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The Condition of the Banking Industry

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Summary

Mortgage lending in the current low-interest rate environment made 2003 a banner year for the U.S. banking industry. Banks earned a record $120 billion last year. However, the industry continues to become more concentrated with fewer small banks. Smaller banks are less able to garner cheaper funds for lending from wholesale markets and are less able to mitigate their credit and interest rate risks through participation in securitization and syndication markets. Smaller banks are more vulnerable to the increased indebtedness of borrowers and anticipated rising interest rates. The three largest banking institutions have assets in the range of one trillion dollars each. Their combined assets represent 30% of FDIC-insured banks. The next four banks hold another 13% of these assets, and the top 25 banks hold more than 50% of the assets of FDIC-insured banks. As a result of bank consolidations, at the end of 2003 there were 118 fewer commercial banks, and 55 fewer savings institutions, than there were at the end of 2002. The Senate Committee on Banking, Housing, and Urban Affairs held a hearing on the condition of the banking industry on April 20, 2004, where most of the issues in this report were discussed.

Despite the overall growth in deposits in the banking system, deposits at smaller banks have begun to decline as deposits at the larger banks continue to grow. Deposits at commercial banks grew at 7.2% and 5.0% at saving institutions between 2002 and 2003. However, in the same period for all FDIC-insured institutions with less than $100 million in assets, deposits declined by 5.0% while deposits grew 10.0% at institutions with assets greater than $10 billion.

The high liquidity and profits in the banking system could be reduced rapidly if relative yields on alterative investments increase sharply due to higher interest rates. In the recession of 2001, smaller banks had not heavily lent to nonfinancial, high-tech companies, which became financially troubled during the recession. Large banks were doing most of that lending, but they were also better prepared for the recession because they had diversified their sources of funding. Despite their preparation, the noncurrent asset ratio (loans at least 90 days past due divided by total assets) for FDIC-insured banks went up to 1.00% for commercial banks with assets greater than $10 billion. Since then, these same institutions' noncurrent asset ratio declined to 0.80%. Smaller commercial banks (less than $100 million in assets) have seen a slight increase in noncurrent assets since the 2001 recession. The ratio went from 0.81% in 2001 to 0.83% in 2003. This slight increase might reflect smaller commercial banks' increased exposure to interest rate risk.

Larger banks are likely to become even more efficient users of regulatory capital under Basel II and thereby better able to expand lending with the planned implementation of Basel II capital rules. Smaller banks would continue to operate under the more burdensome regulatory capital standard, Basel I.

This report will be updated as legislative and financial developments warrant.

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The Bottom Line[1]

Last year was a banner year for the U.S. banking industry. As **Table 1** shows, the industry comprising commercial banks and thrifts or savings institutions earned a record $120.6 billion, surpassing the 2002 record earnings of $105.6 billion. These are Federal Deposit Insurance Corporation (FDIC) -insured institutions. The historically high profits are attributable to the low-interest rate environment that has held since 2001. Specifically, mortgage lending is a major contributor to the profitability of banking mainly because of application and servicing fees. In contrast, the demand for business loans and for underwriting equity securities was weak in 2002 and 2003.

Recent profitability is diffuse throughout the industry. More important, the safety and soundness of the industry as measured by bank capital — the owners' money that is the first line of defense against bank failure — have also been strong. Despite the growth in capital, FDIC-insured commercial banks reported a net profit of more than $102 billion in 2003, as shown in **Table 1**, column (4), and an overall equity capital ratio of 9.10% as shown in column (6).[2] Similarly, total thrift profits were $18.056 billion in 2003, up 17.86% from the previous record of $15.244 billion in 2002. Only one thrift institution fell below the well-capitalized standard. In sum, the bottom lines of all 7,769 commercial banks were only slightly more profitable than the 1,411 thrift institutions covered. The return on assets (ROA) for the commercial banks in 2003 was 1.40%, while the thrifts had a ROA of 1.28%.

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[1] The Senate Committee on Banking, Housing, and Urban Affairs held a hearing on the condition of the banking industry on April 20, 2004, where most of the issues in this report were discussed.

[2] The Controller of the Currency speaking about nationally chartered banks said, "Today, all national banks, with the exception of a few small banks under special supervision, have risk-based capital ratios [capital divided by total assets] above 8 percent [the regulatory requirement] and more than 90 percent of national banks have risk-based capital ratios above 10 percent." Testimony of the Comptroller of the Currency, John D. Hawke, in U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *An Examination of the Condition of the Banking and Credit Union Industry*, Apr. 20, 2004, p. 9, at [http://banking.senate.gov/_files/ACF23F.pdf].

Table I.
FDIC-Insured Institutions' Numbers, Assets, Profits, Equity Capital Ratios, and Noncurrent Assets, 2001 and 2003

Institutions	# of Inst.	Total Assets (bil. $)	Total Profits (mil. $)	Return on Assets, %	Equity Capital Ratios, %	Non-current Assets to Total Assets 2001	Non-current Assets to Total Assets 2003
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Commercial Banks	**7,769**	**7,602**	**102,546**	**1.40**	**9.10**	**0.97**	**0.77**
Greater than $10 billion	83	5,543	76,505	1.43	8.64	1.00	0.80
$1 billion to $10 billion	341	947	13,165	1.46	10.58	0.73	0.65
$100 million to $1 billion	3,434	910	11,061	1.27	9.91	0.73	0.71
Less than $100 million	3,911	201	1,815	0.93	11.27	0.81	0.83
Thrift Institutions	**1,411**	**1,474**	**18,050**	**1.28**	**9.41**	**0.66**	**0.62**
Greater than $10 billion	47	981	13,352	1.43	8.90	0.53	0.65
$1 billion to 10 billion	110	217	2,305	1.11	9.91	0.79	0.51
$100 million to $1 billion	776	251	2,136	0.88	10.59	0.60	0.57
Less than $100 million	478	25	263	1.07	13.24	0.78	0.82
Total/Weighted Averages	**9,180**	**9,077**	**120,596**	**1.39**	**9.15**	**0.77**	**0.75**

Source: FDIC *Quarterly Banking Profile*, Tables II-A, II-B, IV-A, IV-B, for the Full Year 2001 and 2003. Available at [http://www2.fdic.gov/qbp/2003dec/all2a.html], [http://www2.fdic.gov/qbp/2001dec/all2.html], and [http://www2.fdic.gov/qbp/2004mar/sav2.html].

The Risk Considerations

Credit Risk

Meeting and even exceeding regulatory capital requirements is relatively easy when the industry is making record profits. As some analysts argue, regulatory compliance gets cheaper as profits grow. But, changing macroeconomic conditions can expose the banking industry to risks. The rapid growth in bank profits was generated when the economy grew rapidly in 2003 (nominal GDP grew 4.9%). The slower rate of economic growth is expected to increase the industry's exposure to credit risk. Credit risk is the risk that borrowers may fail to fully make the obligated payments of their loans. In short, credit risk is probability of default. According to Alan Greenspan, "At present, credit risk-management practices [in the banking industry] are perhaps least developed in measuring risk associated with exposures

related to construction projects and to financing commercial real estate, which have grown rapidly, particularly among regional and community banks."[3] In 2003, this type of asset constituted a record 19% share of all bank lending. Credit risk is highly correlated with interest rate risk because higher interest rates tend to reduce borrowers' available income and increase the probability of default as borrowers take on new loans with higher required payouts.[4]

The level of consumer indebtedness is a major credit risk concern. Total household indebtedness is at an historic high of 112% of after-tax income. In 2003, homeowners use about 14% of their disposable income to meet their major financial obligations. In 1993, they used 12%. The situation is worse for renters. They are using 31% of their disposable income for financial obligations. In 1993, they used only 24% of their disposable income to meet these financial obligations.[5] Rising household indebtedness has raised concerns about the sustainability of the growth in consumer spending (the main source of recent economic growth). Since interest rates are beginning to rise, banks may see a rise in nonperforming loans because households now have a greater exposure to variable-rate consumer loans and adjustable mortgages. Some borrowers with weaker credit histories and balance sheets may well experience problems meeting their obligations.

Interest Rate Risk

Low interest rates have been a source of bank profitability; the probability of interest rates rising is also a major source of interest rate risk exposure for banks. Lending exposes banks to risk due to changes in the market interest rates. This is best illustrated by an example: suppose a bank makes a two-year, $1 million loan for which it charges 10% interest per annum. And, the bank faces the choice of market financing of the loan with a two-year time deposit at 9% per annum or with a one-year time deposit at 8% per annum.[6] The 9% choice would result in $10,000 in certain interest earnings for each of the two years for a total of $20,000. However, if the bank chooses the one-year financing, it will earn $20,000 in year one. But its earnings in year two will depend on the currently unknown one-year interest rate that will prevail a year from now. Should the one-year interest rate remain unchanged at 8%, the bank will earn a second year of $20,000 for a total of $40,000. If in the second year the one year interest rate falls to 5%, the bank would do even better and record a second year earning of $50,000 for a total of $70,000. But if the market interest rate rises to 13%, the bank would suffer a loss of $30,000 in year two, wiping

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[3] Testimony of the Chairman of the Board of Governors of the Federal Reserve System Alan Greenspan, *An Examination of the Condition of the Banking and Credit Union Industry,* April 20, 2004, p. 3, at [http://banking.senate.gov/_files/ACF243.pdf].

[4]See Stuart I. Greenbaum and Anjan V. Thakor, *Contemporary Financial Intermediation* (New York: Dryden Press, 1995), p. 361.

[5]See CRS Report RL30965, *Rising Household Debt: Background and Analysis,* by Brian W. Cashell.

[6]Market financing a loan means that the bank borrows the funds it uses for the loan from lenders in the financial marke. The bank charges its borrower a higher interest than it pays for those funds in the market.

out all profits plus $10,000 or 50% of the earnings it made in the first year and taking a loss overall. The risk could be avoided by choosing the two-year financing.

The example reveals the reason for concern that banks may be taking advantage of the low-interest environment to maintain or boost their interest income by using short-term financing for higher earning long term loans, but that could make them increasingly vulnerable to a rise in rates. On the other hand, prepayment is a concern of bankers when market interest rates fall, leading mortgage borrowers to pay off their higher interest rate mortgages with new lower interest rate mortgages. Prepayments tend to lower banks' interest income and profits.

Competition in the Industry

Over the last two decades, the banking industry has been rapidly consolidating through mergers and acquisitions, which means that there are fewer but larger banks. According to the chairman of the FDIC, "Once the recently announced mergers are complete, there will be three banking companies whose assets are in the range of one trillion dollars each. Their combined assets will account for approximately 30 percent of the assets of FDIC-insured institutions. The next four largest holding companies will have assets in the range of $200 to $400 billion, and they will account for another 13 percent of industry assets. The top 25 banking companies hold over one-half of industry assets, while the top 100 hold almost three-quarters."[7] As a result of the bank consolidation, at the end of 2003 there were 118 fewer commercial banks, and there were 55 fewer thrifts than there were 2002.[8]

Cost of Funds Is Lower for Large Banks

In the low-interest rate environment, larger banks clearly have an advantage over smaller banks in raising deposits that fund loans. Residential real estate loans held by banks rose about 20% in both 2002 and 2003. Consumers have taken advantage of declining mortgage rates to extract funds from the increased value of their homes. A sizeable part of these funds from refinancing and home equity loans has been used to pay off higher credit card and installment debts.[9] Smaller banks have a greater reliance on retail funding which mainly comes from their customers' deposits. The interest rate difference between the lower mortgage loan rates and the rates banks pay

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[7] Testimony of Chairman Federal Deposit Insurance Corporation Donald E Powell, in U.S. Congress, Senate Committee on Banking, Housing and Urban Affairs, *An Examination of the Condition of the Banking and Credit Union Industry*, Apr. 20, 2004, p. 8, at [http://banking.senate.gov/_files/powell.pdf].

[8] See Office of Thrift Supervision, *2003 Fact Book* and Federal Deposit Insurance Corporation, *Quarterly Banking profile,* Mar. 2004, [http://www.ots.treas.gov/docs/17340.pdf], and [http://www2.fdic.gov/qbp/2004mar/cb1.html], and [http://www2.fdic.gov/qbp/2004mar/sav1.html].

[9] Testimony of John D. Hawke, Jr. before the Committee on Banking, Housing, and Urban Affairs, *An Examination of the Condition of the Banking and Credit Union Industry*, Apr. 20, 2004, p. 6, [http://banking.senate.gov/_files/ACF23F.pdf].

for deposits has narrowed. Bankers call this an erosion in smaller banks' net interest margins. For insured commercial banks, net interest income as a percentage of earnings declined 27 basis points [a basis point is one-hundredth of a percentage point (0.01%)] in 2003 to 3.80%, the lowest level in more than a decade. In contrast, larger banks rely more heavily on wholesale funding.[10] Large banks are able to borrow funds from large cash generating corporations such as McDonald's and ExxonMobil, insurance companies, and pension funds in domestic and international financial markets. In a low-interest rate environment, deposits continue to flow into banks, particularly to larger banks because the rate of return on alternative money market instruments is lower. Consequently, deposits at commercial banks grew at 7.2% and at saving institutions at 5.0% between 2002 and 2003. However, for all FDIC-insured institutions with less than $100 million in assets, deposits declined by 5%, while deposits grew 10% at institutions with greater that $10 billion in assets. These larger institutions share of all deposits was 65%.[11]

The high liquidity and profits in the banking system could be reduced rapidly if relative yields on alterative investments increase sharply due to higher interest rates. In the recession of 2001, smaller banks had not heavily lent to nonfinancial, high-tech companies, which became financially troubled during the recession. Large banks were doing most of that lending, but they were better prepared because of their broader sources of funding. In that recession, the noncurrent loan ratio for all FDIC-insured institutions (loans at least 90 days past due) went up to 1.00% for commercial banks with assets greater than $10 billion (see column (7) in **Table 1**). Since then, these same banks' (with assets over $10 billion) noncurrent asset ratio has now declined to .80%. Smaller commercial banks (less than $100 million in assets) have not improved. Instead, they saw a slight decline in credit quality since the 2001 recession. Their noncurrent asset ratio went from .81% in 2001 to .83% in 2003.

Large Banks' Real Estate Lending Adds Stability

The performance of bank loans to nonfinancial firms differs from the performance of mortgage loans over the business cycles. Commercial bank loans backed by real estate as percentage of their total assets went from 27% in 2001 to 30% in 2003, while these loans for the smaller thrift institutions went from 58% to 59%. Because nonfinancial firms generally have the ability to pass on costs, including high interest cost, to their customers in the form of higher prices, their ability to keep bank payments current in higher inflationary periods is less impaired by rising interest rates. In contrast in recessions, nonfinancial firms tend to have less pricing power causing a decline in profitability. This in turn could impair these firms' ability to maintain payments on their bank loans. Consequently, noncurrent assets of banks tend to rise in recessions.

It is important to note that noncurrent loans in real estate as well as nonfinancial loans are likely to rise in recessions. However on residential mortgage

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[10]Testimony of Alan Greenspan, *An Examination of the Condition of the Banking and Credit Union Industry*, p. 4.

[11] *FDIC Quarterly Banking Profile*, Table III A, A Full Year 2002 and 2003 All FDIC-Insured Institutions.

loans, higher interest rates tend to drive up homeowners' payments, particularly in the case of the recently more popular variable-interest rate mortgages. If homeowners' incomes do not rise with higher interest rates, homeowners' ability to keep up with these higher mortgage payments may be impaired. As a result, noncurrent bank assets will rise if homeowners fail to keep up with their mortgage payments. On the other hand, in recessions when interest rates usually fall, homeowners usually see their payments fall. Or, to take advantage of the lower rates, fixed mortgage rate holders refinance at lower rates to pay off higher interest rate mortgages.[12] In recessions with accompanying lower interest rates, noncurrent mortgage payments to banks tend to decline on real estate backed loans. In short, the quality of nonfinancial loans and mortgages tends to offset each other over the business cycle, which helped to stabilize bank income over the recessions.

Table 1 shows that overall noncurrent assets of FDIC-insured institutions are down since the 2001 recession. For commercial banks noncurrent assets went from 0.97% in 2001 to 0.77% in 2003. Similarly, for thrift institutions the noncurrent assets moved in the same direction from .66% in 2001 to .62% in 2003. All banking institutions might be more vulnerable to higher interest rate risk because of their heavier mortgage lending. But smaller banks might be already feeling the negative impact of their heavy mortgage lending for which some of them might not be equally prepared as the larger banks. **Table 1** shows that noncurrent assets for commercial and thrift institutions with less than $100 million have increased since 2001. Not shown in the table is that the smaller banks usually carry a significantly higher percentage of noncurrent real estate loans than larger banks. For institutions less than $100 million in assets these past due loans were 1.36% in 2003 and 1.56% in 2001. For all FDIC-insured institutions with assets over $10 billion, these same past due real estate loans were 0.93% in 2003 and 1.41% in 2001. Both figures are larger for the smaller banks. That may explain why nine smaller banks are already under special supervision by regulators.

Risk Management

Bank regulators have been encouraging banks to take specific steps to ensure the safety and soundness of the banking system. As mentioned above, banks overall have long met or exceeded the regulatory risk-based capital standards. The regulators are now placing great emphasis on improving credit-risk management, developing and improving their methods of measuring risk on a transaction-by-transaction basis. These methods are to better quantify risk and establish a more formal and disciplined process to recognize, price, and manage risk. To ensure compliance, bank regulators have been moving from the traditional regime of periodic examinations to in-house examiners. The Office of the Comptroller of the Currency, for example, has placed resident examiners in the 24 largest national banks. These examiners, and specialists in areas such as commercial and retail credit, capital markets, bank technology, and asset management provide the regulators with real time risk management information.

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[12] Prepayments create additional problems for banks if banks financed the original mortgages with higher interest rate and longer term funds that they can not prepay.

At the same time, regulators are still using periodic on-site visits for smaller banks' regulatory compliance examinations. But the requirement to manage risk on a transaction-by-transaction basis is applied to smaller banks as well. Large banks are expected to take a holistic, portfolio view of management using advances in technology to garner information to help them underwrite and manage their credit risk. Regulators claim that larger banks have reduced their credit risk exposure to concentration by using the syndicated loan markets which broadly distribute credit exposure within the U.S. banking system as well as to foreign bank and non-banking organizations.[13] Similarly, the greater use of securitization markets has provided another way to manage risk concentration and to diversify their funding sources to provide greater access to under served markets. Moreover, the growth of derivatives markets has provided larger banks tools to manage their interest risk exposures. For example, because residential real estate lending is typically associated with low credit risk because of diversification, solid collateral, and borrowers' vested interest, banks are able to reduce this exposure by using hedges like interest rate swaps and options, which then enable banks to manage future shifts in interest rates while expanding lending. Most smaller banks are unable to take advantage of these tools because of the cost of these instruments.[14]

The use of these risk mitigating tools to protect against interest rate risks poses two challenges for regulators. First, risk mitigating tools are complicated, contingency instruments whose hedge value is extremely difficult to determine before hand. Regulators as well as bankers often rely on judgment to estimate their protective value against risks. Second, if these derivative instruments are truly effective protection against interest rate risk, smaller banks are disadvantaged by their availability almost exclusively to larger banks. Most smaller banks don't have enough assets to enter these markets, or their management is not sophisticated enough to understand how to use them successfully.

Compliance with Basel II

Some U.S. banks will be operating under new capital requirements that could change their profitability in the domestic as well as in the international banking markets. Both houses of Congress have held hearings on Basel II Capital Accords. On May 9, 2003, the United States Financial Policy Committee for Fair Capital Standards Act (H.R. 2043) was introduced at a hearing of the House Financial Services Committee. The Senate Committee on Banking, Housing, and Urban Affairs held a hearing entitled *A Review of the Basel Capital Accord* on June 18, 2003. From these hearings it is clear that U.S. regulators are committed to

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[13] Ibid. Hawke, pp. 9-11; and Greenspan, pp.6-8.

[14] Both commercial and saving institutions borrow through advances from the Federal Home Loan Banks (FHLBs) at very low interest rates to make mortgage loans. In 2003, FDIC-insured commercial banks borrowed $245.3 billion from the FHLBs; thrift institutions borrowed $234.3 billion, but thrift institutions' advances from the FHLBs grew 8.3% between 2002 and 2003, while the commercial banks' advances grew about half as fast or 4.8%, according FDIC data. This suggests that the larger commercial banking institutions have been more successful at garnering funding from more competitive non-FHLB sources than the generally smaller institutions.

implementing Basel II as soon as problems with certain regulations are resolved. Basel II relies more heavily on bankers' and regulators' judgments of the methods used in determining risk and required capital than the set formula approach of Basel I.[15]

The planned implementation of Basel II in the United States will bifurcate bank regulatory capital standards, which some regulators believe will give a greater advantage to some larger banks operating under Basel II. U.S. financial regulators, led by the Federal Reserve, intend to require Basel II for only the most important, internationally active banks, and presume that other major banks will also eventually join the system. On August 4, 2003, U.S. federal banking regulators jointly issued an advance notice of proposed rulemaking (ANPR).[16] According to the ANPR, the overwhelming majority of commercial banks in the United States will continue to operate under Basel I. The agencies expect to identify only 10 large international banks to be designated core banks. Another 10 banks may voluntarily opt into the new standards after meeting infrastructure and other supervisory and disclosure requirements. These 20 banks combined account for about 99% of foreign assets held by the top 50 domestic banking organizations and approximately two-thirds of U.S. domestic banking assets.[17] This means that the overwhelming share of the international banking business will be under Basel II, but an overwhelming majority of U.S. banks are not likely to be. Because of the up-front costs that Basel II would impose on banks, most U.S. banking institutions are likely to remain exempt. Basel II could enable the larger banks under it to expand lending at more competitive rates.[18]

Conclusion

The banking system was more profitable in 2003 than it has ever been and the system's safety and soundness in terms of capital is better than it has been for decades. However, the industry is getting more concentrated. Larger banks clearly have advantages over smaller banks in funding assets and also mitigating credit and interest rate risk. Banks are benefitting from the low-interest rate environment that has raised consumers' willingness to take advantage of declining mortgage rates to extract funds from the increased value of their homes. A sizeable part of the funding from refinancing and home equity loans has been used to pay off higher credit card

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[15] See CRS Report RL31984, *The Basel Capital Accord: A return to Bank Supervisory Judgments*, by Walter W. Eubanks.

[16] U.S. Department of the Treasury, "Internal Ratings-Based Systems for Corporate Credit and Operational Risk Advanced Measurement Approaches for Regulatory Capital," *Federal Register*, vol. 68, no. 149, Aug. 4, 2003, pp. 45948-45988.

[17] Roger W. Ferguson, Jr. *Basel II: Scope of Application in the United States*, statement before the Institute of International Bankers, New York, New York, June 10, 2003, [http://www.federalreserve.gov/boarddocs/speeches/2003/200306102/default.htm].

[18] See George French et al., *Risk-Based Capital Requirements for Commercial Lending : The Impact of Basel II*, Apr. 21, 2003, [http://www.fdic.gov/bank/analytical/fyi/2003/042103fyi.html].

and installment debt. This process has left banks vulnerable to increased credit and interest rate risks should rates rise and the economy slow significantly. Consumers are spending a larger portion of their disposable income on financial obligations which exposes the banks to credit risk. Credit risk is the risk of default. Banks are also vulnerable to interest rate risk because of the declining interest rate margin between the interest the banks pay for funds which they loan and the interest they receive from the borrowers. Rising interest rates could result in reduced profitability, especially if the rates result in losses on longer term loans. This particularly is true for smaller banks that rely heavily on retail funding.