

Economic Conditions and Emerging Risks in Banking

The Economy Is Strong and Interest Rates Are Poised to Rise

U.S. Economy Set to Post a Strong Year

- The economy grew at a 6 percent annual rate during the last half of 2003 and is expected to grow at a still-sturdy 4 percent pace this year.
- Continued growth in corporate investment, increased inventory building, and renewed hiring are all expected to support this growth pace.

Interest Rates Are Poised to Rise

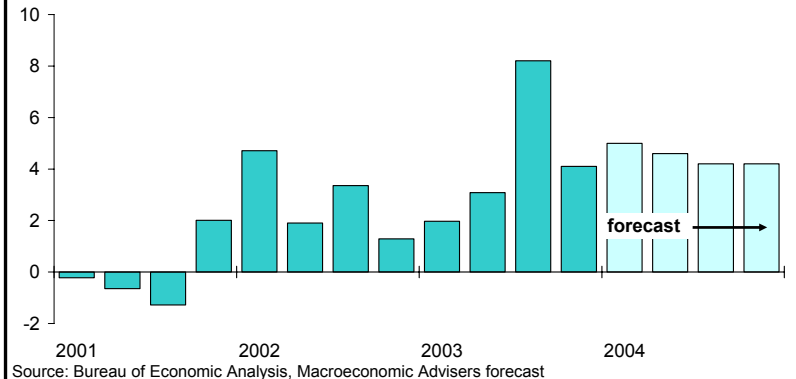
- In nominal and inflation-adjusted (real) terms interest rates are at their lowest levels in decades.
- Historically low interest rates and strong economic growth are creating expectations that interest rates will rise.
- Analysts are divided as to when the Fed will raise interest rates but most predict an increase by year end.
- Longer term, the large federal budget deficit could place additional upward pressure on interest rates.

Labor Market Conditions May Be Turning

- After a three year hiatus, job growth appears to be turning upward, as the economy added 171,000 jobs per month on average during the first quarter of 2004.
- If this trend holds, firms may start to add more full-time staff.
- Temporary employment played a major role in job growth during the past year, in part because these workers typically are not covered by costly benefit plans.
- Despite stronger job growth, the average time displaced workers spend getting re-employed remains elevated at over five months.

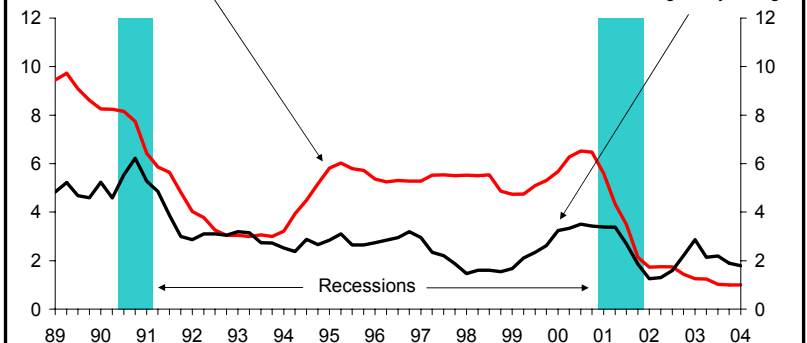
The U.S. economy is expected to grow at about a four percent pace this year.

Real Gross Domestic Product (GDP)
Quarterly percent change at annual rate



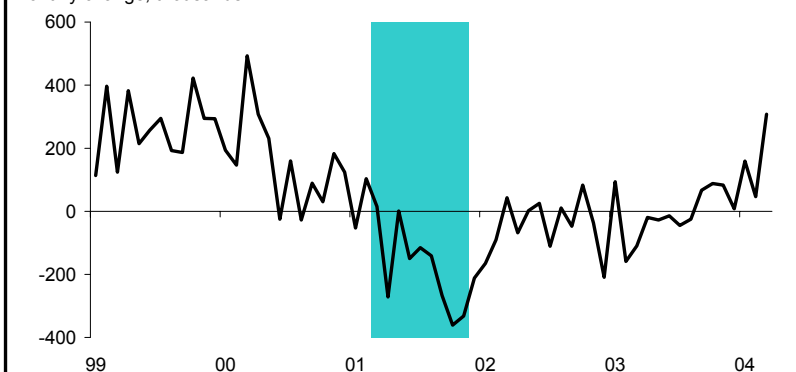
With short-term interest rates at a 45-year low, a rate hike is inevitable, if not imminent.

Effective Federal Funds Rate
Percent



Job growth finally appears to be strengthening, more than two years after the recession's end.

Nonfarm Payrolls
Monthly change, thousands



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Sturdy Job Growth Should Persist in 2004

Improved Hiring at Smaller Firms May Boost Payrolls in 2004

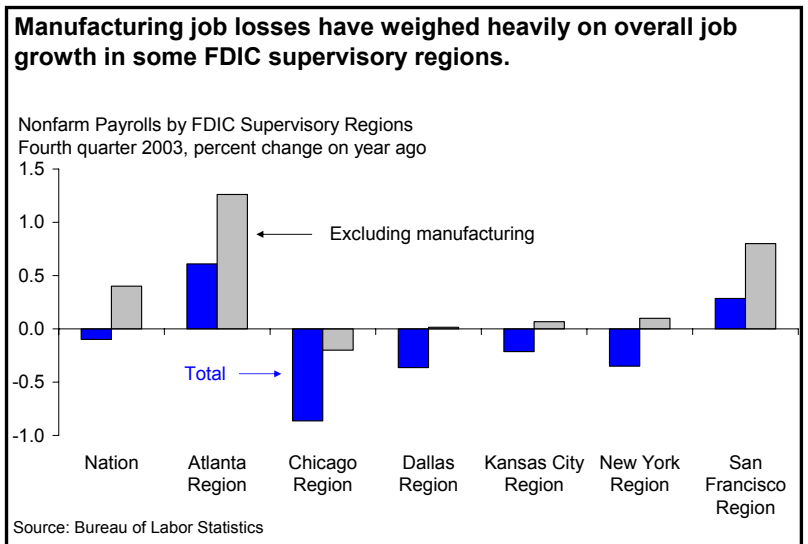
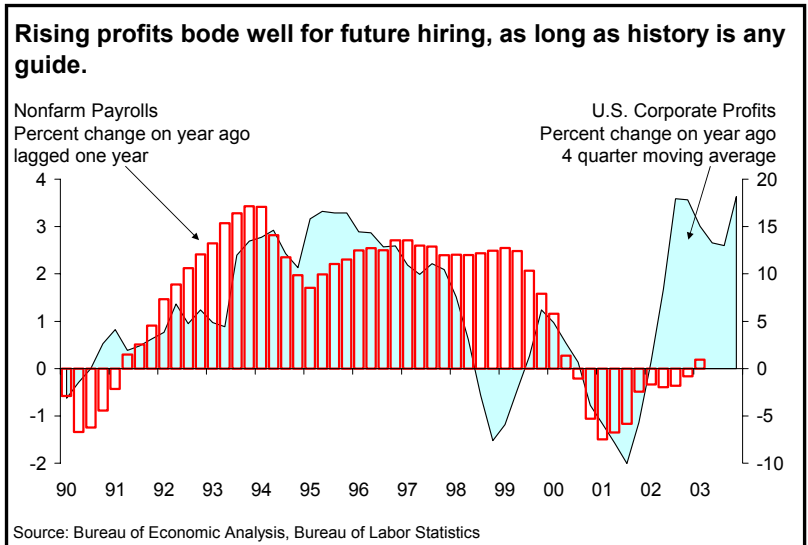
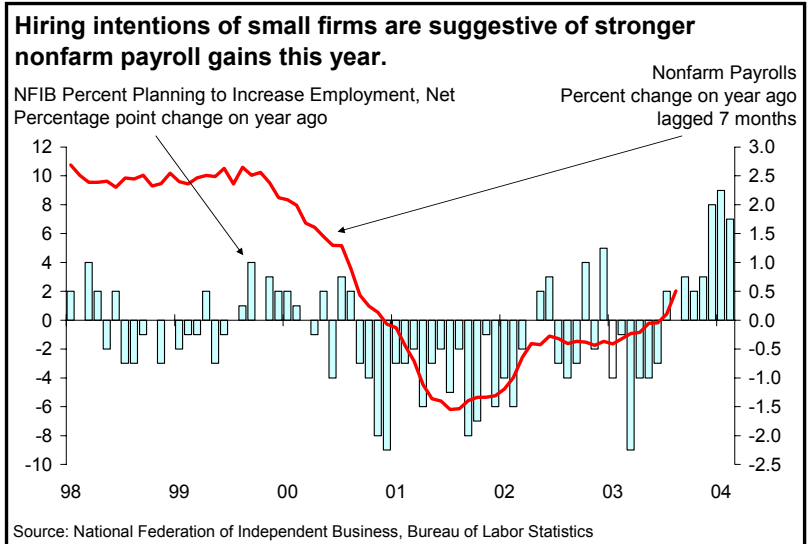
- During 2001, roughly 50 percent of all U.S. private sector workers were employed at businesses with fewer than 500 employees—over half of those at firms with less than 100 workers—according to the Small Business Administration.
- Recent surveys by the National Federation of Independent Business indicate that smaller firms may accelerate their hiring pace this year.
- Historically, improvements in the net hiring survey from NFIB have been followed by increased job growth within seven months.
- Given small firms account for three-fourths of new job creation and also account for much of the annual revisions to job growth, these firms already may be contributing significant job gains to the overall economy.

Stronger Corporate Profits Should Support Job Growth

- U.S. corporate operating profits rose by 17 to 18 percent in both 2002 and 2003.
- Usually, a turnaround in profit growth of this magnitude has led to stronger job growth after about a year—implying sturdy jobs gains are in store for 2004.

A Stable Factory Sector Should Allow for Stronger Overall Job Growth

- The factory sector has struggled more than other parts of the economy to return to health.
- An ongoing resurgence in factory orders and shipments should help to stabilize factory employment.
- A simple cessation in factory job losses would go a long way to restoring healthy job gains across the FDIC's supervisory regions.



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Dollar Collapse Could Mean Higher Interest Rates, but Risk Is Low

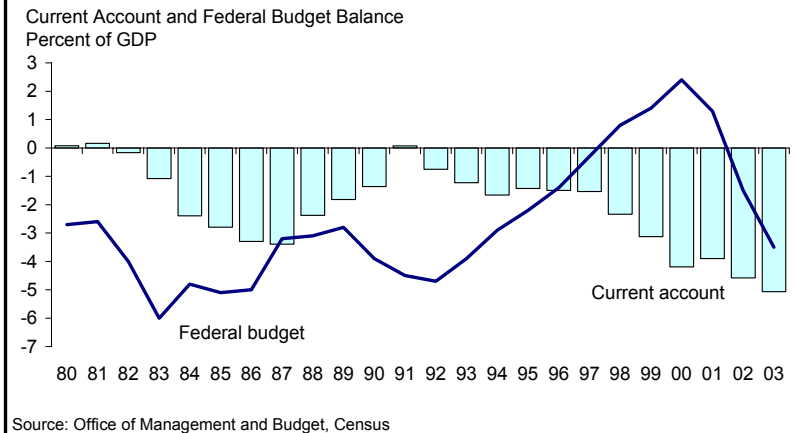
The Risk of a Dollar Collapse Remains Low

- A substantial increase in both the US federal budget and current account deficits, along with a 30 percent decline in the dollar versus the euro since 2001, have raised concerns that the dollar could, at some point, decline precipitously.
- Despite the dollar's recent weakness, foreign investment inflows remain positive.
- While a dollar collapse seems unlikely, such a scenario could lead to a significant rise in interest rates without an accompanying acceleration in economic growth.
- Rising rates absent a stronger economy could limit growth in higher-yielding loans, strain commercial real estate through higher debt service and lower rents, and increase losses on variable rate loans, especially for subprime consumer borrowers.

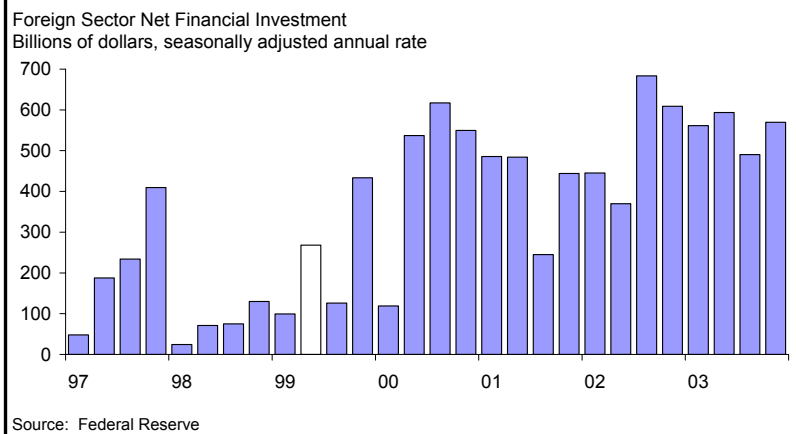
Asia's Trade Relationship with the U.S. May Mitigate the Risk of a Dollar Collapse

- A dollar collapse could hurt Asian economies more severely than it might our own, given these countries continue to run large trade surpluses with the United States.
- This, coupled with policies aimed at boosting exports through currency intervention, leaves Asian nations with large dollar holdings that are ultimately recycled back to the US.
- By purchasing US treasury and agency debt, Asian nations help to keep US interest rates low, thereby stimulating US borrowing and consumption—which lifts US demand for Asian exports.
- Asian holdings of U.S. treasury debt have surged in recent years, jumping by about 60 percent in the past two years.
- The latest official data also indicate that as of mid-year 2002, Japan and China were the single largest foreign holders of U.S. Agency debt, at 18 and 12 percent, respectively.

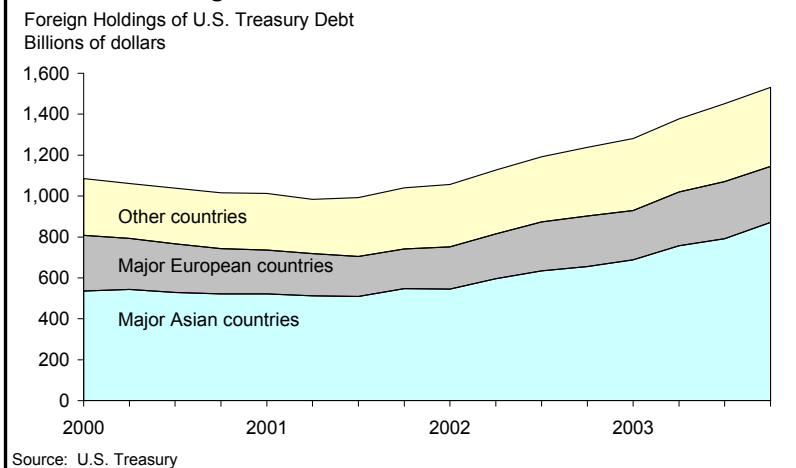
The record current account deficit and an accelerating budget deficit are weighing on the U.S. dollar's foreign exchange rate.



Despite a decline in the value of the dollar, net capital flows from abroad have remained positive, even accelerating in late 2003.



Asian countries have increased their share of U.S. Treasury securities holdings relative to the rest of the world.



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Banking Industry Performance Remains Positive

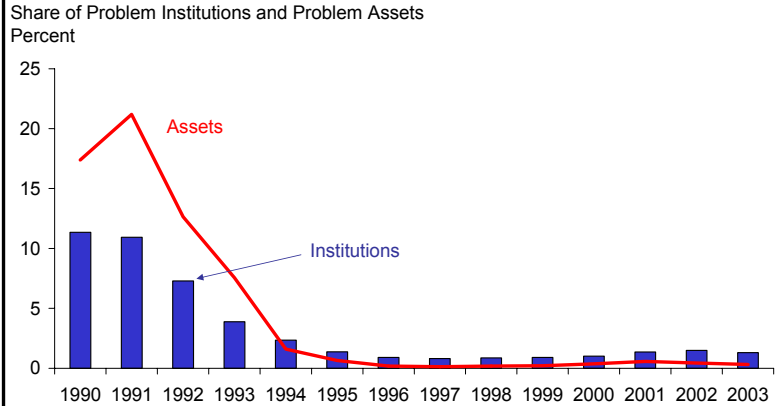
Most Metrics of Bank Performance Are at or Near Records for High Quality

- The percentage of institutions with CAMELS ratings of 4 or 5 decreased in 2003, and remains historically low.
- The number of unprofitable institutions also has remained low in this cycle at less than 6 percent of the total. Capital ratios remain at record levels.
- FDIC-insured institutions earned record profits in all four quarters of 2003.
- Reduced provisions, securities gains, and increased efficiency overcame margin compression to raise the industry return on assets (ROA) by eight basis points year-over-year to 1.38 percent.

Improving Credit Quality Is Temporarily Boosting Earnings

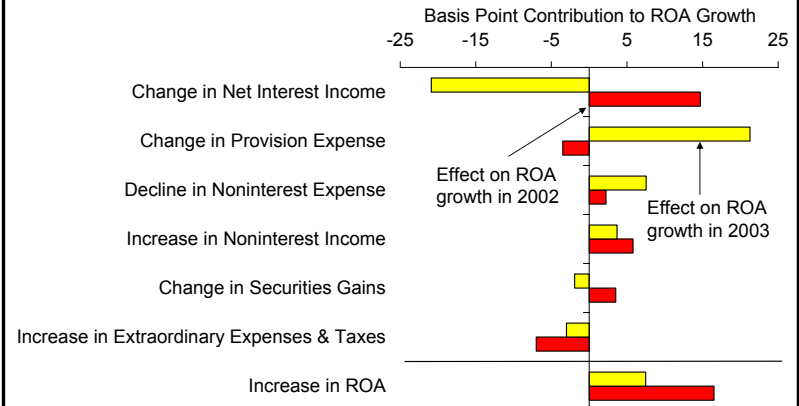
- ROA growth has slowed, and the primary source of growth has changed from improved net interest margin in 2002 to lower provision expenses in 2003.
- Industry asset quality improved during the year, driven by dramatically improving commercial and industrial (C&I) loan quality at large banks.
- Continued reductions in provision expenses may be difficult to realize going forward given declining reserve ratios and sustained loan growth.
- For the first time in more than a decade, net charge-offs exceeded additions to loan reserves in 2003.
- Loan growth in higher-risk loan categories, such as commercial real estate (CRE) and C&I, is likely to continue at its 2003 pace or higher as residential mortgage lending slows and business lending activity rises.

The number and assets of problem institutions remains low.



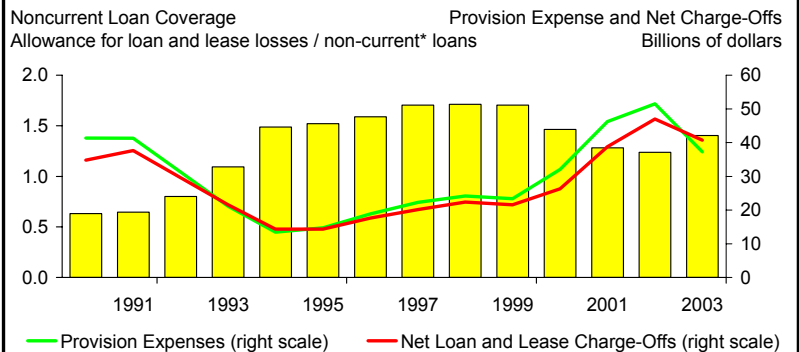
Source: FDIC
Problem institutions: CAMELS rated 4 or 5.

The primary source of earnings growth changed from improved net interest income in 2002 to reduced provisions in 2003.



Source: FDIC

Coverage of noncurrent loans has improved, but charge-offs exceeded provisions in 2003.



* Noncurrent loans include nonaccrual loans and loans 90 days or more past due and still accruing interest.
Source: FDIC

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Strong Earnings Despite Low Net Interest Margins (NIMs)

Historically Narrow Net Interest Margins (NIMs) Are an Industry Weak Spot

- Despite strong growth in earning assets and a persistently steep yield curve, the annual industry net interest margin (NIM) ended 2003 at a 12-year low.
- Although over half of insured institutions reported improved fourth-quarter NIMs, due to improving funding costs and asset yields, only one in three institutions reported an improved annual NIM.
- As short-term interest rates rise, active portfolio hedging by large mortgage holders may exacerbate interest rate volatility.

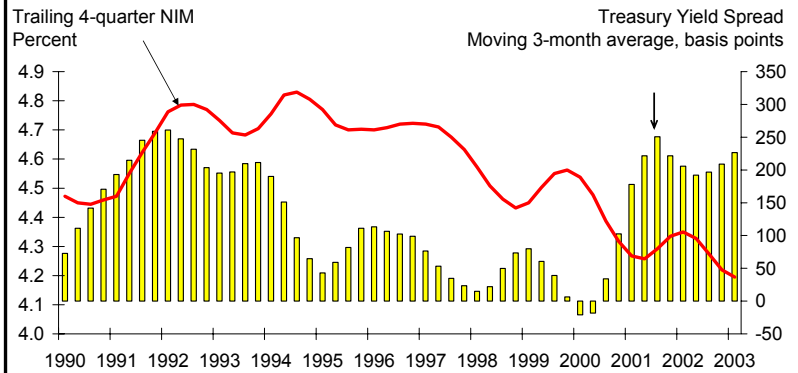
Fees Offer Some Flexibility to Banks Forced to Raise Deposit Rates

- The steep yield curve has not benefited NIMs as much as in previous rate cycles because funding costs have reached an effective floor.
- Deposit fees can partially offset relatively higher funding costs. Larger institutions have been better than their smaller peers at raising fees earned on deposits.

Mortgage-Related Interest Rate Risk Will Continue to Challenge NIMs

- For the full year, mortgage-related assets accounted for over 40 percent of the increase in total industry assets.
- Rising rates will extend the average maturity and depress the value of mortgage-related assets, compressing NIMs, if held, and causing losses, if sold.
- Holders of mortgage-related assets will seek growth in higher-yielding loans to support NIMs as interest rates rise. Community banks, however, are already concentrated in CRE lending.

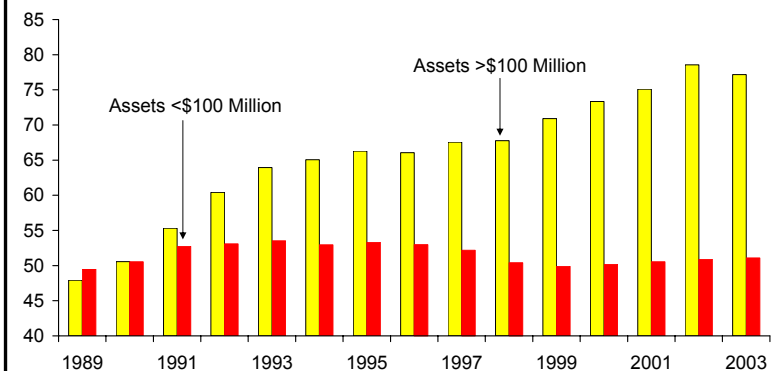
Net interest margins (NIMs) remain historically low despite a persistently steep yield curve.



Source: FDIC and Federal Reserve Board. Median NIMs for banks with assets less than \$10 billion excluding specialty banks. Spread is the difference between 10 year and 3 month Treasury rates.

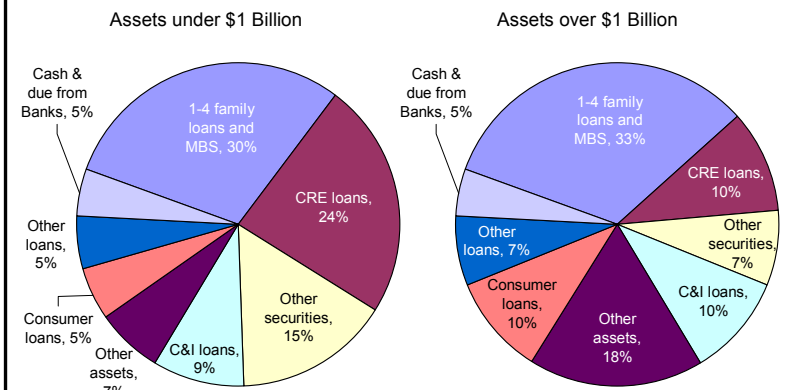
Larger banks have boosted deposit fees to help offset higher deposit rates.

Service Charges on Deposits to Average Deposits, by Institution Asset Size
Basis points



Source: FDIC

About a third of large and small bank assets are mortgage related; but large-bank balance sheets are better diversified.



Source: FDIC

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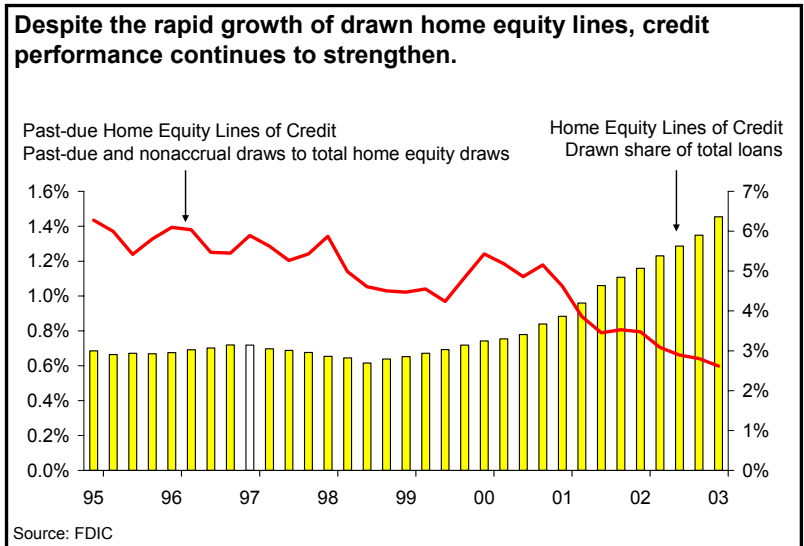
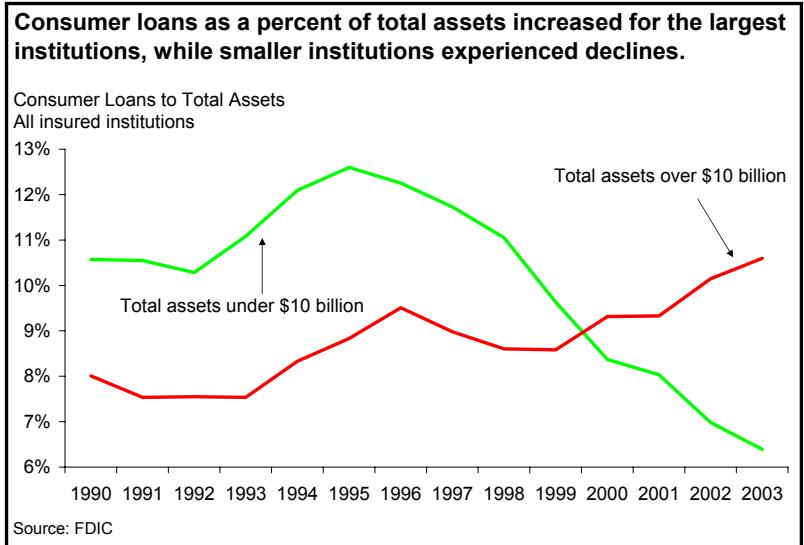
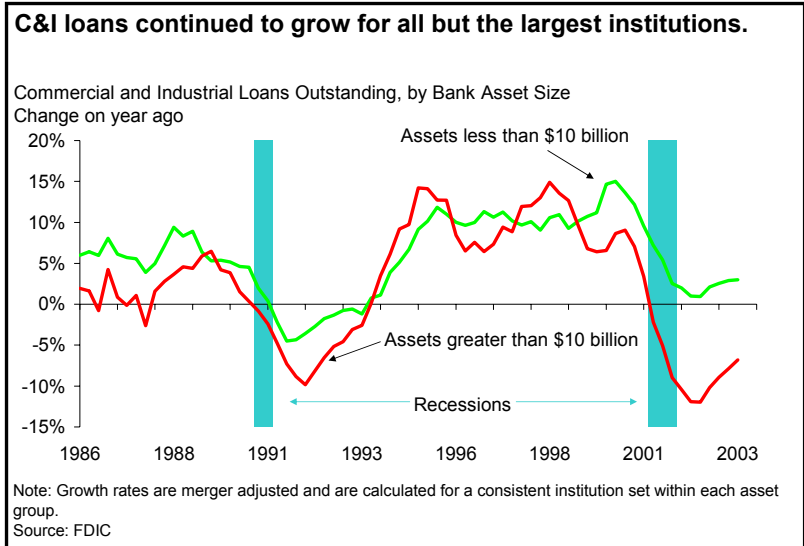
Weak C&I Activity Has Increased Consumer Exposure at Large Banks

C&I Loan Growth Has Been Weakest at Largest Institutions

- C&I loans have declined by over 15 percent, or almost \$164 billion, in the last 12 quarters, but the decline was limited to only the largest institutions.
- Large corporate borrowers have either delayed bank borrowing, due to strong internal cash positions, or found more favorable terms in capital markets.
- Demand for large C&I loans may increase as the availability of alternate funding sources diminishes and bank loans become more cost effective.
- Although growth slowed significantly through this last business cycle, institutions with less than \$10 billion in assets have seen more than a decade of uninterrupted C&I loan growth.

Household Credit Quality Increasingly a Concern

- Lack of C&I loan demand from large business clients has motivated the largest lenders to target the increasingly-indebted consumer.
- Sources of concern about households include rising household indebtedness (a record 112 percent of disposable personal income in late 2003) and the near record pace of personal bankruptcies, which exceeded 1.5 million in 2003.
- Insured institutions report improvement in consumer credit quality at the median, but the net charge-off rate for smaller consumer lending specialists has become more volatile recently.
- The prospect for rising interest rates could increase losses on variable rate consumer loans, such as home equity lines and credit cards, especially for subprime borrowers.



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Mortgage Credit Risk May Be Aggravated by Rising Interest Rates

Mortgage Foreclosures Already Have Reached an All Time High

- Nationally, the mortgage foreclosure rate reached 1.3 percent in fourth quarter 2003 (the highest since the start of data in 1979).
- Many states report significant increases in foreclosure rates. Areas most affected have been those with high concentrations in manufacturing, slow economic growth, and slower rates of home price appreciation.

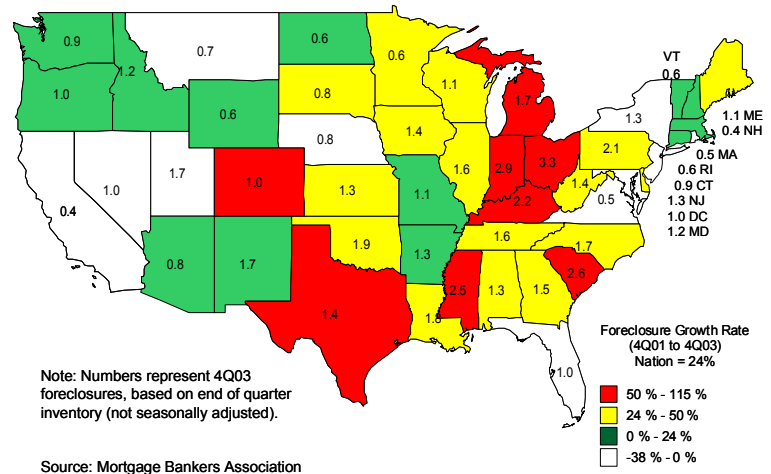
When Interest Rates Rise, Increased Use of ARMs May Mean Increased Credit Troubles

- Loss rates on mortgages over time have been very low, averaging less than 0.5%.
- Despite historically low fixed mortgage rates, more borrowers have been taking out adjustable-rate debt on their homes.
- Data from LoanPerformance indicate that over half of subprime mortgages are adjustable rate product—two to three times the level for conventional borrowers.
- These factors suggest a higher level of mortgage credit risk when interest rates rise.

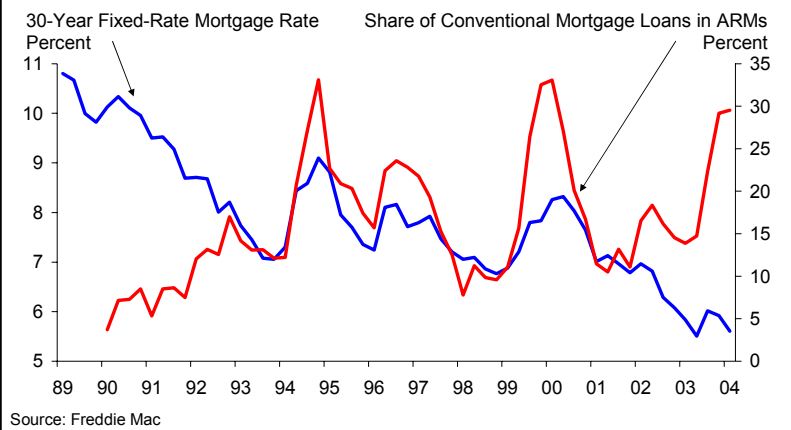
Home Prices in Certain Markets May Be More Likely to Respond Negatively to Rising Interest Rates

- During the past four years, U.S. home price appreciation has been about 50 percent faster than the rate of growth in disposable incomes.
- This has raised concerns over the potential for a bubble in U.S. home prices and price declines if interest rates rise.
- However, while systemic factors such as interest rates can affect overall home price trends, local supply and demand factors play a greater role in driving home prices.
- Home prices in historically volatile markets may be more at risk from rising interest rates.

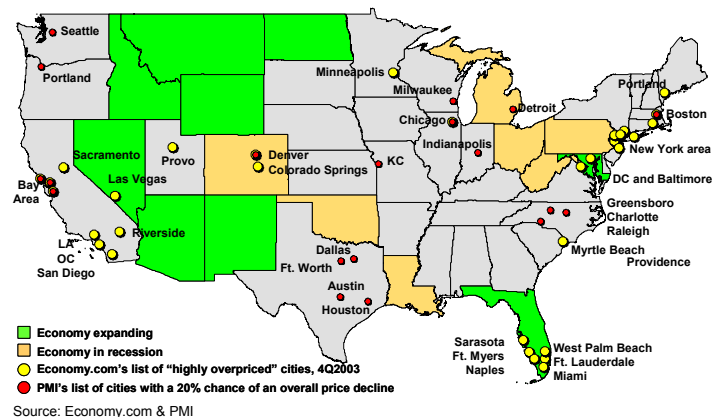
The foreclosure rate is escalating rapidly in the Midwest, Southwest, and Southeast.



Adjustable rate mortgage debt has represented a rising share of loans.



Home prices in some markets may be more vulnerable to negative economic shocks, such as a sharp rise in interest rates.



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Rising Commercial Real Estate Exposure Is an Area to Watch

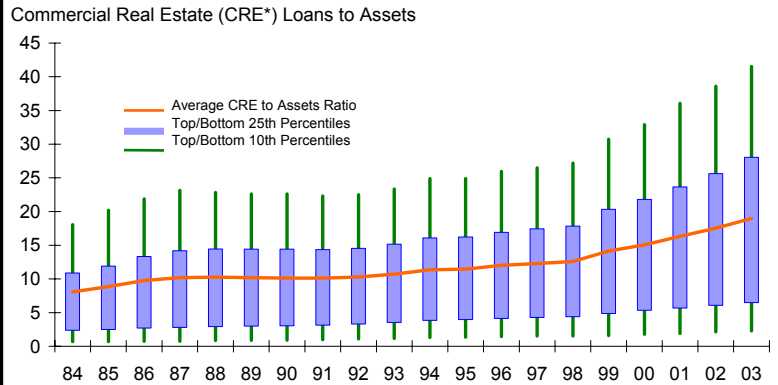
Bank CRE Portfolios Are Performing Well, Despite Poor Fundamentals

- National vacancy rates for office, retail, and warehouse stand at or near historic highs of 17.9 percent, 12.9 percent, and 10.5 percent, respectively, and are even higher in some markets.
- Improving absorption rates bode well for future vacancy rates; but higher rents are not expected soon given significant amounts of under-utilized space.
- Despite weak fundamentals, the median CRE concentration has increased to 164 percent of Tier 1 capital, up from 92 percent in 1993.
- The median concentration is particularly high in the FDIC's San Francisco and Atlanta Regions, at 327 percent and 284 percent of Tier 1 capital, respectively.
- CRE portfolios show strong performance with average charge-off rates below 0.1 percent and a nonperforming ratio of 0.8 percent of total CRE loans.
- Bank CRE portfolios have been buffered by low interest rates. Improved underwriting and regulatory requirements, and increased public ownership and transparency of commercial real estate transactions also have benefited banks.
- Rising interest rates could strain commercial real estate through higher debt service.

CMBS Pools Faring Poorly Compared with Insured Institutions

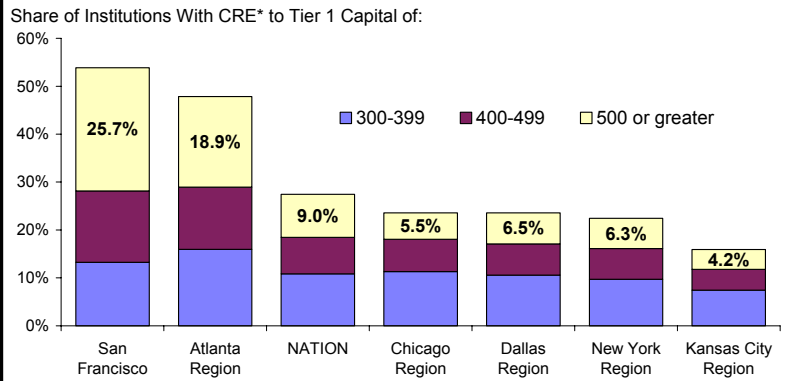
- CRE loans in CMBS pools are mostly fixed rate with severe prepayment penalties.
- As a result, these loans are exhibiting to a great extent the effects of declining CRE fundamentals, demonstrating how other CRE loans might have fared if not for lower interest rates.

Commercial real estate loan exposures among FDIC-insured institutions continues to rise.



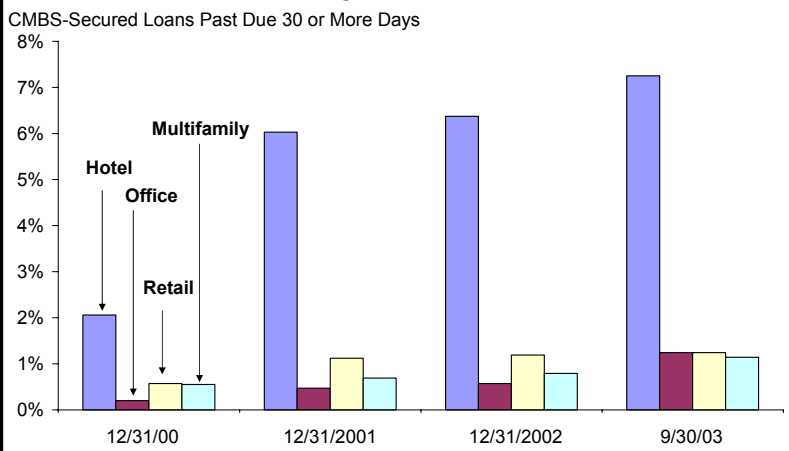
*CRE includes construction & development, multifamily, and nonresidential real estate loans. Source: FDIC, year-end data.

CRE exposure is elevated, particularly in the Atlanta and San Francisco Regions.



*CRE includes construction & development, multifamily, and nonresidential loans. Source: FDIC, data as of 4Q 2003.

Performance of all CMBS loans deteriorated in this cycle with hotel-secured loans suffering the most.



Source: FDIC and Standard & Poor's

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Other Risks We Are Monitoring and Industry Stress Test Results

Derivatives Exposures Highly Concentrated

- The top three commercial bank broker-dealers dominate U.S. bank derivatives activities, accounting for over 87 percent of commercial bank derivative notional amounts.
- Eroding confidence in any one of these broker-dealers could result in a rapid change in its risk profile, leading to market disruptions that challenge liquidity in derivatives markets.

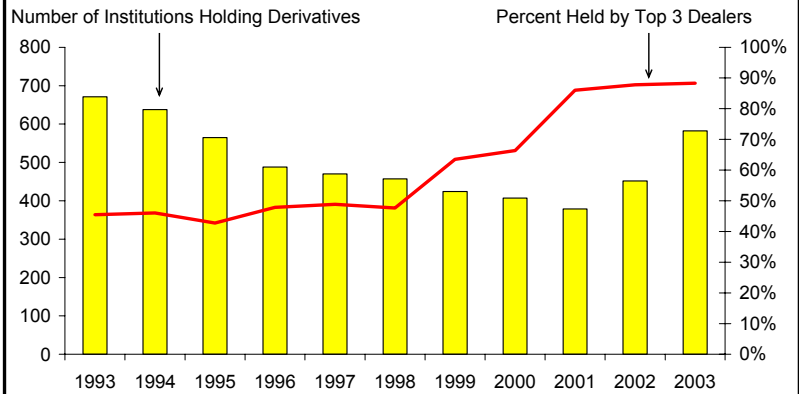
Persistent Severe Drought in Midwest Is Adversely Affecting Some Farmers

- A prolonged drought has reduced crop yields and even land values in a few western counties of Kansas and Nebraska – the first declines since the 1980's.
- The overall condition of farm banks in affected areas is strong, with some elevation in past due and classified loans.

The Banking Industry Is Well Poised to Absorb Problems

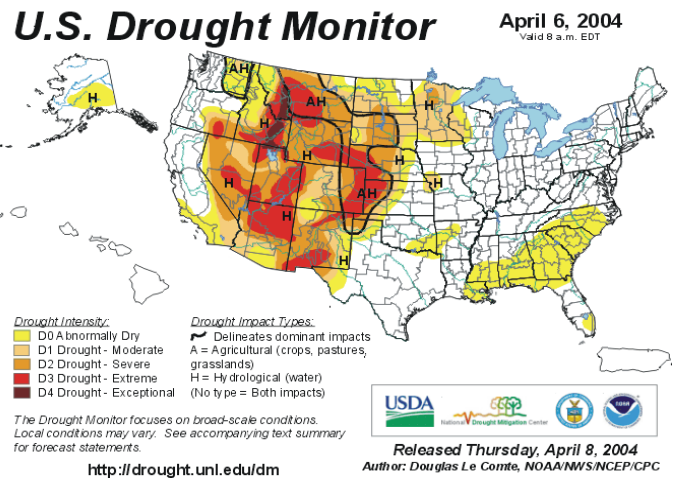
- Modeling the vulnerability of the industry to a severe 300 basis point rise in loan loss rates over two years shows that the industry is significantly better able to withstand higher loan losses than it was in 1991 because of higher earnings and stronger capital levels today.
- While a simulation cannot capture the effectiveness of bank management and policies or other idiosyncrasies associated with individual banks, it does highlight the remarkable and relative strength of bank balance sheets.

The concentration of derivatives activities at the top three dealers has risen to over 87 percent of total notionals.

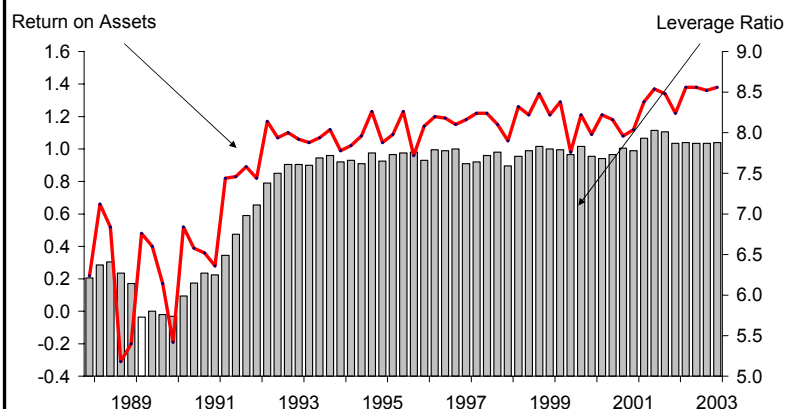


Source: FDIC

Agricultural and hydrological drought condition continue to affect the Great Plains and West, impacting crop yields and pasture conditions



Industry performance and capital levels are sharply improved since the last recession.



Source: FDIC