FDIC Quarterly Banking Profile Press Briefing
First Quarter 2004 Results for FDIC-Insured Institutions
Thursday, May 27, 2004

Overview
FDIC-insured institutions reported record net income of $31.9 billion in the first quarter of 2004.

This marks the fifth consecutive quarterly increase in earnings for the industry, as well as the fifth consecutive quarterly earnings record.

Net income rose by 2.8 percent from the fourth quarter of 2003, and by 7.9 percent, or $2.3 billion, from a year ago.

First quarter earnings growth was supported by a record increase in interest—earning assets—driven mostly by growth in mortgage-related assets—and by a large decline in loan loss provisions, as credit quality continued to improve.

The industry also recognized $2.6 billion in gains on the sale of securities during the quarter.

The industry return on assets, or ROA, was 1.38, down just one basis point from its all-time record of a year ago.

More than half of all institutions reported higher earnings in the first quarter, while half reported higher ROAs.

Components of Earnings Growth
Breaking down first quarter earnings growth into its five main components provides a more detailed picture.

Net interest income contributed $3.8 billion to growth in pre-tax net income compared to a year ago.

Virtually all of the improvement came about from a decline in total interest expense, while total interest income grew only slightly.

The industry's net interest margin narrowed again to 3.68 percent, down 7 basis points from the fourth quarter, 12 basis points from a year ago, and 38 basis points from two years ago.

Despite lower interest margins, net interest income was lifted during the quarter by a record $354 billion increase in earning assets.

Noninterest income rose $3.8 billion from its year-ago level, posting its second largest quarterly value ever.

Market-related activities and loan servicing fees both contributed to the increase in noninterest income, though servicing fees fell off somewhat in the first quarter.

Provision expenses declined by $2.7 billion from a year ago, marking perhaps the most significant trend in these earnings results. I'll have more to say about this trend in a moment.

Factors working against these first-quarter gains included noninterest expenses, which were $6.5 billion higher than a year ago, and gains on the sale of securities, which were $1.1 billion lower.

But the net result was first quarter pre-tax net income that was $2.8 billion higher than a year ago.

Sources of Asset Growth
Mortgage-related assets made up 71 percent of total asset growth during the quarter.

Supporting mortgage activity during the quarter was a dip in mortgage rates that prompted another round of mortgage refinancing.

Purchase mortgage applications remained at record levels due to continued strong homebuilding activity.

Commercial real estate loans and – especially – home equity lines continued to grow faster than other major loan categories, much as they did during the second half of last year.

Commercial and industrial (or C&I) loans held by the industry shrank for the 13th consecutive quarter.

However, the longer we see this string of declining C&I loans continuing into the expansion, the less we're inclined to read into it.

As we described to you last quarter, the economic factors that should support increases in C&I lending – including business investment in inventories and equipment – are expanding at a healthy pace.

One reason C&I loans haven't grown is that corporate borrowers have chosen to issue bonds in record volumes, taking advantage of historically low interest rates.

Another reason is simply the fact that collateralized business borrowing frequently takes the form of commercial mortgage loans.

Finally, the largest banks have built a business around originating commercial credits and selling them to other banks as well as non-bank investors.

Improvement in Commercial Credit Quality
Loan performance improved across the board for FDIC-insured institutions during the first quarter.

Compared to year-ago levels, both noncurrent loans and net loan chargeoffs declined as a percent of outstanding balances for every major loan category.

Still, in dollar terms, more than 80 percent of the decline in noncurrent loans was attributable to improvement in bank C&I loan portfolios.

All of the improvement in the dollar value of net loan chargeoffs came from the C&I category.

The improvement in commercial loan portfolios of the largest banks represents a remarkable turnaround from the corporate-sector problems that grabbed headlines during and after the 2001 recession.

Some of the hardest-hit sectors during the downturn – including telecommunications, computers, and energy – staged impressive recoveries last year.

An economic rebound based on low interest rates and high rates of productivity growth turned out to be highly conducive to the profitability of these, and other, industry sectors.

The result has been a sustained decline in noncurrent C&I loans held by large banks.

We observe that the historically long periodicity of commercial credit cycles – along with the generally positive economic outlook at present – suggests that the improvement in large bank C&I loan performance may not yet have run its course.

What that also implies is that the accompanying trend toward declining provision expenses also could continue to boost the bottom line of the banking industry during the remainder of 2004.

Industry Structure and FDIC Insurance Funds

In terms of the overall structure of the industry, we see historically high capital ratios, relatively few unprofitable institutions, and a declining number of problem banks.

Total deposits grew by 2.9 percent during the quarter, while the FDIC deposit insurance funds remained stable.

During the quarter, the BIF reserve ratio slipped 1 basis point to 1.31 percent of insured deposits, while the SAIF reserve ratio rose three basis points to 1.39 percent.

The reserve ratio for the two funds combined remained unchanged at 1.33 percent.

Outlook

FDIC-insured institutions are currently riding on a string of ten consecutive quarters where net income has increased on a year-over-year basis.

This is the longest such string since the early 1990s.

A resurgent economy has lifted credit quality across the board, while gains in the corporate sector have helped the industry to address its single biggest credit quality problem.

While low interest rates continue to squeeze margins, they have also facilitated mortgage activities and investment gains that have enhanced the industry's bottom line.

The consensus outlook for the U.S. economy calls for continued strong economic growth and higher interest rates in the second half of the year.

A strong economy will continue to be a plus for loan growth and credit quality.

But, going forward, higher interest rates could pose a significant challenge for mortgage lenders and variable-rate borrowers.

Higher interest rates will put to the test the hedging strategies of mortgage lenders and other holders of long-term assets.

Higher interest rates will also eventually raise the cost of servicing most C&I loans and commercial real estate loans, as well as home equity lines and adjustable-rate home mortgages.

Higher debt service costs could, in turn, result in higher loan defaults in these variable-rate portfolios.

On balance, however, the current performance of the industry is very strong and the outlook is positive.