THE FDIC PRELIMINARY BANK EARNINGS REPORT
THIRD QUARTER 2001

- **EARNINGS DECLINES AT LARGE BANKS CAUSE DROP IN INDUSTRY PROFITS**
- **A MAJORITY OF BANKS REPORT HIGHER NET INCOME**
- **QUARTERLY LOSS PROVISIONS REACH HIGHEST LEVEL IN MORE THAN 10 YEARS**
- **LOAN GROWTH CONTINUES TO SLOW WHILE DEPOSIT GROWTH REMAINS STRONG**
- **ASSET-QUALITY INDICATORS SHOW FURTHER DETERIORATION**

Higher Loss Provisions Hold Down Industry Earnings

Insured commercial banks reported net income of $17.4 billion in the third quarter of 2001, a decline of $1.9 billion (9.7 percent) from the third quarter of 2000. The largest factor in the earnings decline was a $4.8-billion (71.8-percent) increase in provisions for loan losses. Banks set aside $11.6 billion during the quarter to cover expected loan losses, the largest quarterly addition to reserves since the fourth quarter of 1990. Adding to the downward pressure on earnings was a $500-million (1.3-percent) decline in noninterest income. The industry’s noninterest revenues were $424 million lower than in the second quarter, marking the second quarter in a row that they have declined. A $2.9-billion (5.7-percent) increase in net interest income and a $1.7-billion improvement in proceeds from sales of securities from the third quarter of last year helped limit the drop in profits. Net operating income, which excludes results from securities sales and other nonrecurring items, was $3.3 billion (16.5 percent) lower than a year earlier. The industry's return on assets (ROA) fell to 1.08 percent in the quarter, compared to 1.28 percent a year earlier. Through the first three quarters of the year, commercial banks earned $55.9 billion, $2.5 billion (4.7 percent) more than in the same period of 2000, although net operating income was $1.3 billion (2.4 percent) lower. The ROA for the first nine months of this year was 1.17 percent, down from 1.20 percent a year earlier.

More Than Half of All Banks Report Higher Earnings

Most of the decline in industry profits occurred at large banks that had sizable expenses for asset-quality problems. More than half -- 55.1 percent -- of all commercial banks reported higher quarterly earnings than a year ago. However, only 44.9 percent reported higher quarterly ROAs than a year earlier, and the average ROAs for all four asset-size groups were down from a year ago. The largest decline was registered by banks with more than $10 billion in assets; their average ROA fell from 1.24 percent to 1.01 percent. Loss provisions absorbed 13.8 percent of this group's net operating revenues (net interest income plus total noninterest income), compared to 9.3 percent for commercial banks with less than $10 billion in assets.

Net Interest Margins Improve at Larger Banks

As was the case in the second quarter, declining short-term interest rates helped improve net interest margins at larger banks. The industry's net interest margin improved from 3.90 percent in the second quarter to 3.93 percent in the third quarter, the same level as in the third quarter of last year. Many community banks did not see their margins improve, however. The average margin at banks with less than $100 million in assets remained unchanged from the second quarter, at 4.26 percent, after declining in each of the previous four quarters. This is well below the group's average of 4.59 percent in the third quarter of 2000. More than half of all banks – 54.2 percent – had higher net interest margins than in the second quarter, but only one-third (33.4 percent) had higher margins than a year ago.

Loan Losses and Troubled Loans Continue to Climb

Banks charged-off $9.3 billion in loans during the quarter, an increase of $3.6 billion (63.6 percent) from last year's third quarter. While much of the increase occurred at large banks, slightly more than half (51.0 percent) of all commercial banks reported higher charge-offs compared to a year ago. As has been the case for almost two years, roughly one-third (35.7 percent) of banks' loan losses came from their commercial and industrial (C&I) loan portfolios. Net charge-offs of C&I loans totaled $3.3 billion, an increase of $1.5 billion (83.8 percent) from a year ago. The net charge-off rate on C&I loans was 1.30 percent, up from 0.69 percent in the third quarter of 2000. Loan losses were also higher in several other loan categories. Net charge-offs of residential mortgage loans rose sharply in the third quarter, as one bank sold a large portfolio of subprime mortgages. Home mortgage charge-offs rose to $938 million in the quarter, compared to $203 million a year earlier. Net charge-offs on leases totaled $338 million, an increase of $217 million.

The amount of loans that were noncurrent (90 days or more past due or in nonaccrual status) also continued to increase, but not as rapidly as charge-offs. Total noncurrent loans and leases rose by $3.1 billion during the third quarter, to $51.8 billion, or 1.34 percent of all loans and leases, a seven-year high. Over the twelve months ending September 30, noncurrent loans increased by $12.9 billion (33.2 percent). C&I loans accounted for $1.1 billion (35.9 percent) of the quarterly increase, and $6.1 billion (47.1 percent) of the 12-month increase. The percentage of C&I loans that were noncurrent rose from 2.03 percent to 2.17 percent during the quarter. This is the highest noncurrent rate since the third quarter of 1993. Other loan categories that registered sizable increases during the quarter include loans secured by commercial real estate properties, where noncurrent loans grew by $526 million (12.6 percent), and real estate construction and development loans, where noncurrent loans were up by $373 million (22.5 percent).

Banks Make Largest Quarterly Addition to Loss Reserves Since 1990

The $11.6 billion in quarterly loss provisions set aside by commercial banks exceeded the $9.3 billion in loans that were charged-off by $2.3 billion, as the industry's reserves for loan losses increased by more than $2.4 billion. This is the largest quarterly increase in industry reserves since the fourth quarter of 1990. The growth in reserves, combined with the lack of loan growth, lifted the industry's ratio of reserves to total loans to 1.77 percent, its highest level since the first quarter of 1999. However, the sharp increase in noncurrent loans during the quarter meant that the industry's "coverage ratio" fell from $1.35 in reserves for every $1.00 in noncurrent loans to $1.32, its lowest level since the first quarter of 1994.

Intangible Assets, Revaluation Gains Provide Record Boost to Equity Capital

Commercial banks' total equity capital increased by $27.9 billion (5.0 percent) during the quarter, the largest quarterly increase ever. The industry's equity capital ratio rose from 8.76 percent to 8.93 percent during the quarter, its highest level since 1940. Retained earnings added almost $4 billion, while increases in goodwill (up $8.6 billion) and revaluation gains on banks' available-for-sale securities (up $14.3 billion before taxes) accounted for much of the rest of the increase. Neither goodwill nor revaluation gains are included in regulatory capital; consequently, the industry's core capital "leverage" ratio rose from 7.73 percent to only 7.81 percent during the quarter, and it remained slightly below the 7.84-percent level of a year ago.

Net Loans & Leases Post First Quarterly Decline In More Than Four Years

A $15.2-billion decline in C&I loans and a $23.0-billion decline in residential mortgage loans caused banks' net loans and leases to fall by $1.2 billion in the third quarter. These declines were partially offset by a $14.4-billion increase in loans secured by commercial real estate properties, and a $10.4-billion increase in home equity loans. This is the first time since the first quarter of 1997 that the industry has had a decline in its net loans. Unused loan commitments continued to grow, increasing by $90.8 billion (1.9 percent), and the utilization rate on banks' loan commitments fell for the fifth consecutive quarter. Banks added $41.8 billion in mortgage-backed securities during the quarter, while assets in trading accounts grew by $38.3 billion. On the liabilities side, savings deposits continued to experience strong growth, rising by $67.7 billion (4.0 percent), while overnight borrowings increased by $37.2 billion (7.3 percent). The industry's ratio of net loans to deposits declined for the second quarter in a row, to its lowest level since mid-year 1999.

Industry Consolidation Slows

The number of insured commercial banks reporting financial results fell to 8,147 banks, from 8,178 at mid-year. The net reduction of 31 banks was the smallest shrinkage in a quarter since the fourth quarter of 1986. There were 30 new banks, while 57 banks were absorbed into other institutions through mergers, and 2 commercial banks failed. The number of commercial banks on the FDIC's "Problem List" declined from 80 to 74 during the quarter, while total assets of "problem" banks fell from $16.5 billion to $14.4 billion.

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TABLE I-A. Selected Indicators, FDIC-Insured Commercial Banks

TABLE II-A. Aggregate Condition and Income Data, FDIC-Insured Commercial Banks

TABLE III-A. First Three Quarters 2001, FDIC-Insured Commercial Banks

TABLE IV-A. Third Quarter 2001, FDIC-Insured Commercial Banks

TABLE V-A. Loan Performance 2001, FDIC-Insured Commercial Banks

Commercial Banks' Earnings Declined in Third Quarter

Net Interest Margins Improved at Many Banks During the Third Quarter

The Industry's Ability to Absorb Credit Losses Remains Strong

Troubled C&I Loans Continue to Grow

Deterioration in C&I Loans has been Greater at Large Banks

Deposit Growth Out-Strips Loan Growth for Fourth Consecutive Quarter

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