Remarks by Governor Mark W. Olson

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U.S. Banking Industry Performance Highlights--2003

The banking industry enjoyed a very good year in 2003, one in which banks were able to adapt to a changing environment and still generate record profits. Several factors contributed to this favorable setting: low interest rates, a boom in mortgage banking and deposit-gathering, and favorable trends in market-sensitive businesses as the year went on.

We are just getting our first look at year-end financial information from Call Reports. Although the figures are still preliminary, there are some interesting findings. In 2003, for the first time, insured commercial banks earned $100 billion dollars. These impressive profits were 14 percent higher than in 2002, which to that point was itself a record year for earnings. The industry's return on assets was almost 1.40 percent, and its return on equity was 15.3 percent.

The level of earnings, even at $100 billion, may not be the most remarkable aspect of the industry's 2003 results. The industry not only earned record profits but, as the year progressed, changed the way they earned these profits. In other words, the industry adapted to changes in the business and economic environment and did well.

Changes really began over the summer, when mortgage originations began to taper off as longer-term interest rates rose. For eight large bank holding companies with major mortgage banking operations, the collective mortgage loan origination volume fell 50 percent to about $200 billion in the fourth quarter. This rate of decline parallels what other market sources indicate. Naturally, the fees associated with these originations declined as well, although not as much as one might have expected. Mortgage originations of $200 billion were still strong for these institutions by historical standards, and income was aided by favorable developments in mortgage servicing, namely the accumulated buildup of servicing portfolios from the surge in mortgage lending and the revaluation of servicing assets due to slower prepayments.

Net interest margins had been narrowing rather steadily since early 2002. A couple of things appeared to be at work. Typically, margin pressure tends to arise at banks facing stiff competitive pressure on loan yields and funding costs, perhaps an escalation in funding costs at banks experiencing rapid asset growth. The current situation is not a typical or normal environment.

The low-interest rate environment had a lot more to do with this narrowing, along with sluggish loan demand. Historically low interest rates have significantly reduced the yields banks earn on their assets, especially mortgages. Banks built up their holdings of mortgages as market conditions generated such remarkable volumes of these loans, and as weak demand for commercial loans left a void in bank balance sheets and income. Historically low rates on new mortgage loans, together with rapid prepayment of higher-rate mortgages, have sharply reduced yields on bank mortgage portfolios. The preliminary data for 2003 indicate that the effective yield on mortgage-backed securities, including adjustable-rate products, fell to 4.22 percent; by late in the year, yields had fallen to only about 3.90 percent.

Along with this pressure on yields, banks have faced an interesting new pressure on funding costs. For much of the last two years, households have been inclined to keep their assets very liquid and flexible. Interest rates have been low by historical terms, and didn't seem to provide much incentive for households to tie up their assets in time deposits. The stock market--at least through the spring of last year--was on a downward track and certainly not providing attractive returns. Flexible bank deposits offered a comfortable compromise, providing positive returns, deposit insurance, and flexibility to redeploy funds if alternative investments became more attractive.

In this setting, bankers have valued core deposits even more highly, and have paid up for them. In particular, they have favored nonmaturity deposits such as money market or savings accounts. Smaller-denomination certificates of deposit, in contrast, have declined steadily over a period of some years. Influenced by the low interest rate environment, banks reduced the rates on their nonmaturity deposits by far less than money market rates had fallen. The result has been tighter margins, but with an important potential side benefit. The success that bankers had in raising these nonmaturity deposits created opportunities to reclaim some of the market share that bank deposits had lost over the previous decade or two. Money market and savings accounts, in particular, now fund 30 percent of bank assets.

Remarkably, despite these pressures, it now appears that bank margins recovered to some degree late in 2003. The improvement was only about six basis points, but appears to be significantly influenced by slower prepayments and the resulting increases in mortgage asset yields. There were a host of other forces at work, suggesting that the improvement in margins may or may not be sustainable. Still, banks were able to turn around their shrinking margins.

Perhaps the biggest contributor to strong earnings has been steady improvement in asset quality--consistent with a gradually improving economy--that allowed for lower charge-offs and lower provisions. By the end of 2003, problem assets had fallen to 0.94 percent of loans, down considerably from the peak level for this credit cycle of 1.27 percent in September 2002. Improvement in economic conditions is a key reason for the sustained decline, along with the liquidity and depth of secondary markets for troubled loans. We also think that better risk management--in particular, better diversification--contributed to this decline. With charge-offs and problem assets declining for more than a year, credit quality is on track to improve further, more so as the economy improves. As a result, we can expect that banks will be able to take their provisions still lower and maybe their reserves as well.

One area in which bank profits lost ground was securities gains. Low interest rates had increased the market value of bank securities holdings, creating the opportunity for banks to sell these securities and take the resulting gains into income. Booking such gains significantly enhanced near-term profits, but of course at the price of lowering future net interest earnings. In any case, increases in longer-term interest rates over the summer meant that the opportunities for securities gains-taking faded. So did the current contribution to earnings from securities gains.

Banks still have not seen significant relief from weak business loan demand. In this business cycle, firms have been reluctant to borrow--in part because of uncertainty about future prospects. The commercial loan business often carries attractive spreads, especially in the middle market. We have seen only the very early signs of recovery in loan demand, including a pickup in bond issuance and syndicated lending.

By one indicator, at least, small business confidence appears to be improving; a development that should be important for community banks. The National Federation of Independent Businesses surveys its members regularly about their sales outlook for the coming three-month period. Those surveys show optimism rising since the summer of 2003. In fact, since November the number of firms expecting an increase in sales exceeds those expecting a decline by more than 30 percentage points. The survey hasn't shown that wide a margin with such a positive outlook for four years.

At this point, the available indicators suggest that banks' earnings prospects are favorable. The market seems to share that outlook, perhaps one reason why bank stock valuations have been improving. Ongoing consolidation in the industry also plays a role, and we have seen a recent wave of merger announcements among the largest bank holding companies. Based on what I hear from community bankers, mergers and acquisitions among big institutions have historically created opportunities for community banks.

I wouldn't be a bank regulator if I neglected to mention that bank capital ratios remain very strong. Nearly 99 percent of banks in the United States are well-capitalized, which is a higher proportion than we have ever seen. Some analysts have expressed concern that bankers would reduce their capital buffers in order to increase dividend payments, especially as the tax treatment of dividend income became more favorable to stockholders. But in spite of these changes in the tax code, the aggregate dividend payout ratio at commercial banks increased only modestly, from 76.4 percent of income to 77.4 percent of income.

Conclusion

In conclusion, the U.S. banking industry is healthy, strong, profitable and well-positioned to play its proper role in supporting growth and prosperity in our economy. Many of the factors that made 2003 such a remarkable year for the industry look like they will carry over into 2004 as well. New challenges will arise as we move ahead, of course, and perhaps some new opportunities as well. Adapting to change is an important aspect of the banking business, and the industry's ability to respond well to changing circumstances was a key to last year's record-setting results. I believe we can look forward with confidence to continued strong performance from the banking industry.

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