

Section Two

Condition of the Federal Banking System

Summary

Profitability at banks improved in the first half of calendar year 2012⁵² but remains below its two-decade average. With loan demand still weak, the substitution of lower-yielding securities for higher-yielding loans continued to compress net interest margins. Expenses due to provisions for loan losses declined again from year-earlier levels and are below their long-run average as a percentage of loans. Credit quality continued to improve, as net charge-off rates fell for all major loan categories.

Discussion

For the first half of calendar year 2012, net income at OCC-supervised banks increased by \$6.6 billion compared with the first half of 2011. Quarterly net income is running at about the same level as five years ago. Profitability, as measured by return on equity, stood at 8.8 percent for the second quarter and above the level of a year earlier. With system assets \$1 trillion higher than five years ago, and with banks holding more capital, return on equity is still well below the level achieved then.

Credit quality and provisions. Credit quality has improved steadily over the past three years. Charge-off rates declined for all major loan categories in the first half of 2012 compared with a year earlier.

Despite the generally improved credit performance, loss rates have remained high for residential real estate, due in part to the backlog of foreclosed

properties. Moreover, an estimated 20 percent of all first-lien mortgages exceed the current value of the homes financed, with much higher shares in the hardest hit states, such as Arizona, Florida, and Nevada.

A number of factors may have delayed the usual foreclosure process. For example, while loan modification programs may avert foreclosure in some cases, in other cases mortgage loans proceed to foreclosure despite modification. As a result, some future foreclosures may simply be postponed rather than avoided. These forces make it unlikely that loss rates will soon return to pre-crisis levels. For commercial real estate loans, charge-off rates have begun to fall, but fundamental performance measures such as vacancy rates are still lagging.

OCC-supervised banks have set aside less in reserves for future losses. Loan-loss provisions fell by \$7.3 billion in the first half of 2012 compared with a year earlier and are below their long-run average as a share of total loans.

Revenues. Pre-provision net revenues edged up 1 percent in the first half of 2012 compared with the same period a year earlier. The weak economy continues to pressure net interest margins, as loans mature and are replaced by low-yielding cash and securities.

Relatively weak economic growth combined with deleveraging by consumers is constraining loan demand, suggesting that banks are unlikely to see a return to pre-crisis growth rates in consumer lending anytime soon. Lending grew 2 percent in the first half of 2012, compared with a year earlier. Corporate

⁵² Only data for the first half of calendar year 2012 were available by publication deadline. Note: Fair value adjustments had a material influence on reported results.

profits have recovered to pre-recession levels, but with many firms accumulating cash, and even medium-size firms now able to access the bond markets, banks have experienced less growth in business lending than they did during previous recoveries.

Growing revenue has been more of a challenge for smaller banks than for larger banks because smaller banks did not benefit as much from the sharp drop in interest rates in 2008, following the onset of the recession.

Noninterest expenses rose sharply in the first half of 2012; this increase, however, was driven by results at one large bank and overstates changes in noninterest expenses across banks generally. Noninterest income grew modestly in the first half of 2012 compared with

a year earlier, in part from increased loan sales. This growth in noninterest income was more than enough to offset the increase in expenses and the weakness in interest income, pushing net income growth into positive territory.

Funding. Business and retail deposits rose sharply during the financial crisis, as other investments appeared less attractive and savers turned to banks for safety. Businesses in particular have accounted for a significant surge in checkable deposits since 2008. Large banks have been the main recipients of these deposit flows, which have helped hold down their funding costs; this pattern continued in 2012. Although these deposits offer low-cost funding, they may be harder for banks to retain if returns increase on alternatives to bank deposits.