FDIC Quarterly Banking Profile Press Briefing
Third Quarter 2003 Results for FDIC-Insured Institutions
Wednesday, December 3, 2003

Overview
At our last industry press briefing in September we expressed some skepticism about the ability of the banking and thrift industries to extend their string of record quarterly earnings.

I am pleased to report this morning that our skepticism was misplaced—at least for the time being. FDIC-insured institutions did indeed report record earnings of $30.4 billion in the third quarter.

This performance just barely exceeded the $30.2 billion in earnings recorded for the second quarter, but is $3.1 billion above levels of a year ago.

These results were recorded in an economic environment that has dramatically improved over the first half of the year.

Economic activity, incomes, investment spending, and even the jobs picture all improved markedly in the third quarter of the year, as government and private indicators have been showing in recent weeks.

We've been describing over the past year how a ‘slow growth' economy has been, in general, very good for banks. These results demonstrate that a more rapid pace of economic activity is also consistent with a strong earnings performance.

At the same time, we will again discuss some of the earnings “headwinds” we described in September, how they affected the third quarter results, and what effect they may have going forward.

Earnings Breakdown
In ratio terms, third quarter performance was similar to the second quarter.

Return on assets fell two basis points from its record-setting second quarter level to 1.36 percent.

Consumer lenders continue to be the strongest-performing segment of the industry. Credit card lenders saw their ROA rise 14 basis points to 4.18 percent, or more than three times the industry average.

Almost 55 percent of all FDIC-insured institutions reported an ROA of at least one percent.

Just over half of all institutions reported a rise in earnings compared to the second quarter and compared to a year ago.

The two biggest factors behind the rise in earnings were growth in noninterest income and a decline in loan-loss provisions.

Noninterest income rose by $2.1 billion, boosted by servicing income, securitization income, and gains on loan sales.

Asset quality improved overall for the industry, continuing a trend that began late last year. Both charged-off loans and noncurrent loans declined. Loan loss provisions were down $1.7 billion from the second quarter and down $5.3 billion from a year ago.

As before, the biggest improvement in asset quality occurred in commercial loan portfolios of large banks.

John Lane will be making additional comments on credit trends in a few moments.

Earnings Headwinds

Notwithstanding the new earnings record posted in the third quarter, some of the “headwinds” we noted in our last release were evident in this quarter's results.

These “headwinds” basically fall into three categories:

Interest Margins. The historically low level of short-term interest rates continued to put downward pressure on net interest margins.

The industry's margin hit a 12-year low of 3.65 percent in the quarter. The industry's yield on earning assets fell 24 basis points to 5.19 percent. That's the lowest asset yield since 1972.

With short-term interest rates at generational lows, variable rate loans continue to reprice downward. Meanwhile, the surge in refinancing activity earlier this year has lowered yields in mortgage portfolios as well.

Mortgage Originations. As we expected, higher long-term interest rates are starting to cut into mortgage origination volumes.

The average weekly volume of mortgage applications fell by 38 percent during the third quarter.

All of the decline was attributable to refinancing applications, which fell by half.

Mortgage applications for home purchases actually rose a little in the third quarter as sales of both new and existing single-family homes reached record highs.

Growth in 1- to 4-family mortgage loans eased a bit in the quarter to $40.6 billion, but holdings of mortgage-backed securities declined by $86 billion.

As a result, industry total assets only increased by $22 billion, compared to an increase of $318 billion in the second quarter.

The point is this—the industry saw strong asset growth in the second quarter, 75 percent of which was in the form of mortgage-related assets. Asset growth fell to virtually zero in the third quarter primarily because total holdings of mortgage-related assets actually fell.

Even so, the dropoff in mortgage activity in the third quarter was not as sharp as we expected. Many loan applications received at the height of the refinancing boom in June were processed in the third quarter, despite a 100 basis point increase in mortgage rates between late June and early August.

The pipeline continues to diminish, however, with weekly refinancing applications down an additional 36 percent thus far in the fourth quarter.

The effects on the bottom line are already evident.

The combination of lower net interest margins and slower growth in interest-earning assets caused the industry's net interest income to decline slightly during the quarter—only the second such decline in the last 22 quarters.

Gains on sale. The increase in interest rates also lowered the market values of fixed-rate securities, and reduced the gains that banks and thrifts realized on securities sales compared to recent quarters.

In the second quarter, these gains accounted for $4.9 billion in pre-tax earnings, or almost 11 percent of the industry's profits.

In the third quarter, they fell to $2.2 billion, and contributed less than 5 percent of industry earnings.

Unrealized gains remaining in bank securities portfolios also fell sharply during the quarter, from $25.1 billion on June 30 to $14.0 billion on September 30.

The bottom line is that while these headwinds are slowing the growth of earnings, they are not yet strong enough to offset the factors that are boosting bank profits.

Loan Demand
A word about loan growth and loan demand.

Despite the resurgence in economic activity in the third quarter, the expansion continued to be dominated by consumer spending and home building.

Together, these items made up three-quarters of all economic activity during the quarter.

But while demand for consumer loans and home purchase loans remains strong, business loan demand remained lackluster during the third quarter. The industry's commercial and industrial (C&I) loans declined for the eleventh quarter in a row.

As before, concerns about the lack of any C&I loan growth are tempered somewhat by the fact that corporate bond issuance remains strong – over $200 billion in the first half of this year – and surveys of small business owners that show remarkably little concern about credit availability.

We believe that commercial loan demand is poised for a rebound.

The latest manufacturing survey by the Institute for Supply Management shows that new orders are the strongest they've been in many years.

The same survey shows that manufacturers are finally poised to rebuild inventories after drawing them down for the last three years running.

Business investment spending is also coming back in a big way.

Spending on equipment and software rose by 19 percent in the third quarter, up from the low single digits in the first half of the year.

These factors bode well for a rebound in commercial loan demand in the fourth quarter and beyond.

Industry Structure and FDIC Insurance Funds

In terms of the structure of the industry, the most noteworthy trend we see is one that has been building for some time, and that is the shrinking rate of decline in the number of FDIC-insured institutions.

While the industry has been steadily consolidating for over 15 years, the net decline in the number of institutions in the third quarter was just 31, the lowest number since the fourth quarter of 1986.

Whether this trend will continue going forward is certainly debatable, and is an item of great interest to all of us. It is just one of the topics being addressed in the FDIC's ongoing study of "The Future of Banking."

The reserve ratios of the FDIC insurance funds rose again during the quarter. The BIF ratio rose two basis points to 1.31 percent and the SAIF ratio rose one basis point to 1.40 percent.

An important factor behind the increase in the insurance fund reserve ratios was a decline in the funds set aside to cover losses resulting from future bank failures and, in the case of the BIF, a decline in the estimated cost of past failures.

Outlook
The U.S. economy continues to look very strong. That, in turn, is boosting prospects for the global economy.

While most analysts do not expect fourth quarter U.S. growth to equal the 8.2 percent pace of the third quarter, signs continue to be strongly positive.

The quickening pace of economic activity is good news, in general, for loan demand and asset quality at insured institutions.

As I mentioned, commercial loan demand, which has been the missing link for the industry in recent quarters, appears poised to rebound.

The upturn in the economy does raise questions about the direction of interest rates—namely, when they will rise and by how much.

Rising interest rates could pose problems for certain segments of the industry, particularly if it is short-term rates that increase.

Mortgage lenders tend to be liability sensitive—particularly given the long expected duration of mortgage portfolios after the recent refinancing boom.

There are also some concerns that higher short-term interest rates could lead to an increase in credit problems on the part of adjustable-rate borrowers, be they homeowners, commercial borrowers, or owners of commercial real estate properties.

We've had two episodes in recent years where short-term rates rose appreciably.

One was in 1994 and early 1995 when the federal funds target rate rose 7 times for a total of 300 basis points.

The other was mid-1999 to mid-2000 when there were 6 increases in the fed funds target for a total of 175 basis points.

What continues to be remarkable about this recovery is the apparent lack of inflation pressure to date and the general expectation that short-term rates will not increase until well into 2004.

Core inflation is running at about 1.3 percent—the lowest level in 40 years.

Futures markets tell us that traders don't expect an increase in short-term interest rates until at least March of next year.

These signs tell us that despite the rebound in the economy, short-term rates may rise later rather than sooner.

To summarize: The outlook for bank earnings remains solid.

The real question from quarter to quarter continues to be: Will there or won't there be another earnings record?

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