

**Quarterly Banking Profile Press Briefing**  
**Second Quarter 2003 Results for FDIC-Insured Institutions**  
**Thursday, September 4, 2003**

## **Overview**

Generally favorable economic and financial conditions boosted the earnings of FDIC-insured institutions to a second consecutive quarterly record in the period ending June 30.

The industry earned \$30.2 billion during the quarter, surpassing the earnings record of \$29.4 billion set in the first quarter.

The increase in second-quarter earnings was attributable to a three main factors:

- 1) Gains on the sale of securities and other assets, helped by a decline in long-term interest rates to their lowest levels in more than a generation.
- 2) Strong loan growth, led by mortgage loan origination volumes which soared to record levels as long-term interest rates declined. Strong loan growth boosted net interest income even as net interest margins narrowed.
- 3) A third consecutive quarterly decline in net loan losses, which helped to reduce provision expenses.

Although the financial strength of the industry remains evident, the sharp rise in long-term interest rates since June creates 'headwinds' that could make it harder for the industry to set new earnings records in the quarters ahead.

### **Low Long-Term Interest Rates Have Boosted Earnings**

In recent quarterly press briefings, we have described how the slow-paced economic recovery since late 2001 has been highly conducive to the record earnings posted by FDIC-insured institutions in 2002 and the first quarter of this year.

Low and declining long-term interest rates have been a key element of this favorable environment.

A three-and-a-half year rally in long-term Treasuries drove the yield on 10-year U.S. government bonds down to a 45-year low of 3.11 percent as of June 13th.

In this environment, FDIC-insured institutions have been able to consistently realize large gains on the sale of securities and other assets.

In the second quarter, pre-tax gains on the sale of assets amounted to \$4.9 billion, compared to \$3.7 billion in the first quarter. In fact, the increase in gains on sale accounted for virtually all of the net increase in industry earnings during the quarter.

The three-year decline in long-term interest rates also brought about record volumes of mortgage originations, led by refinancing activity.

The weekly mortgage origination index of the Mortgage Bankers Association of America peaked at an all-time high in the second week of June. Since then, weekly mortgage

applications have fallen by 60 percent while “refi” applications have fallen by more than 75 percent.

In terms of today’s results, I would point out that mortgage lending made up 72 percent of loan growth in the second quarter, up from 70 percent in the first quarter.

### **A Changing Economic Environment**

During June the economic climate seemed to shift rather suddenly. The most visible aspect of this shift was a sharp increase in long-term interest rates.

The yield on 10-year Treasury instruments rose by 130 basis points between June 13 and the end of July.

The monthly increase of 65 basis points in July was the largest monthly increase since May 1987.

Although many factors are thought to underlie the rise in long-term interest rates, the trend appears to have roughly coincided with a shift in investor sentiment as to the future direction of the U.S. economy, the downside risks of the economic outlook, and how those trends might shape Federal Reserve policy.

Indeed, recent signs appear to confirm what economists have been forecasting for much of this year—that the pace of economic activity will be markedly faster in the second half of this year compared to the first half of the year and 2002.

The consensus forecast of the Blue Chip Economic Indicators, for example, calls for real growth in U.S. gross domestic product to be 3.7 percent in the third quarter and 3.8 percent in the fourth quarter.

### **How A Faster Recovery Will Affect FDIC-Insured Institutions**

A question we have discussed in previous quarterly briefings is how the anticipated upturn in the U.S. economy may shape the earnings of FDIC-insured institutions in future quarters.

Our perspective has been that with the excellent financial performance of the industry during the slow-growth portion of the recovery, there was little reason to expect this performance to deteriorate significantly as the pace of economic activity picked up.

Record earnings in the second quarter appear to confirm this overall perspective.

We continue to see the generally strong earnings and balance sheet fundamentals of the industry remaining in place for the foreseeable future.

However, given the dependence of the industry on securities gains and mortgage lending in the first half of the year, and the significant rise in long-term interest rates since June, it may well be that earnings comparisons with the first half of the year could become more difficult in coming quarters.

I’ll discuss some of these developing “headwinds” to earnings growth in future quarters as I summarize the components of second quarter earnings.

## **Second-Quarter Details**

First, some details from the second quarter results.

Return on assets for the industry remained at 1.38 percent—the same as last quarter and one basis point ahead of a year ago.

More than half of all institutions (57 percent) reported higher earnings than a year ago, while almost half (47 percent) had a higher ROA.

Only 533 institutions reported a net loss for the quarter, down from 676 in the second quarter of 2002. This is the lowest number of unprofitable institutions in over five years.

Both the number and total assets of problem institutions fell during the quarter.

The reserve ratio of the FDIC's Bank Insurance Fund (BIF) rose by one basis point to 1.29 percent.

The reserve ratio of the Savings Association Insurance Fund (SAIF) also rose by one basis point to 1.38 percent.

## **Lending Activity**

The 12-month rate of asset growth of the industry rose for the fifth consecutive quarter to 11 percent.

Almost three quarters of this growth occurred as a result of mortgage lending. This activity will certainly slow in coming quarters due to higher interest rates.

But while refi activity has already fallen off, substantial volume remains in the origination pipeline and housing activity remains very strong.

Existing home sales remained at all-time highs in August, while housing starts rose to new highs for this cycle.

Commercial loans, on the other hand, declined for the tenth consecutive quarter.

As before, the shrinkage is mainly concentrated at a few large banks. But annual data collected in June also show that the trend has been spreading to small commercial loans during the past year.

Tighter standards play some role, but slack loan demand has played a larger role.

We expect that business loan demand should pick up in the second half of the year along with overall economic activity.

Given their generally strong financial condition, FDIC-insured institutions will remain reliable providers of credit for both businesses and households.

## **Interest Margins**

Falling interest rates during the second quarter continued to put downward pressure on net interest margins. But the strong growth in mortgage loans, in particular, allowed banks to grow their net interest income in spite of the narrower margins.

Margins could improve going forward due to the recent rise in long-term interest rates, but that will depend on what kind of volume we see in mortgage lending and securities purchases.

Higher rates are unlikely to cause significant increases in funding expenses, since banks and thrifts tend to fund their assets with short-term liabilities.

The challenges of generating margin growth in this unique interest rate environment represents one of the “headwinds” for the industry in terms of generating growth in net interest income going forward.

### **Credit Quality**

Asset-quality indicators improved for the third consecutive quarter.

The percentage of total loans that were noncurrent – 90 days or more past due or in nonaccrual status – fell from 1.31 percent to 1.24 percent during the quarter.

The amount of loans charged off was \$118 million below the level of the first quarter and \$1 billion less than a year earlier.

The area of greatest improvement in asset quality has been commercial and industrial loans.

After 5 years of rising levels of troubled loans, we have seen significant improvement in noncurrent commercial and industrial (or C&I) loans and in C&I loan charge-offs for three consecutive quarters.

This improvement has occurred where most of the previous deterioration took place – at large commercial banks.

This looks to us like a longer-term trend, albeit one that depends on continued improvement in the overall economy.

Credit-card loans remain an exception to the improving trend in asset quality.

Net charge-off rates on credit-card portfolios have continued to rise in line with increases in personal bankruptcy filings, which totaled some 1.6 million in the 12 months ending in June.

The profitability of credit card lenders has not been adversely affected by higher loan losses; as a group, credit card lenders earned a return on assets of over 4 percent during the quarter.

Asset-quality indicators for the other areas of the industry’s loan portfolio remain fairly stable. This includes commercial real estate portfolios, where market conditions have deteriorated but loan performance remains strong.

The improving overall trend in asset quality continues to have a positive effect on core earnings.

Loan-loss provisions have declined from year-earlier levels in each of the last three quarters.

Lower loss provisions accounted for more than one-third of the year-to-year improvement in net operating revenue during the second quarter.

### **Earnings Outlook**

A key factor in subsequent quarters will certainly be lower gains on the sale of securities and loans.

These gains have been one of the fastest-growing components of net income for more than a year, reaching a record high in the second quarter.

However, now that interest rates have risen, these gains are unlikely to be as high again.

Operating earnings, which exclude these gains, have not been rising as rapidly as net income; without these gains, net income improvement will be more difficult to achieve.

Pressure on operating earnings could come from slower asset growth.

Higher interest rates will slow origination volumes for mortgage loans. While we anticipate higher demand for commercial loans, it is not clear that that handoff has taken place as of yet.

On the plus side, lower expenses for loan-loss provisions should continue to boost operating earnings.

Overall, the near-term outlook is for continued strong earnings, but new quarterly earnings records may become harder to achieve.