Remarks by Richard A. Brown
Chief Economist, FDIC
FDIC Quarterly Banking Profile Press Briefing
Second Quarter 2004 Results for FDIC-Insured Institutions

Thursday, August 26, 2004

Overview

After posting a string of five straight quarterly earnings records, the net income of FDIC-institutions fell slightly in the second quarter to $31.2 billion (Chart 1).

This was the second most profitable quarter in the history of the industry.

While net income came in $656 million less than the first quarter, it was $986 million higher than the quarterly record of a year ago.

Net operating income did set a record of $30.0 billion during the quarter.

It took a decline of almost a billion dollars in gains on sales of securities to keep net income from also posting a new high.

Higher noninterest expenses at a few large banks also helped hold down earnings during the quarter.

Return on assets fell seven basis points to 1.31 percent.

Almost 60 percent of all institutions reported higher earnings in the quarter, while 55 percent had higher ROAs.

Credit Quality Continued to Improve

Loan performance continues to improve, particularly in the commercial loan portfolios of the largest banks.

There is abundant evidence of financial recovery in the corporate sector.

Corporate profits in the first quarter of this year were 28 percent higher than levels of a year ago.

Default rates on speculative-grade corporate bonds, which tend to lead loss rates on bank commercial loans, continued to fall through the second quarter (Chart 2).

These trends helped push total noncurrent loans – that is, loans past due 90 days or more plus nonaccrual loans – down by $4.2 billion in the quarter.

More than half of the decline was in loans to commercial borrowers.

During the last six quarters combined, noncurrent loans have declined by $17.4 billion, or over 25 percent.

The ratio of noncurrent to total loans fell below 1 percent to 0.89 percent – its lowest level in the 20 years this item has been reported to the FDIC (Chart 3).

Net loan chargeoffs fell by $600 million to $8.2 billion – their lowest level in over three years.

This chart shows total "troubled loans" – noncurrent plus chargeoff -- at their lowest level in over 4 years (Chart 4).

For a sixth consecutive quarter, the industry set aside less in loss provisions than it charged-off, as large banks continued to reduce their loss reserves.

Effects of Higher Long-Term Interest Rates
A sharp rise in long-term interest rates during the second quarter had a mixed effect on industry earnings (Chart 5).

The yield on 10-year Treasuries rose some 76 basis points during the quarter.

This increase in long-term rates contributed to a $25 billion decline in the market value of securities carried on the books of FDIC-insured institutions.

While this market value decline was not reflected in current period industry earnings, it does show how sensitive portfolios have become to changes in interest rates.

Gains realized on the sale of securities in the second quarter slipped by $954 million to $1.65 billion.

At the same time, higher interest rates contributed to a $1.7 billion increase in servicing income, as the value of mortgage servicing portfolios rose.

Net Interest Margins Remain Tight
Net interest margins remained historically tight for the industry, falling four basis points to 3.64 percent (Chart 6).

The decline in margins was somewhat concentrated at large institutions, as a slight majority of institutions (52 percent) reported improved margins in the quarter.

Still, narrow margins remain a bigger problem for small institutions because they rely more heavily on net interest income.

While historically-low short term interest rates have clearly hurt margins, it is not entirely clear how they will be affected by the Federal Reserve's ongoing program to raise rates.

The effect of rising rates on margins will depend on the strategy followed by each institution.

Growing the loan portfolio will tend to help margins in a rising rate environment.

The more you depend on core deposits to fund asset growth, the better able you will be to keep interest expenses in check.

On the other hand, institutions that have had to rely more on wholesale funding will find themselves more vulnerable to rising interest costs in this environment.

Finally, concentrations in long-term mortgage-related assets – which have grown significantly in recent years – will tend to hold down interest income as rates rise.

Instead, the value of these assets tends to decline in a rising rate environment, as we saw in the second quarter.

Record Loan Growth Boosted Net Interest Income

The industry was able to raise net interest income by $1.7 billion in the second quarter on the strength of record loan growth.

Total loans and leases increased by $234.6 billion, or 4.2 percent (Chart 7).

Strong growth was registered in loans to both households and businesses:

- Home equity loans increased by $39.3 billion (10.4 percent);
- Other 1- to 4-family mortgage loans increased by $70.5 billion (4.2 percent);
- Real estate construction and development loans grew by $14.0 billion (4.9 percent);
- Commercial real estate loans increased by $18.4 billion (2.6 percent);
- C&I loans, which had declined in each of the previous 13 quarters, increased by $16.6 billion (1.8 percent).

We have been anticipating an eventual turnaround in C&I loan growth at some point this year (Chart 8).

We reported earlier this week in the FDIC Outlook that the fundamentals behind commercial loan demand – that is, business-sector inventory building, investment spending, and merger activity – are all headed upward.

Today's data confirm that a turnaround in commercial lending is indeed taking place. Expansion in bank C&I lending is now a matter of fact.

Annual data reported as of June 30 also showed that commercial loans to small businesses increased by $9 billion from a year ago (Chart 9).

Small business loans had shrunk by $3 billion during the previous year.

Signs point to a heightened degree of competition among FDIC-insured institutions to make commercial loans.

This is consistent with both the early stage of the current business cycle and the improvements we've seen in commercial credit quality.

Mortgage lending has cooled off considerably since the middle of last year – particularly for refinancing.

But moderation in long-term interest rates has kept origination volumes higher than we might have expected going into this year.

Home Equity Lending Has Accelerated
I would like to draw your attention to the rapid increase we're seeing in home equity lending.

This chart shows that U.S. homeowners liquidated over $300 billion in owner's equity last year through cash-out refinancing and home equity borrowing (Chart 10).

While cash-out refinancing appears to be down by more than half from last year, home equity borrowing continues to grow rapidly.

Home equity loans held by FDIC-insured institutions increased at an annualized rate of over 40 percent in the second quarter (Chart 11).

Clearly, banks and thrifts are aggressively growing this area of their portfolios.

They are doing so at a time when interest rates are rising, debt service ratios are at all-time highs, and home values in many areas have been rising faster than incomes and inflation.

Home equity loan performance for FDIC-insured institutions remains very good at present.

But this elevated rate of growth, combined with the introduction of new and more liberal loan structures, suggest that some homeowners and some lenders may be assuming higher levels of risk.

Industry analysts are studying these trends, and so are the analysts here at the FDIC. We expect to publish some of our preliminary findings on this topic before the end of the year.

Also of Note
There were 30 new charters added during the quarter, while 62 institutions were absorbed by mergers and one insured institution failed.

The number of institutions on the FDIC's "Problem List" fell from 114 to 102 during the quarter, while the assets of "problem" institutions declined by $4 billion.

The Bank Insurance Fund (BIF) ended the quarter with a reserve ratio of 1.31 percent, down from 1.32 percent at the end of March.

The reserve ratio of the Savings Association Insurance Fund (SAIF) also fell slightly, from 1.36 percent to 1.34 percent.

Outlook for Remainder of 2004

Economic fundamentals remain positive for the industry. Rising oil prices are slowing economic growth at the margin, but this may mean that interest rates will rise more slowly than originally expected.

In terms of the earnings outlook for the industry, it is unclear how much more overall loan performance can improve before leveling off.

Declining provision expenses played a major role in the industry's recent string of earnings records, but this positive factor will at some point diminish in importance (Chart 12).

Commercial lending is set to assume a greater role in overall loan growth going forward, while mortgage and home equity loans would figure to play a smaller role.

Rising rates will continue to have a mixed effect on the bottom line.

In a rising rate environment, it remains especially important that institutions recognize and address any interest-rate exposures that are created by concentrations in long-term mortgage-related assets funded by wholesale liabilities.