The banking industry's string of six consecutive quarters of record earnings ended in 1998:IIIQ as earnings dropped to $15.0 billion. Industry profits were $1.1 billion less than in 1998:IIQ. Despite this setback, return on equity remained above 14% and equity capital increased $11.4 billion to $457.4 billion (8.68% of industry assets), its highest percentage since 1941. In addition, the industry's "coverage ratio" rose to a record $1.94 in reserves for every $1.00 of noncurrent loans. Consequently, banks appear well positioned to weather any potential reversal of fortune. One cloud in this otherwise bright sky is that the net charge-off rate on all commercial bank loans rose to 0.73% in 1998:IIIQ, the highest rate reported by the industry since 1993:IVQ.

Commercial banks' assets increased $86.4 billion in 1998:IIIQ and $400 billion (8.2%) in the 12 months ending September 30. Much of the quarter's growth was in loans to commercial borrowers (up $23.6 billion), loans for commercial real estate properties (up $9.3 billion) and construction (up $6.7 billion), and consumer loans other than credit cards (up $8.3 billion). Banks' on-balance-sheet portfolios of credit card loans, residential mortgage loans, and home equity loans all declined during 1998:IIIQ. The amount of credit card loans that were securitized and sold off-balance-sheet increased $13.9 billion. Banks continued to reduce their holdings of U.S. Treasury securities (down $25.1 billion), while increasing their mortgage-backed securities (up $40.6 billion). Total securities increased $29.1 billion. Intangible assets registered their smallest quarterly increase in two years, reflecting slower growth in merger-related goodwill and a reduction of $244

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Banking Conditions (cont.)

million in mortgage-servicing assets as mortgage prepayments increased. Banks’ off-balance-sheet derivatives contracts rose $4.6 trillion during the quarter, more than double the previous largest quarterly increase, partly because of turmoil in overseas financial markets.

Banks’ international operations continue to create uncertainty for the industry. While net income from domestic operations remained relatively strong, income from foreign operations declined significantly in 1998:IIIQ. Banks’ earnings from domestic operations were $429 million (3.1%) higher than in 1998:IIQ. The percentage of earnings from international operations, which had been in the 10%-14% range over the last few years, has fallen to 2%-4% in two of the last four quarters. U.S. banks’ exposure to foreign lending (measured by the percent of loans to non-U.S. borrowers) has been rising sharply since 1997:IIQ after falling sharply throughout 1996.

The greatest drag on industry earnings came from large banks’ trading activities, which produced $1.9 billion less pretax revenue in 1998:IIIQ than in the previous quarter. This was partly a reflection of international operations, which contributed $1.5 billion less to bottom-line profits than in 1998:IIQ. Loss provisions for foreign operations increased $203 million, while domestic loan-loss provisions grew $1.2 billion. These negative factors were more than offset by a $1.3 billion decline in income taxes and a $792 million increase in net interest income. Net interest margins improved slightly, averaging 4.12% for the quarter, up from 4.10% in 1998:IIQ. A year ago, the industry’s margin was 4.24%.