FDIC Quarterly Banking Profile Press Briefing
Fourth Quarter 2003 Results for FDIC-Insured Institutions
Thursday, February 26, 2004

Overview

FDIC-insured institutions wrapped up the most profitable year in their history in the fourth quarter of 2003.

Net income totaled $120.6 billion for the year, making it the third straight year of record earnings for the industry.

Net income was $31.1 billion in the fourth quarter, making it the fourth straight quarter of record earnings.

Setting a new quarterly earnings record in the fourth quarter of the year is somewhat unusual, as seasonal factors tend to push earnings lower in the fourth quarter.

The last time we saw net income peak during the fourth quarter of the year was in 1997.

Earnings Breakdown: 2003 in Review

Because seasonal factors are so important in the fourth quarter financials, it may be more instructive to summarize 2003 results as a whole.

Pre-tax net income increased by $22.4 billion, or 14.3 percent during the year.

Of this increase, some $14.2 billion - or almost two-thirds - was attributable to a decline in loan loss provisions.

Most of this decline in loss provisions reflects improvement in the commercial loan portfolios of large banks, where huge losses had been recorded on corporate loans during and just after the 2001 recession.

Improvement in corporate credit quality during the year could also be seen in the number of publicly-traded U.S. companies that filed for bankruptcy. During 2003, the number of bankrupt companies fell by 25 percent and their total assets fell by 75 percent.

Net interest income made a much more modest contribution to 2003 earnings growth compared to the previous year.

While we saw net interest income soar by $25.3 billion in 2002, it rose by only $5.3 billion in 2003.

Why the leveling off in net interest income?

Basically because it proved very difficult for banks to improve on the strong asset

growth and high yield spreads they enjoyed in 2002.

The industry net interest margin fell by 23 basis points in 2003 to 3.73 percent. This marked the lowest annual industry NIM since 1990.

Institutions have found it very difficult to pass along historically low short-term interest rates to depositors, for fear of losing market share.

This is especially significant for community banks, which rely heavily on net interest income.

Noninterest income-that is, income related to fees, service charges and gains on certain transactions-grew by $18.9 billion during 2003 compared to the previous year.

The biggest contributors to this increase were servicing fees (up $5.5 billion), loan sales (up $5.6 billion), securitization income (up $2.3 billion) and investment banking revenue (up $1.1 billion).

These activities reflect earnings related to consumer and mortgage banking, as well as capital markets activities that supported record volumes of bond issuance by U.S. companies during the year.

Earnings Headwinds Revisited

Amid the consistently strong earnings performance of recent quarters, we have been on the lookout for earnings headwinds that could eventually break the string of quarterly net income records.

Most of these headwinds relate to rising interest rates.

Long-term interest rates rose abruptly in June and July of last year. Since then they have eased, though not to the 45-year lows they had reached in mid-June.

One effect of last summer's increase in long-term rates was a dropoff in gains on the sale of securities in the second half of the year.

While securities gains rose by 133 percent in the first half of 2003 from a year ago, total gains for the year fell by 5.4 percent compared to a year ago.

Another result of higher long-term interest rates in the second half of the year was a dramatic falloff in mortgage refinancing activity.

The refinancing index of the Mortgage Bankers Association of America was 71 percent lower in the fourth quarter of last year compared to its record second-quarter level.

By contrast, the index of mortgage applications for home purchases actually rose by 1 percent over this interval.

Lending Activity

Mortgage and consumer lending were the leading sources of loan growth for the industry during 2003, while commercial lending continued to shrink.

In the first half of the year, mortgage lending led the industry, with residential loans making up 72 percent of growth in total loans and mortgage-related assets making up 52 percent of growth in total assets.

In the second half of the year, we saw a shift toward consumer lending, with credit card loans, consumer loans, and related securities making up 61 percent of total asset growth.

We continue to look for a handoff from growth led by households to growth led by business spending.

In the economy, we see signs that this is starting to take place. Sharp increases in business investment in both equipment and inventories are now evident.

Corporate mergers so far this year are about twice the level of a year ago.

Ordinarily, these would be bullish signals for commercial loan growth at FDIC-insured institutions.

But commercial and industrial - or C&I - loans held by FDIC-insured institutions fell by $9.2 billion in the fourth quarter of the year, marking the 12th consecutive quarter of decline.

For the year, C&I loans fell by $31 billion, or 3.3 percent.

The continued unusually-low interest rate environment appears to be playing an important role in this trend.
Highly-rated companies are similar to households in that they have been eager to lock up long-term financing at historically low fixed rates.

In the first nine months of the year, the total indebtedness of nonfinancial businesses rose by $226 billion. Most of that increase took the form of corporate bonds.

While we continue to anticipate a rebound in commercial lending by FDIC-insured institutions, the relative attractiveness of bond issuance at the moment may make the turnaround slower than we might have otherwise expected.

Credit Quality

Credit quality trends remain highly positive.

The big issue of recent years has been in commercial loans to large corporate

borrowers.

But, as we have discussed, it was a rebound in loan performance in those very portfolios that was the driving force behind the industry's record earnings during the year.

Credit card losses fell a little during the year, but remained higher than in any year prior to 2002.

We continue to observe a close connection between credit card chargeoffs and personal bankruptcy filings, which hit a new record high of 1.6 million during 2003.

But an improving economy is not likely to move either series significantly downward, as both are related in part to a greater availability of unsecured credit.

Loan performance trends remain very favorable at present in portfolios of one- to four-family mortgages, home equity lines of credit, and commercial real estate and construction loans.

We do have some generalized concerns about high loan concentrations, weak market fundamentals, and interest-sensitive borrowers among some of these loan types; however, any significant problems associated with those factors remain well out on the horizon.

Industry Structure and FDIC Insurance Funds

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

The number of bank mergers last year fell again to 275, well below the volumes recorded in the mid-1990s.
Whether the spate of recent large-bank transactions will spark a wider resurgence in merger activity remains to be seen.

Of interest in this regard was a further widening of the gap in the efficiency ratios of large banks and small banks during the year.

The long-term downward shift in the non-interest expenses of large banks appears to be a factor that could continue to drive consolidation in the industry.

At the same time, we saw an increase in new charters last year to 119.

This, too, is significant in that it reflects the continuing importance of community banking in an economy where as many as three quarters of all net new jobs are generated by small businesses.

The deposit insurance funds remained stable during the fourth quarter.

During the quarter, the BIF reserve ratio remained at 1.32 percent of insured deposits, while the SAIF reserve ratio dipped three basis points to 1.37 percent.

Outlook

This is shaping up to be a promising year for the U.S. economy and for FDIC-insured institutions.

Analysts are forecasting economic growth of 4.5 percent or better, but it is not at all clear at this point that a significant rise in interest rates is imminent.

Once interest rates do rise, the effect on banks and thrifts will depend on the type and severity of the increase. Many of the effects on securities gains and refinancing activity have already been felt.

Continued expansion by the business sector in terms of investment spending and job creation will be an essential element in solidifying the expansion and moving it away from such a heavy reliance on consumer spending and homebuilding.

Banks, too, would stand to benefit from more robust business spending because it should eventually lead to greater demand for commercial loans.

The current financial strength of FDIC-insured institutions is an important element in the overall economic picture.

FDIC-insured institutions, both large and small, are generally in a good position to make loans to both businesses and households.

And with that we will be glad to take your questions.