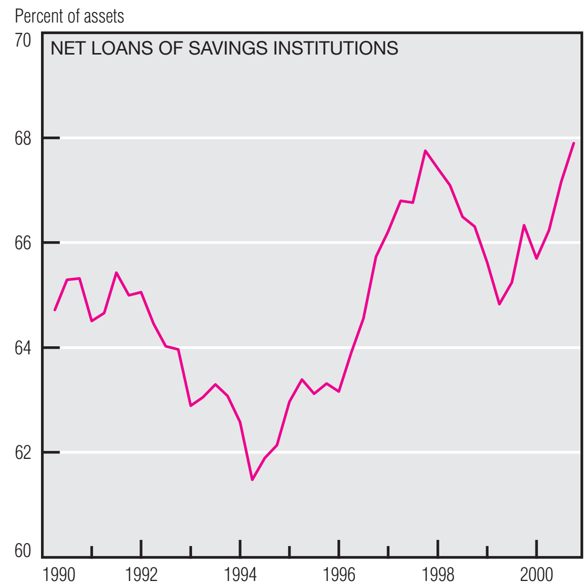
(*continued on next page*)

Banking Conditions (cont.)









a. Net income equals net operating income plus securities and other gains and losses.
b. Ratio of loan-loss reserves to noncurrent loans.
NOTE: All charts refer to FDIC-insured institutions.
SOURCE: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, 2000:IIIQ.

down $273 million from a year ago. Profitability remains a concern because almost 10% of savings institutions reported losses in 2000:IIIQ and just 27% had an ROA higher than 1%. Their average ROA fell to 0.86% from 1.00% a year ago.

As with banks, the inverted yield curve has put downward pressure on thrifts' net interest margins. Higher short-term rates have increased funding costs, but the yield on earning assets has not kept pace. Unlike banks, thrifts' noninterest income continues to rise at a fairly stable rate.

Savings associations' credit quality, while still far better than it was during the savings and loan crisis, has been slipping since 1998. For the first time in a year, loan-loss reserves did not keep pace with the increase in noncurrent loans. Noncurrent loans rose $253 million in the third quarter, while reserves increased only $239 million, lowering the coverage ratio to 132%. The percent of loans that were noncurrent increased for commercial and industrial loans (up 13 basis points to 1.39%), credit cards (up 10 bp to 1.33%), and real estate construction and land loans (up 5 bp to 0.79%).

Savings associations' assets rose $25 billion over the quarter, led by a $16 billion increase in home mortgages. Securities were the only major asset category to decline. Although deposits grew a robust $13.6 billion, one-third of this increase came from a single institution that completed the purchase of a large branch network from a commercial bank. On another positive note, equity capital climbed to 8.32% of assets from 8.16% in 2000:IIQ as a result of capital infusions, retained earnings, and lower losses on available-for-sale securities.