Depository Institutions

Profits made a comeback to FDIC-insured commercial banks during the first three months of 2002. First-quarter net income reached a record-setting $21.7 billion, which represents a 16.4% improvement over the previous quarter and a 9.6% increase over 2001:1Q.

Despite declining interest income, commercial banks’ noninterest (fee) income was still strong, reaching a high of $41.5 billion in 2002:IQ, the second consecutive quarter it has increased. This is another sign that the earnings pressures that tormented banks in the second and third quarters of 2001 are finally abating.

Commercial banks’ strong earnings performance is once again apparent in the net interest margin, which reached 4.2%, up from 3.9% in 2001. This factor, coupled with asset growth declining to 3%—the slowest rate since 1992—pushed banks’ return on assets to 1.33%, the highest level since 1989. This is the second consecutive quarter that return on assets has increased; it was 1.26% in 2001:IVQ. First-quarter return on equity, at 14.5%, also showed an improvement over 2001. However, it is still below its 2001:IQ level of 14.7% and well below its recent high of 15.3% in 1999.

In 2002:IQ, net loans and leases as a share of assets increased to 58.7%, up from 58.2% in 2001:IVQ. Although the increase is small and the level is well below its recent high of 61.3% in 2000:IIIQ, the ratio still indicates increasing activity in the lending market.

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Unfortunately, asset quality continued to slip in the first quarter. Net charge-offs (gross charge-offs minus recoveries) have been rising since 1999, and they exceeded $11 billion, 1.1% of commercial banks’ loans and leases. In 2001:Q, net charge-offs were less than $7 billion. The greatest deterioration occurred in the loan portfolios of banks with total assets over $10 billion. Problem assets (nonperforming loans and repossessed real estate) are also on the rise: They reached 0.57% of total assets, their highest level since 1994.

Parallel to declining asset quality, the percent of problem banks (that is, banks with substandard exam ratings) reached 1.27%, the highest level since 1995. However, declining asset quality is not a significant problem for FDIC-insured commercial banks, where the percent of unprofitable institutions is falling. Loss reserves, which protect banks against expected losses, remain at healthy levels, although they have declined since 1998. The coverage ratio (prudential reserves as a share of noncurrent loans and leases) currently stands at 131%. Core capital, which protects banks against unexpected losses, is at its highest level—7.95%—up from 6.17% in 1990. All of these performance indicators are consistent with a strong banking sector.