Strong Bank Earnings Reflect Nature of U.S. Downturn

August 29, 2002

Second quarter 2002 earnings results for commercial banks show that the benefits of a steep yield curve continue to outweigh the costs of higher credit losses. Despite the lingering effects of the recession that began in March 2001, banks earned a record $23.4 billion in the second quarter. The industry return on assets (ROA) was 1.41 percent--tying the previous record posted in the third quarter of 1999. Complete second quarter financial results are available in the Preliminary Bank Earnings Report published today.

The fact that the banking industry could post such strong results on the heels of the recession underscores the fact that the industry remains one of the bright spots in the U.S. economic outlook. Unlike the last recession, when credit losses depressed bank earnings and contributed to hundreds of failed or undercapitalized institutions, the banking industry is currently in a position to serve as more of a shock absorber for U.S. economic activity. The overwhelming majority of FDIC-insured institutions display the kind of balance sheet and earnings strength that will allow them to support the economic recovery by lending to creditworthy businesses and consumers.

The bad news in today's earnings report is that credit losses increased again in the second quarter. Banks charged off $10.5 billion in bad loans during the quarter--a 33 percent increase from a year ago. Most of the damage was done in commercial and industrial loans (especially to non-U.S. borrowers), credit card loans, and other consumer loans. Rising credit losses in the commercial sector came as no surprise, considering the high number of prominent corporate bankruptcies that occurred in the second quarter. The rise in losses on credit cards and other consumer loans pose more of a concern given heavy consumer debt loads and the so-far tentative nature of the apparent economic recovery.

But the key point is this: the recession brought with it an interest-rate environment that has helped banks more than offset these credit losses and post record earnings. The average monthly yield curve spread during the second quarter, as measured by the difference between the yields on 10-year and 6-month Treasury instruments, was 3.38 percent--a level that has been surpassed during only eight quarters since 1960 and none since 1992. The steep yield curve helped banks boost net interest income by $12.8 billion during the quarter compared to a year ago. The average margin was 4.13 percent, compared to 3.86 percent a year ago.

Low interest rates have also stimulated home sales and home refinancing activity. Residential mortgage loans grew by $30.5 billion during the quarter, while home equity lines grew by $21.8 billion and holdings of mortgage-backed securities rose by $45.2 billion. These sources of growth in lending activity more than offset another decline in commercial and industrial loans--the sixth quarterly decline in a row. Again, the mix of loan growth in the second quarter comes as no surprise; banks responded to strong demand by home buyers and home owners as well as to relatively weak demand for loans by the corporate sector.

Banks continued to pursue lending opportunities in the second quarter on the strength of solid growth in savings deposits (up $50.9 billion), short-term nondeposit borrowings (up $37.4 billion), and Federal Home Loan Bank advances (up $13.8 billion). Strong loan growth and strong funding growth are evidence that the banking industry remains a reliable conduit for financial intermediation despite the turmoil that has occurred in the financial markets.

As the U.S. economy moves toward recovery, conditions will likely change for the banking industry. Credit

losses will at some point level off and begin to decline. Some signs of this appeared in the second quarter as total nonperforming loans increased by only $1.3 billion (or 2.3 percent), the smallest increase in over two years. Noncurrent loans to domestic C&I borrowers declined for the first time since the second quarter of 1998. Further improvements in these figures can be envisioned as economic conditions improve. Demand for commercial loans will also likely increase as the economy recovers. However, an improving economy is also likely to bring with it higher short-term interest rates and a narrowing of the yield curve spread. In this event, net interest margins are likely to decline from their currently high levels.

But a further offset to lower margins will continue to be the income banks are booking from non-interest sources. Non-interest revenues in the first half of 2002 were $5.2 billion higher than during the first half of 2001. Even as one would expect offsetting fluctuations in credit losses and interest margins over the business cycle, fee income and loan growth should continue to represent long-term sources of income growth for the industry.

For the complete Preliminary Bank Earnings Report (published August 29, 2002), go to:
http://www.fdic.gov/news/news/press/2002/pr9202a.html

Chart 1

Banking Industry Earnings Continue to Exhibit Strength

Dollars in Billions

Year	Quarter	Net Operating Income	Securities and Other Gains/Losses, Net
1998	1	14.85	1.06
1998	2	15.72	0.37
1998	3	14.67	0.39
1998	4	14.04	0.72
1999	1	17.61	0.35
1999	2	16.86	0.05
1999	3	19.53	-0.15
1999	4	17.70	0.02
2000	1	19.96	-0.46
2000	2	15.50	-0.86
2000	3	20.02	-0.72
2000	4	17.16	0.46
2001	1	19.31	0.50
2001	2	18.55	0.55
2001	3	16.67	0.70
2001	4	17.60	0.87
2002	1	21.38	0.35
2002	2	22.61	0.83

Source: FDIC, Preliminary Bank Earnings Report, Second Quarter 2002

Chart 2

The Banking Industry Continues to Increase Its Protection Against Losses

As Percent of Banking Industry Assets

Year	Equity Capital	Reserves	Income
1984	6.14	0.74	0.30
1985	6.19	0.85	0.31
1986	6.19	0.98	0.31
1987	6.02	1.66	0.36
1988	6.28	1.48	0.42
1989	6.21	1.62	0.43
1990	6.45	1.63	0.41
1991	6.75	1.60	0.42
1992	7.51	1.54	0.40
1993	8.00	1.42	0.59
1994	7.78	1.30	0.70
1995	8.11	1.22	0.72
1996	8.20	1.17	0.85
1997	8.33	1.09	0.85
1998	8.49	1.05	0.75
1999	8.36	1.02	0.91
2000	8.50	1.02	0.86
2001	9.09	1.10	0.82
2002	9.25	1.10	1.00

Source: FDIC