An Update on Emerging Issues in Banking

Favorable Interest-Rate Environment Drives Record First-Quarter Bank Earnings

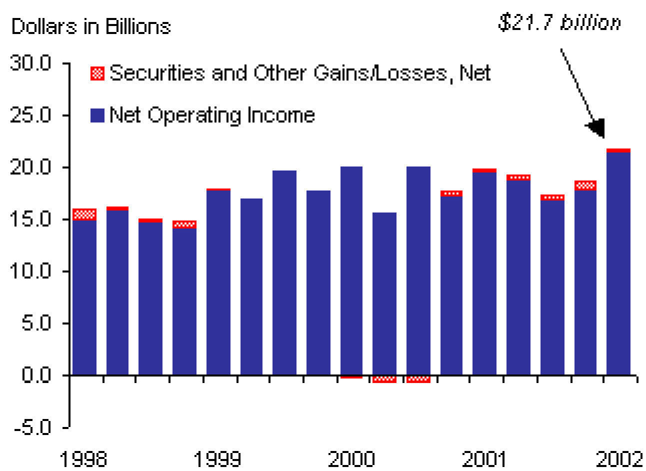
June 3, 2002

Summary

Commercial banks earned a record $21.7 billion in the first quarter of 2002, besting the previous quarterly earnings record set in the first quarter of 2001 by 9.6 percent (see Chart 1). The average return on assets was 1.33 percent, the third-highest ever for the industry.

Chart 1

Bank Net Income Sets a New Record in First Quarter



Source: FDIC *Preliminary Bank Earnings Report*, First Quarter 2002

The greatest contribution to the improvement in earnings in the first quarter came from a highly-favorable interest rate environment that boosted net interest income. The increase in net interest income reflected wider net interest margins at large banks, whose average funding costs fell more rapidly than their average asset yields during the quarter. Earnings also were helped by slow growth in operating expenses, which were only two percent higher than a year ago. These positive developments outweighed the negative effects of rising expenses for loan-loss provisions, lower market-sensitive noninterest revenues, and lower gains on securities sales. Almost two-thirds (64 percent) of all commercial banks reported higher earnings than in the first quarter of 2001. Earnings gains were lower at small banks.

The effects of last year's economic weakness were evident in rising levels of loan losses and noncurrent loans. Most of the deterioration in asset quality occurred at larger banks, in commercial and industrial (C&I) loans and in credit-card loans. Foreign borrowers accounted for a rising share of troubled

C&I loans in the first quarter. A sharp increase in charge-offs of credit-card loans was caused by a few large charges related to loan sales and restructurings.

In line with higher credit losses, the industry has also seen more failures and more problem banks. Six insured commercial banks failed during the first quarter, the largest number of bank failures in a quarter since the third quarter of 1994. The number of commercial banks on the FDIC's "Problem List" increased from 95 to 102 in the quarter, and assets of "problem" banks rose from $36 billion to $37 billion.

Total loans at commercial banks fell during the quarter, the first time in five years that they have contracted. Commercial and industrial loans declined for the fifth consecutive quarter, even though a majority of banks reported increases in their C&I loans. Residential mortgage loans also declined. Growth remained strong in commercial real estate loans and home equity loans, as well as in credit cards and other consumer lending. Total deposits at commercial banks declined along with industry assets. The percent of assets funded by deposits remained unchanged during the quarter, at 66.9 percent. The composition of deposits continued to shift toward a larger proportion of domestic savings deposits, while deposits in foreign offices, domestic demand deposits, and domestic time deposits all declined.

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Chart 1

Bank Net Income Sets a New Record in First Quarter

FDIC-Insured Commercial Banks, Dollars in Billions

Year	Quarter	Net Operating Income	Securities and Other Gains/Losses, Net
1998	1	14.9	1.1
1998	2	15.7	0.4
1998	3	14.7	0.4
1998	4	14.0	0.7
1999	1	17.6	0.3
1999	2	16.9	0.1
1999	3	19.5	-0.2
1999	4	17.7	0.0
2000	1	20.0	-0.5
2000	2	15.5	-0.9

2000	3	20.0	-0.7
2000	4	17.2	0.5
2001	1	19.3	0.5
2001	2	18.6	0.6
2001	3	16.6	0.7
2001	4	17.8	0.9
2002	1	21.4	0.4

Source: *FDIC Preliminary Bank Earnings Report*, First Quarter 2002