Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION SECOND QUARTER 1999

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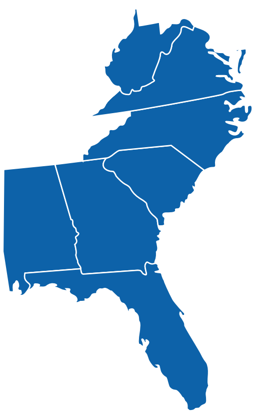

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In Focus This Quarter

◆ ***Economic Conditions and Emerging Risks in Banking*—This article provides an overview of economic conditions and banking industry trends, with a primary focus on potential risks to insured depository institutions.**

- ***Economic Developments*—Low interest rates, dormant inflation, and rising stock markets have all contributed to a generally positive near-term outlook for the U.S. economy.** ***See page 3.***
- ***Trends Affecting Banking Lines of Business*—Although credit conditions appear strong, risks exist in the major banking lines of business.** ***See page 7.***

  Consumer Lending*—Continued high consumer loan loss rates raise questions about how lenders will fare under less favorable economic circumstances.** ***See page 8.

  Commercial Lending*—Corporate loan growth accelerated in 1998 even as the corporate sector showed signs of stress.** ***See page 9.

  Commercial Real Estate and Construction Lending*—Selected metropolitan markets are experiencing rapid commercial development despite declining indicators of demand.** ***See page 10.

  Agricultural Lending*—Falling commodity prices threaten U.S. farm operators.** ***See page 11.

  Funding and Interest Rate Risk*—Intense competition and the changing term structure of interest rates have presented challenges for banks and thrifts.** ***See page 12.
- ***Indicators of Industry Performance*—Weaknesses appear to be developing for banks with certain types of exposures, and the dispersion in performance among insured institutions is increasing.** ***See page 13.***

By the Analysis Branch Staff

Regional Perspectives

◆ ***Atlanta Region Economic Growth Continues to Outpace That of the Nation*—Economic growth in the Atlanta Region continued to outpace that of the nation into early 1999, while commercial bank and thrift returns remained reasonably strong in the fourth quarter…earnings momentum may be slowing, however…several banks in the Region with significant consumer loan exposure are located in or near counties with high personal bankruptcy rates, and this fact could imply higher credit risk for such institutions should the economy weaken.** ***See page 16.***

By Atlanta Region Staff

The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation for the following eight geographic regions:

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Boston Region (CT, MA, ME, NH, RI, VT)
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Economic Conditions and Emerging Risks in Banking

Periodically, the Division of Insurance assesses conditions in the economy and across the banking industry in an effort to evaluate the types of risks that could adversely affect the performance of insured depository institutions. The analysis that follows describes the salient aspects of this assessment by focusing on three areas: 1) developments and conditions in the U.S. and global economies; 2) trends affecting particular banking lines of business; and 3) selected indicators of bank performance.

In brief, the U.S. economy continues to provide a favorable environment for the banking industry. The industry as a whole has exhibited strong loan growth and minimal credit losses. Nevertheless, there are areas of concern, including subprime and high loan-to-value consumer lending, higher levels of leveraged commercial lending, localized overbuilding of commercial real estate, and the potential for credit quality problems among agricultural banks. Although it is uncertain when, or even if, these concerns will ultimately affect overall industry performance, the potential for stress among insured institutions is being monitored.

Economic Developments

Conditions Have Improved Markedly since Late 1998

The U.S. economy is now in its eighth year of expansion, the longest peacetime expansion during the post-World War II era. Although analysts raised concerns about the durability of the expansion amid the late-1998 financial market turmoil, the economic outlook since that time has improved for a number of reasons: 1) the 75 basis point reduction in short-term U.S. interest rates between September and November helped to support consumer spending and business investment; 2) following several quarters of decline, U.S. exports rose unexpectedly during the fourth quarter; 3) inflation remained dormant even though U.S. labor markets were extremely tight; and 4) equity valuations for large-cap stocks rebounded and erased most of the losses incurred during August and September.

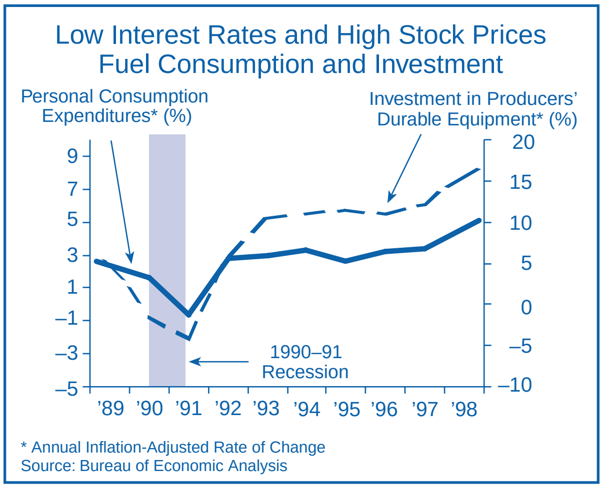
Consumer Spending and Business Investment Are Key to Economic Strength

Most of the standard indicators of health for the U.S. economy currently register values associated with the best macroeconomic conditions in our history. Growth in real gross domestic product (GDP) was 3.9 percent for all of 1998—the third consecutive year in which growth exceeded 3.5 percent. The U.S. economy added over 3.1 million jobs during 1998, while unemployment averaged just 4.5 percent, the lowest annual figure since 1969. Despite this robust economic activity, inflation was also the lowest in a generation. Consumer prices rose by just 1.6 percent in 1998, extending a seven-year streak during which prices have risen by less than 3 percent per year. At the same time, strong gains in the productivity of U.S. workers helped real hourly earnings rise by 2.7 percent—the best performance since 1972—while unit labor costs of businesses rose by only 1.9 percent.

Growth in business investment spending, which typically peaks in the early years of an economic expansion, has actually accelerated during the current expansion (Chart 1, next page). A number of factors appear to be responsible for this investment boom. One is the need for producers to invest in new technologies in order to cut costs and remain competitive. Also, rising stock prices, low interest rates, and low yield spreads during the past few years have helped keep the cost of capital relatively low. The result has been an economic expansion in which approximately 20 percent of net growth in real GDP has come from investment in producers' durable equipment, versus approximately 10 percent during the long expansions of the 1960s, 1970s, and 1980s. Bank commercial and industrial lending has expanded at an average annual rate of 10.6 percent over the past five years, largely on the strength of business investment spending.

The underlying factors that drive consumer spending are strong. Low unemployment and rising real incomes have boosted the ***Conference Board's*** consumer confi-

CHART 1

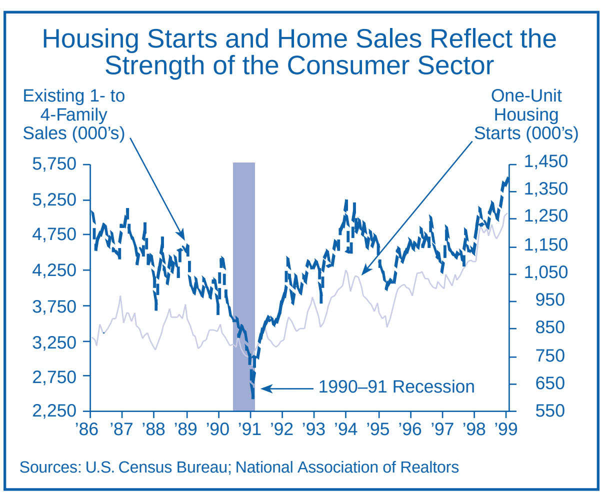


dence index to its highest values since the late 1960s. Increases in new home construction reflect these favorable conditions. Almost 1.5 million new homes were completed during 1998—the highest level in ten years—while a record 4.8 million existing homes were sold (Chart 2). U.S. automobile sales reached 15.5 million in 1998, their best performance since 1986. Low interest rates also enabled a record number of homeowners to reduce their monthly interest expenses by refinancing their mortgages during 1998.[1]

Although real disposable personal income grew by more than 3 percent during 1998, personal savings was essentially zero during the fourth quarter. This was the lowest rate of personal savings recorded in the United States since the Great Depression. The decline in personal savings has prompted much discussion of its causes and potential implications for the economy and for consumer credit quality. Most analysts have argued for the importance of a "wealth effect" from rising stock values on consumer spending.[2] They note that although consumers are saving little out of current income, household wealth continues to grow rapidly, driving consumer spending higher. The willingness of American consumers to spend has been a prime factor in prolonging the economic expansion for the United States and in supporting the economies of countries around the world that depend on exports to the United States. This high degree of reliance on the U.S. consumer has led analysts to voice concerns that the wealth effect might reverse itself, leading to a sharp drop in consumer spending if there is a sustained stock market decline.

[1] The Refinancing Index of the ***Mortgage Bankers Association*** posted an all-time high of 4,389 in the second week of October 1998. The index is scaled to a level of 100 as of the third week of March 1990.

CHART 2



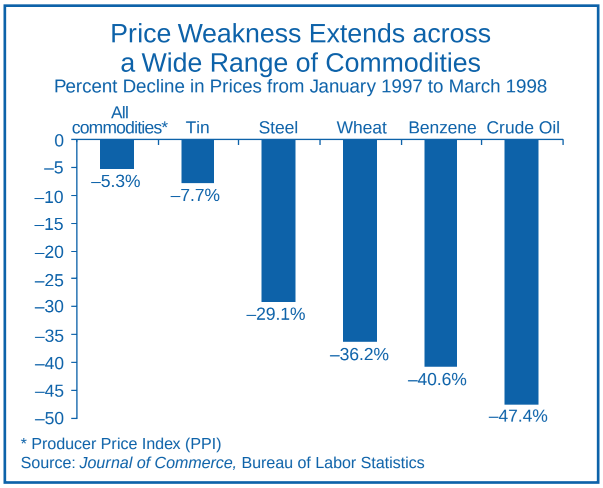
Conditions Vary across Industry Sectors

While overall conditions in the U.S. economy are good, certain sectors have been undergoing significant strain because of low commodity prices and weak foreign demand.

Commodity price weakness extends across a wide range of items, from agricultural goods to industrial commodities to basic manufactured goods (Chart 3). Among agricultural commodities, grain prices have fallen substantially from their record-high levels of just three years ago, while prices for hogs and soybeans have also been under severe pressure. Industrial commodity prices have fallen sharply, with steel prices down by nearly 30 percent since January 1997. Certain manufactured goods show a similar pattern. The price of the industrial chemical benzene has fallen by 40 percent since January 1997, while the price of computer memory chips fell by more than 80 percent during that time. Oil prices decreased by nearly 50 percent between January 1997 and February 1999. Since mid-March, however, oil prices have increased as a result of agreements among oil producers to limit output. Analysts are uncer-

[2] Personal savings is measured as the difference between disposable personal income (personal income less tax payments) and total consumption outlays. Increasing household wealth may reduce personal savings either through a reduction in disposable income or through increased consumption outlays. Tax payments resulting from capital gains will reduce measured disposable personal income. Increasing household wealth may lead to higher consumption outlays by means of the wealth effect.

CHART 3



tain how long any reductions in output will be maintained or how much oil prices may increase during the next several months.

Three trends in the global economy appear to be responsible for weak commodity prices. First, sustained low inflation has taken root both in developed nations and in many emerging economies. Low inflation has eliminated much of the speculative demand for commodities that was evident during the 1970s. Low inflation has also made it difficult for manufacturing firms to raise prices, while at the same time encouraging the implementation of new technologies to cut costs. Second, large-scale investment in plant and equipment during the 1990s in both developed and emerging countries has added vast amounts of new global manufacturing capacity, making industrial overcapacity a source of price weakness in a number of industries. Third, successive currency crises and the resulting recessions that have taken place in Asia, Eastern Europe, and Latin America have reduced global demand for commodity goods. Moreover, U.S. firms find that their products are less price competitive abroad because of the relative strength of the dollar.

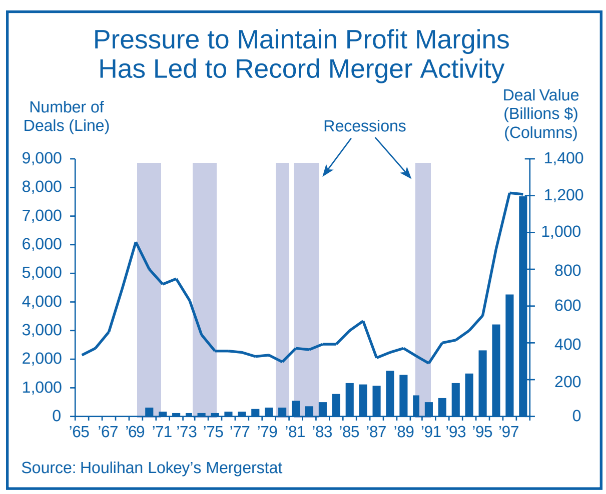
One reason the overall U.S. economy has proven so resilient in the face of weakness in the manufacturing sector is that firms have been able to restructure to cut costs and improve their market positions. Global overcapacity in industries such as oil and autos has been a driving force behind the record number and dollar value of merger deals announced during 1998. Mega-mergers involving Exxon-Mobil and Daimler Benz-Chrysler helped push the dollar volume of mergers announced in 1998 to almost $1.2 trillion—nearly double the level announced in 1997 and far greater than any year during the "merger mania" of the 1980s (Chart 4).

U.S. Foreign Trade Reflects Recent Turmoil in the Global Economy

The U.S. economy increasingly relies on exports to fuel its overall growth. Between 1994 and 1997, export growth contributed about 1 percentage point each year to total net growth in real GDP. However, with the onset of the Asian economic crisis in 1997, the export sector stalled and became a drag on overall U.S. economic activity. During the first three quarters of 1998, exports decreased at an annualized rate of 4.4 percent, led by declines in capital goods, industrial material and supplies, and food and agricultural products. Weakness in exports was not limited to Asia; in fact, Canada, Mexico, and South America were also weak markets for U.S. goods and services during most of 1998. Declining goods exports and rising imports combined to push the U.S. balance of trade to a record deficit of $169 billion during 1998—a 50 percent increase from the year before. The trade deficit continued to increase in early 1999. Data for January show an imbalance of nearly $17 billion, the largest monthly deficit ever recorded.

Despite the weakness in foreign demand that was observed during much of last year, U.S. exports rose sharply at the end of 1998. Total exports jumped by 19.7 percent during the fourth quarter, contributing 2.0 percent of the total 6.0 percent growth in GDP during the

CHART 4



quarter. This unexpected increase in U.S. exports involved nearly every region of the world except Eastern Europe. Export shipments increased across most product types, with the greatest increase in activity observed in capital goods.

The Outlook for the Global Economy Remains Uncertain

Developments during the past six months have resulted in an improved outlook for the global economy, but some key uncertainties remain. While the global financial system is more stable today than it was six months ago, some of the world's most important economies either remain in recession or are experiencing slower growth. In this environment, the potential remains for shocks to arise in the global economy that could adversely affect the performance of the U.S. economy and the credit quality of insured depository institutions.

Canada. The Canadian economy is healthier than at any time during the past several years. Canada's economy is expected to track overall growth in the United States, in part because U.S. demand for goods and services is the principal support for Canadian exports. Canada's relatively high dependence on weak commodity industries, such as metals, grains, and livestock, poses risks for producers and for local economies closely tied to these commodities.

Mexico. Mexican GDP growth was 4.6 percent in 1998, reflecting relatively strong employment and wage gains, high levels of foreign direct investment, and robust non-oil export growth. Looking ahead, inflation remains a concern. At the end of 1998, the inflation rate was 18.7 percent, up from a low of 15 percent in the middle of the year. The ***Blue Chip Economic Indicators*** consensus forecast calls for real GDP growth of 2.9 percent during 1999, down from 4.6 percent in 1998.

Western Europe. Europe's problems are similar to those of the United States in that they stem from declining growth in manufacturing exports. Despite a 175 basis point cut in short-term interest rates in the U.K. since October 1998, the Bank of England forecasts economic growth of less than 1.0 percent in 1999. In Germany, manufacturing activity has also decreased, owing to weakness in export markets. German GDP shrank by 0.4 percent during the fourth quarter of 1998, while unemployment remains above 10 percent. In response to signs of growing weakness in Germany and other major economies in the 11-member "Euro-zone," the European Central Bank cut short-term interest rates by 50 basis points to 2.5 percent on April 8, 1999.

Eastern Europe. Much of Eastern Europe is faced with slow growth or recession following the devaluation of the ruble and the default on Russian government debt in August 1998. The Russian economy shows few signs of recovery amid high inflation and halting progress in economic reform. Poland and Hungary, Eastern Europe's engines of growth before the Russian crisis, are facing rising current account deficits and a slowdown in export growth.

Asian Pacific Rim. The Japanese economy remains mired in a long-running recession that has resulted in a greater number of bankruptcies (up 17 percent in 1998), falling domestic demand, and pessimism among consumers and businesses alike. Japanese GDP fell by 2.8 percent during 1998, and analysts call for a drop of 0.8 percent in 1999.

There are signs that the worst phase of the Asian economic crisis may have passed.[3] In the Philippines, South Korea, Hong Kong, and Thailand, current accounts have moved from deficit to surplus as devalued currencies continue to depress imports. Foreign capital is returning to the region, as evidenced by the 27 percent increase in foreign direct investment in Korea during 1998. However, weak consumer spending remains a problem for the entire region, which ships fully 40 percent of all exports to other Asian Pacific Rim nations.

In China, which has been relatively immune to the worst of the region's economic crisis, slower growth is also forcing economic restructuring. With annual economic growth below the targeted 8 percent mark, economic planners have been forced to reduce production and close plants in the oil, steel, glass, and cement industries. Meanwhile, the government is trying to stimulate demand by investing in public infrastructure and by urging banks to increase lending to the private sector.

[3] See "The Asian Economic Crisis: Implications for the U.S. Economy," *Regional Outlook,* Third Quarter 1998. Also available at http://www.fdic.gov/publish/regout/ro19983q/ny/infocus1.html.

Latin America. With the apparent stabilization of the Asian economies, attention has now focused on emerging problems in Latin America. The 50 percent devaluation of the Brazilian *real* versus the dollar that began in January 1999 has depressed economic activity and renewed fears of inflation. Consensus estimates place Brazilian economic growth at negative 3.5 percent for 1999, while short-term interest rates are likely to remain high (currently about 42 percent) to prevent further capital flows out of the country.

Risks Remain despite a Positive U.S. Economic Outlook

Robust economic growth, low inflation, and stable interest rates appear to be the most likely economic scenario for the remainder of 1999, according to the consensus forecast of the ***Blue Chip Economic Indicators.*** If this outlook actually comes to pass, we can expect that the vast majority of insured institutions will continue to enjoy moderate loan growth and generally favorable indicators of financial performance and condition.

Despite this positive outlook, the risk remains that the expansion could be derailed by one of three types of shocks. The first would be a resurgence of inflation resulting from demand-induced shortages of labor or other key economic resources. Although inflation has been consistently low in recent years, investors remain on the lookout for any signs of higher prices. While it is not certain that a recession would result, it is worth noting that rising short-term interest rates in response to increasing inflation have preceded every recession during the past 40 years.

The second type of shock that could end the expansion is a sustained period of deflation. Concern about deflation arises from the low prices many commodity producers are receiving and the effects of foreign currency devaluations on U.S. import prices. Although these trends have helped to keep U.S. inflation and interest rates low, at some point they could impose a heavier burden on U.S. businesses by shrinking revenues and profit margins, mirroring what has already occurred in some commodity-based industries.[4]

The third type of shock is financial market instability. Consumer confidence, which has reflected recent increases in stock market wealth, could tumble in the event of a severe and prolonged decline in the stock market. Business investment has also depended on the support of strong and stable financial markets that offer firms access to capital on favorable terms and facilitate restructuring in troubled industries. A recession accompanied by financial market instability could pose a particular threat to bank loan performance because it would likely produce a disorderly shakeout of troubled firms marked by a rise in bankruptcies and loan defaults.

[4] See "How Will the Expansion End?" *Regional Outlook,* Second Quarter 1998. Also available at http://www.fdic.gov/publish/regout/ro19982q/sf/infocus2.html.

Trends Affecting Banking Lines of Business

Overview

Trends in bank and thrift lines of business align closely with those of the economy. Most insured institutions have prospered during this economic expansion, as shown by the industry's continuing earnings growth, strong capital levels, and improving or stable loan performance across most major loan categories. Likewise, today's strong economy depends to a great extent on the continuing availability of consumer and business credit from banks and thrifts. Even during the closing months of 1998, when capital market funding sources became quite volatile, credit continued to flow from insured institutions. During that turbulent period, insured institutions may have acted as a stabilizing force for businesses, consumers, and farmers by continuing to provide credit, albeit at higher prices and with stricter underwriting terms in some cases.

Although credit conditions appear strong, a number of insured institutions' loan portfolios are shifting toward a riskier mix of credits. Underlying reasons for these shifts vary, but likely explanations include opportunities to earn higher yields and confidence about the overall economic outlook. The following paragraphs discuss credit risk trends and highlight possible areas of concern in the major lending lines of business at insured institutions. The influence of recent interest rate changes and competitive factors on asset/liability and credit risk management is also explored.

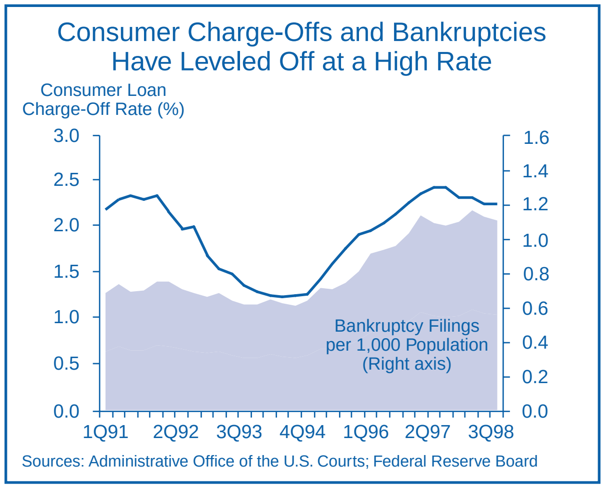
Consumer Lending

Debt Growth Sustains Consumer Spending but Could Contribute to Financial Strains under Less Favorable Economic Conditions

Much of the strength and stability of the overall U.S. economy owes itself to the continuing growth in consumer spending. While higher personal incomes and consumer confidence are important contributing factors, lower interest rates and expanding avenues of credit access have also played key roles in supporting consumer spending. With mortgage debt leading the way, consumer loan growth rates accelerated in 1998. The key factor driving mortgage loan growth was lower interest rates, which encouraged many consumers to purchase homes, refinance existing mortgages, and consolidate their personal debts through home equity loans. As a result, the growth in home mortgage credit during 1998 reached a post-recession high of 10 percent. Other consumer loan types, such as auto and credit card debt, grew at slower but accelerating rates of 8 percent and 5 percent, respectively.

Nonmortgage consumer loan loss rates remain above previous recession levels despite the apparent strength of the consumer sector. Chart 5 shows that nonmortgage consumer loss rates have declined slightly from their peak in the fourth quarter of 1997, but remain above the rates experienced during the prior recession. The chart also shows that consumer credit loss rate trends are closely related to the rise in personal bankruptcy filings, which reached an all-time high of 1.4 million in 1998.[5] The good news for consumer lenders is that the growth rate in personal bankruptcies has slowed. However, this leveling off does not mean that consumer credit quality concerns have abated. The overriding concern is how personal bankruptcies and consumer credit losses, already at high levels, would be affected by less favorable economic conditions. Another concern is whether current consumer spending patterns will be supported by a new round of credit card growth. Since revolving credit card balances typically carry higher interest rates than home equity loans, this "reloading" of credit card debt would further strain the financial flexibility of consumers.

CHART 5



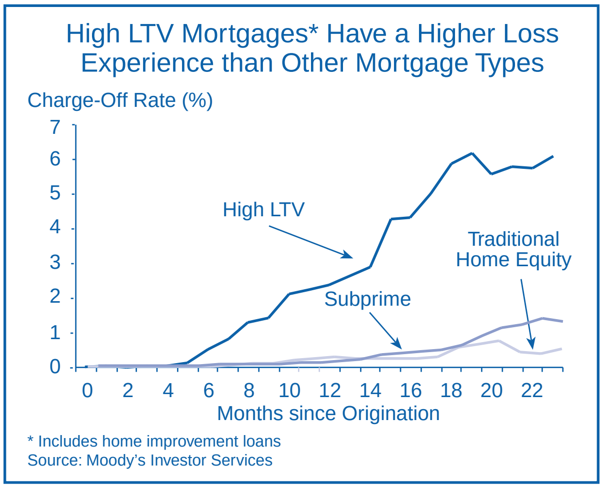
High Loan-to-Value Mortgage Products and Subprime Lending Transform Consumer Lending

Consumer lending practices have changed significantly since the last recession. Because of intense competition and declining net interest margins, consumer lenders are reaching out to borrowers further down the credit quality spectrum and relaxing traditional collateral requirements. Bank supervisors have indicated that a growing number of insured institutions are involved in some form of subprime lending. Subprime loans, designed for borrowers with blemished or limited credit histories, can take a variety of forms, including home equity, automobile, and credit card loans. As compensation for increased risk, subprime loans carry higher interest rates than prime-rate loans and often require substantial collateral margins.

Insured institutions are also embracing another relatively new consumer loan product: high loan-to-value (LTV) loans. High LTV loans, where the combined amount of senior and junior liens against a home exceeds its value, are usually made to borrowers with "clean" or unblemished credit histories. However, the lack of collateral protection results in much higher loss experience when a borrower defaults. As Chart 6 shows, high LTV loans have had a higher loss rate experience (adjusted for seasoning) than either traditional home equity loans or subprime loans. Moreover, the delinquency rates on recent-vintage home equity loan pools

[5] Reasons for the rise in personal bankruptcy rates are further explored in a series of ***Bank Trends*** articles published by the FDIC. See, for example, "A Time Series Model of the U.S. Personal Bankruptcy Rate, 1970-1996," February 1998, and "The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-Offs, and Personal Bankruptcy Filings," March 1998. Both reports can be accessed at www.fdic.gov/publish/bktrnds/index.html.

CHART 6



have deteriorated as high LTV loans have proliferated.[6] At the same time, recent regulatory surveys of credit underwriting practices show easing standards on home equity loans.[7] The loss experience of these higher risk consumer products during less favorable economic circumstances is unknown and continues to be a concern.

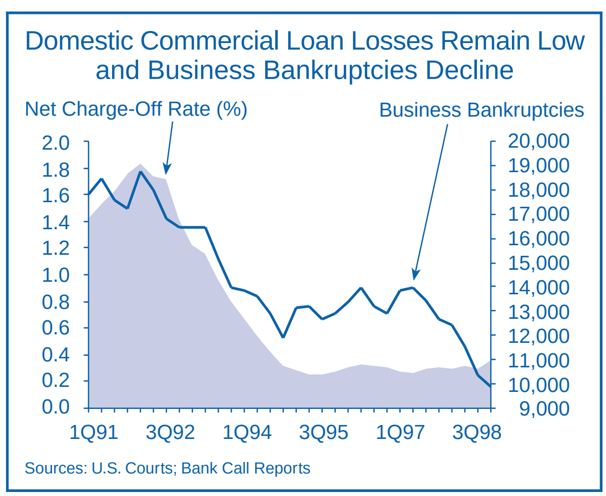
Commercial Lending

Commercial Loan Performance Remains Strong but Corporate Financial Strains Are Developing

Continued strength in the corporate sector is reflected in the level of corporate bankruptcy filings, which have declined since the middle of 1997 to just under 10,000 in the fourth quarter of 1998. Bank losses on commercial credits remain low but did register a modest increase during the fourth quarter (see Chart 7). In addition to strong economic fundamentals in high tech, construction, finance, service-related, and other sectors, U.S. businesses have benefited from significantly lower interest rates and an abundant supply of credit. Credit access provided by banks was particularly important to U.S. businesses in the latter part of 1998. During this period, sharply higher interest rate spreads on corporate bonds[8] and commercial paper led many companies to tap cheaper funding sources, including existing unused credit and commercial paper lines held by commercial banks. As a result, commercial banks experienced a 15 percent (annualized) rate of growth in fourth quarter 1998, the highest rate of commercial loan growth in 16 years.

Although commercial loan loss rates are low, financial strains are becoming apparent among certain U.S. business sectors. Bank lending to U.S. businesses has grown at a faster pace than GDP during each of the past eight quarters. Moreover, growth in bank commercial lending through 1998 has come at a time when total after-tax U.S. corporate profits have begun to decline.[9] Deteriorating profits are especially prevalent in sectors with exposure to weak commodity prices and slower export growth. For many businesses, lower profits have resulted in a reduced capacity to service outstanding debt obligations. For instance, a recent ***Bank of America Corporation*** study reported that amendments to syndicated loans in the latter half of 1998 were driven increasingly by borrowers seeking relief from financial performance-related covenants.[10] Financial strains are

CHART 7



[6] "Moody's Home Equity Index Update." *Moody's Investor Services*, October 2, 1998, p. 3.

[7] For example, the ***Office of the Comptroller of the Currency's*** "1998 Survey of Credit Underwriting Practices" indicated that 33 percent of the banks offering home equity loans eased standards, compared with only 7 percent that tightened standards. The report is available at http://www.occ.treas.gov/cusurvey/scup98.pdf.

[8] ***The Merrill Lynch U.S. Investment Grade Corporate Bond Master Index*** indicates that corporate bond spreads over ten-year Treasury rates rose 58 percent, an increase of 63 basis points, from the end of July 1998 to the end of October 1998.

[9] See the ***Bureau of Economic Analysis Corporate Profit Index.***

[10] "Covenants Provide Loan Repricing Opportunity." *Bank of America Report*, January 25, 1999.

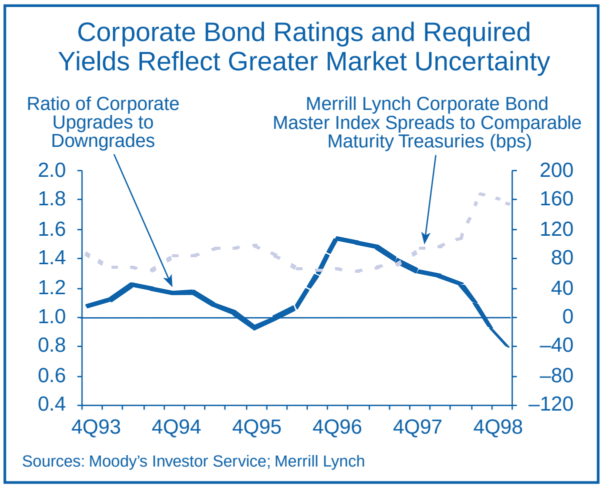
also reflected in the level of corporate bond defaults, which ***Standard and Poor's*** reported at 48 ($10.8 billion in affected debt) in 1998, up 182 percent from 1997 levels (up 150 percent in dollar volume terms).[11]

As Debt Markets Become More Cautious, Syndicated Lending Shifts toward Higher Risk Borrowers

Although the longer-term trend has been toward more aggressive corporate lending strategies, many insured institutions responded to the financial market turmoil in late 1998 with a heightened sense of caution. Recent surveys of underwriting practices conducted by the federal banking agencies show that many banks tightened standards in late 1998 across many product lines.[12] However, tighter lending terms do not appear to have quelled either loan demand or loan production substantially.

Syndicated lending trends suggest an increase in corporate lending risks.[13] Despite the flight to quality that occurred in the latter part of 1998, syndicated loans to leveraged companies jumped 41 percent to $273 billion during 1998. Over the same period, nonleveraged loans declined 35 percent to $599 billion. Although corporate merger activity accounts for much of the increase in leveraged lending volume in 1998, some lenders appear to be taking advantage of the higher yields available in this market relative to yields on lower risk credits. The apparent shift toward a higher risk mix of total syndicated credit outstanding is occurring at the same time that corporate bond defaults for speculative grade issues are trending upward.[14] Moreover, trends in corporate bond spreads and rating agency actions on corporate bond debt suggest a bond market that is becoming increasingly cautious about the outlook for U.S. businesses (see Chart 8).

CHART 8



Commercial Real Estate and Construction Lending

Construction Loan Growth Accelerates as Overbuilding Pressures Increase in Certain Markets

In 1998, the value of private commercial construction rose 4.0 percent over 1997 levels, reflecting a moderate slowdown in growth compared with a compounded average annual growth rate of 8.4 percent since 1992. In contrast, the pace of residential development has accelerated. The value of private residential construction rose 11.5 percent in 1998, compared with an annual average growth rate of 8.0 percent since 1992. Construction loans at insured institutions grew 20 percent in 1998, the highest growth rate since 1986.[15]

Although market fundamentals are strong throughout most major U.S. markets, some metropolitan areas appear to be vulnerable to an oversupply of commercial space. The ***Regional Outlook***, First Quarter 1999, highlighted nine markets that may be susceptible to commercial overbuilding on the basis of the following factors: 1) the rapid pace of current construction activity in those markets; 2) high vacancy rates relative to construction in progress in some cases; 3) projections of rising vacancy rates by market analysts; and 4) various recent shifts in demand indicators. Data through June 1998 indicate that construction activity in these markets

[11] "Corporate Defaults Rise Sharply in 1998," ***Standard & Poor's,*** March 5, 1998.

[12] See ***Federal Reserve Board*** Senior Loan Officer Opinion Surveys for November 1998 and January 1999, http://www.bog.frb.fed.us/boarddocs/snloansurvey/.

[13] Syndicated loans are credit facilities made to medium and large corporate borrowers by a group or syndicate of lenders. Analysts often segment this market into "leveraged" lending (loans to heavily indebted companies) and nonleveraged lending.

[14] ***Moody's Investor Services*** reports that trailing 12-month default rates for speculative-grade issuers rose from 2.02 percent at the end of 1997 to 3.31 percent at year-end 1998. These default rates compare to an all-corporate trailing default rate of 0.68 percent in 1997 and 1.27 percent in 1998.

[15] Construction loan growth captures growth in both residential and nonresidential development.

has not yet abated to reflect moderating demand levels.[16] Overbuilding concerns may be tempered to the extent that tighter commercial real estate lending standards slow the pace of development.[17]

Loan Underwriting Study Reveals Sounder Practices Compared with the 1980s, but Intense Competition Forces Some Concessions on Pricing and Structure

Beginning in August 1998, FDIC analysts set out to investigate construction loan underwriting practices in banks servicing various rapidly growing markets. The study identified several differences between today's lending practices and those prevalent during the last cycle. Most importantly, today's lenders are making credit decisions on the basis of improved appraisals, increased attention to project cash flows and project feasibility, and better market information on competing projects. However, intense competition has forced an across-the-board reduction in loan pricing margins even compared with margins at the height of the 1980s building boom.

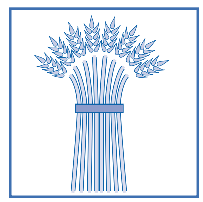
The study also identified some instances of aggressive loan structures, including pricing at extremely thin margins, waiving or limiting personal guarantees, waiving cash equity requirements, and lending on thin collateral margins. Borrowers who secured the most aggressive loan terms were typically larger developers, who presumably have the resources and financial flexibility to weather adverse conditions. Nevertheless, waiving personal guarantees and eliminating a borrower's financial exposure to project risks are practices often cited in conjunction with the heavy construction loan losses experienced during the previous real estate downturn. Finally, the study found that many real estate investment trusts and large corporate developers have been able to obtain long-term unsecured financing for development purposes. The lack of collateral protection could make these loans particularly vulnerable to declining commercial real estate prices.[18]

Agricultural Lending

Farm Banks Threatened by Falling Commodity Prices

Farm banks generally performed well in 1998, reporting a modest increase in nonperforming loans from 1.09 percent at year-end 1997 to 1.13 percent as of year-end 1998. Although delinquent loans rose only slightly in the aggregate, farm banks in some localized areas such as northeast North Dakota and northwest Minnesota experienced sharply higher problem loan levels and reduced profits in the aftermath of three consecutive years of low prices, bad weather, and crop disease-related problems. Moreover, recent surveys by the federal banking agencies, which show rising levels of farm carryover debt at farm banks, suggest that nonperforming loan data may understate borrower difficulties.

During 1998, the outlook for significant portions of the farm sector deteriorated following a dramatic fall in prices for several major farm commodities. Prices for wheat, corn, soybeans, and hogs fell to ten-year lows and were below the economic breakeven cost of production for many producers. For areas heavily dependent on these commodities, the ***U.S. Department of Agriculture*** (USDA) projects that producers will experience substantial declines in net cash income from 1999 through 2003.[19] In 1999, the USDA projects farm income to fall 7.1 percent, to $44.6 billion, from last year's level of $48 billion.



Although current conditions have the potential to cause stress for substantial numbers of farm banks in certain regions, some significant differences exist between today's circumstances and those that led to the farm

[16] The nine markets are Atlanta, Charlotte, Dallas, Las Vegas, Nashville, Orlando, Phoenix, Portland, and Salt Lake City. "Commercial Development Still Hot in Some Markets but Slower Development May Be Ahead." *Regional Outlook,* First Quarter 1999, www.fdic.gov/publish/regout/ro19991q/na/index.html.

[17] Consistent with commercial and industrial underwriting trends, commercial real estate lenders reacted to market volatility in late 1998 by tightening loan terms and raising pricing margins. See, for example, the Federal Reserve Board Senior Loan Officer Opinion Survey for November 1998 and January 1999.

[18] Loan covenants may mitigate some of the risks of lending without collateral protection. Common covenants include maximum leverage ratios, minimum equity requirements, and limits on encumbered assets through recourse or cross-collateralization to third parties.

[19] A substantial portion of the ***USDA's*** projected decline in the net cash income for U.S. farmers over the next five years is attributable to reductions in government payments to farmers.

bank crisis of the mid-1980s. Current favorable factors include 1) lower debt-to-equity for farm producers; 2) substantially lower interest rates; 3) moderately appreciating farmland prices relative to the more rapid appreciation (and subsequent price corrections that followed) in the 1970s and 1980s; and 4) better underwriting practices by farm lenders. Nevertheless, if weak exports of farm products and low commodity prices continue for the remainder of this year, the condition of farmers could deteriorate significantly, increasing financial stress at insured farm banks.

Funding and Interest Rate Risk

Deposit Funding Becomes More Difficult to Obtain

Competitive pressures in the banking industry are not restricted to lending. Insured institutions are also finding it difficult to attract deposits in today's marketplace, largely because of the existence of higher yielding investment products. For example, the ***Investment Company Institute*** reports that net inflows into mutual funds have exceeded net increases in deposit accounts in all but three quarters since mid-1991. The fourth quarter of 1998 marked the sixteenth consecutive quarter that mutual fund inflows outstripped deposit increases. As deposits have become more difficult to attract, loan portfolios have expanded in line with the overall growth in the economy. As a result, institutions have turned increasingly to other borrowings for funding. These trends are captured in Chart 9, which shows that the ratio of bank and thrift loans to deposits reached a record 88 percent in December 1998. Small community banks and thrifts (institutions with less than $1 billion in assets) are most affected by deposit trends, since they tend to rely more heavily on deposit funding than larger institutions with greater access to the capital markets.

Interest Rate Changes Pose Asset/Liability Management Challenges

Interest margin pressures are posing challenges for insured institutions. In addition to the effect of competitive pressures, changes in interest rates have had a substantial influence on institutions' net interest margins. The flattening of the yield curve in 1998, for example, appears to have contributed to a decline in margins to their lowest levels since 1991 for both large and small insured institutions (see Chart 10). For insured institutions with more traditional asset/liability structures (longer-term asset holdings funded with shorter-term deposits and borrowings), a flatter yield curve results in lower spreads between asset yields and interest costs.

The decline in long-term interest rates during 1998 also led to a record volume of mortgage refinance activity, as indicated by the ***Mortgage Bankers Association's Refinancing Index.***[20] Among many mortgage lenders, the most immediate impact from this refinancing activity was the revaluation of servicing assets and lower servicing fee income. Some mortgage lenders also saw a significant increase in overhead as they expanded staff to accommodate higher loan application volumes. A

[20] This index hit its peak in mid-October and has since declined in line with a modest upward movement in fixed mortgage rates.

CHART 9

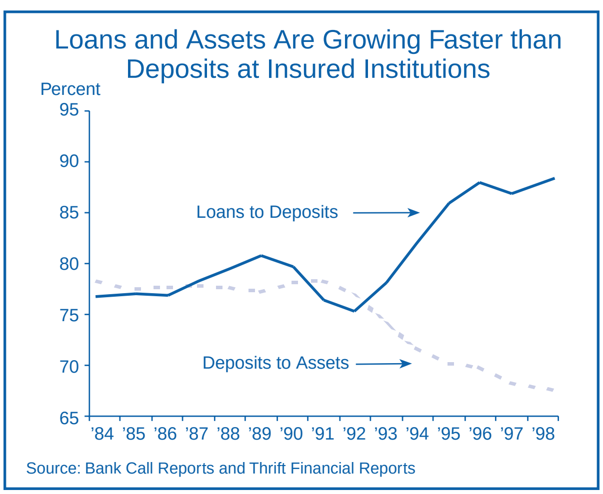
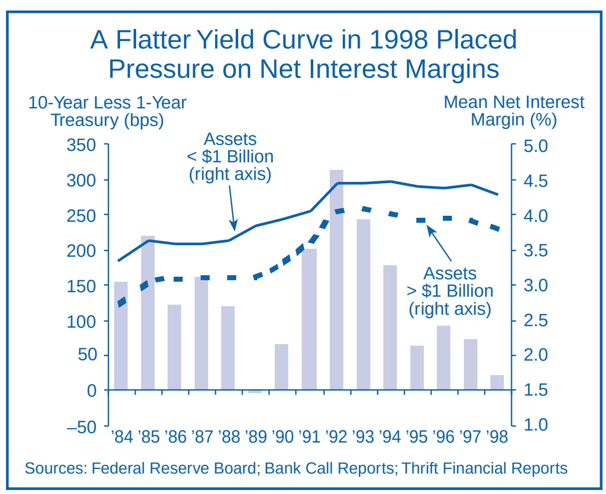


CHART 10



longer-lasting impact involves the shift in borrower preferences toward fixed-rate mortgages. According to ***Freddie Mac,*** approximately 65 percent of adjustable-rate mortgages refinanced in 1998 were replaced with 30-year fixed-rate mortgages. Another 30 percent were refinanced into 15- and 20-year fixed-rate mortgages. As a result of this activity, mortgage lenders may tend to have a higher proportion of assets held in longer-term mortgage loans, leading to further margin pressures should interest rates rise.

As discussed in previous sections, many insured institutions appear to be turning toward higher risk consumer and corporate lending strategies. Such strategic shifts may be at least partially in response to pressures on net interest margins. The search for higher yield spreads may also explain the continuing growth in nondeposit funding sources, which often take the form of complex obligations with embedded options that can reduce funding costs at the expense of additional interest rate risk.

Indicators of Industry Performance

Market Signals for the Banking Industry Are Mixed

Diminished concerns over the near-term economic outlook and reduced financial market volatility resulted in a sharp turnaround in investor attitudes toward banks in the fourth quarter of 1998. During the quarter, the ***SNL Bank Stock Index***[21] rose 21 percent, recovering all of the value it lost during the turmoil of the third quarter. The index has continued to rise in 1999.

Although equity indicators have been generally positive, ratings actions in 1998 for the long-term debt of U.S. banks and finance companies reflect developing problems for certain industry segments. In sharp contrast to the previous six years, when upgrades far exceeded downgrades, ***Moody's*** downgraded as many bank and finance company debt ratings as it upgraded during 1998. In the fourth quarter of 1998, Moody's downgraded the long-term debt ratings of 27 bank and finance companies and upgraded only 15—the highest quarterly ratio of downgrades to upgrades since 1992. Downgrades during 1998 were centered in finance companies specializing in nonportfolio subprime lending and bank holding companies with exposure to emerging markets.

Bank Performance Remains Strong but Earnings Variability Is Increasing

Recent stable industry profitability in the aggregate has masked an increasing range of profit variability for individual commercial banks. Over the past six years, the annual aggregate return on average assets (ROA) for commercial banks has shown little fluctuation, ranging from a low of 1.15 percent in 1994 to a high of 1.24 percent in 1997.[22] However, the variability in commercial bank profitability, as measured by the distribution of the industry's ROA excluding the top and bottom 5 percent, has widened since 1994 (see Chart 11). For example, ROA for the worst 5 percent of the industry was negative 0.29 percent or less in 1998, reflecting a steady decline from 0.2 percent in 1995. Similarly, ROA for the most profitable 5 percent of commercial banks was above 2.16 percent, up from 1.94 percent in 1994.

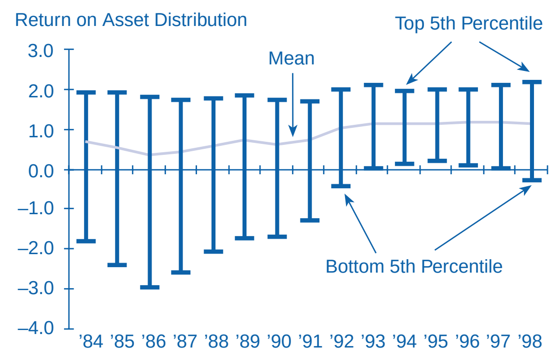
Reasons for the increasing variability of commercial bank ROA can be further analyzed by segregating institutions along predominant product or business lines. Chart 12 (next page) details the distribution of 1998

[21] This index tracks the market capitalization of approximately 520 banking companies.

[22] *FDIC Quarterly Banking Profile,* Fourth Quarter 1998, www2.fdic.gov/qbp.

CHART 11

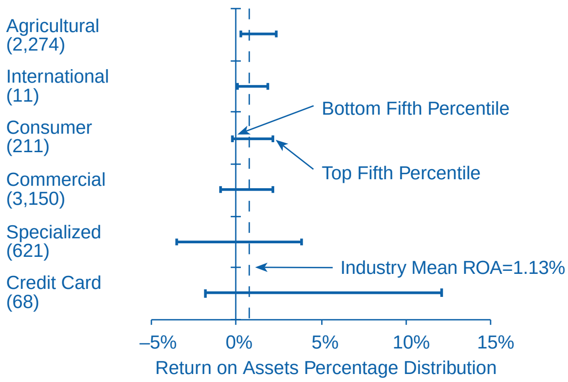
The Range of Profitability for Commercial Banks Is Increasing



Source: Bank Call Reports

CHART 12

1998 Performance Varies by Business Specialization



Note: Group institution count is in parentheses.
Source: Bank Call Reports (Research Information System)

ROA for six selected groups of banks segregated by line of business concentrations. This chart reveals that bank performance varies considerably by business specialty. For example, the distribution of ROA of credit card lenders[23] differs significantly from that of other bank groups, including other consumer lenders.[24] Small specialized banks[25] and commercial lenders[26] followed credit card lenders as the groups with the greatest variability in profitability in 1998. Moreover, 75 percent of the least profitable commercial banks were members of small specialized or commercial groups. New banks have also influenced the dispersion of bank ROA. Banks chartered in 1997 and 1998 make up more than 60 percent of the industry's worst performers. However, earnings variability widened in 1998 even when newer institutions are excluded from the analysis.

[23] Banks with at least 50 percent of managed loans in managed credit card receivables and at least 50 percent of managed loans in total managed assets.

[24] Banks with consumer loans and single-family mortgages in excess of 50 percent of assets that do not meet separate credit card or mortgage lending concentration thresholds.

[25] Banks with total assets less than $1 billion, and less than 40 percent of assets held in loans, that do not fall in other business specialties. Members of this group include *de novo* banks and more seasoned banks with low loan activity, such as trust companies.

[26] Banks with 25 percent or more of assets in commercial and commercial real estate loans.

Far fewer commercial banks posted losses in 1998 than during the period from 1984 to 1992. Still, the number of unprofitable institutions appears to be rising despite generally favorable economic conditions. These concerns are mitigated somewhat, since today's worst-performing institutions are generally much better capitalized and are burdened with fewer problem assets than their counterparts during the 1980s.

Summary

Most indicators of U.S. economic health remain robust in spite of the difficulties posed by low commodity prices and falling exports during 1998. The consensus forecast of leading economic analysts calls for continued growth in the U.S. economy for the rest of 1999. At the same time, a number of threats to this favorable outlook exist, including the possibility of higher inflation and higher interest rates stemming from strong economic growth. Other scenarios involve a very different threat—namely, price deflation brought on by global overcapacity and a decline in U.S. exports. Shocks that might arise in the foreign sector or in the financial markets, as experienced during 1998, remain a significant concern during 1999. Consumer spending and business investment seem particularly vulnerable to such shocks at this stage of the expansion.

Favorable economic conditions are reflected in the overall performance of the banking industry. Still, a number of indicators suggest that the risk profile of some insured institutions is increasing. Responding to significant competitive pressures, and perhaps emboldened by the long duration of the current expansion, many institutions are expanding their involvement in higher-risk consumer loan products, such as subprime and high LTV loans and higher-risk leveraged commercial loans. The overall shift toward higher-risk credits is occurring despite signs of financial strain on the part of many consumers (in the form of record personal bankruptcies) and businesses (in the form of declining profits and increasing bond default rates). Credit-related concerns also extend to commercial real estate, where some markets are exhibiting rapid commercial real estate development at the same time that demand indicators are trending downward. Finally, sustained weak commodity prices are placing strains on farmers and could eventually lead to higher agricultural loan delinquencies.

Bank and thrift net interest margins are being pressured by a flatter yield curve and heightened competition. Community institutions, which rely most heavily on interest income, are particularly vulnerable to tighter margins. The major concern in this area is that insured institutions will combat falling margins by entering into riskier funding and lending strategies.

Market indicators and reported financial data reflect favorable industry performance as well as new sources of risk. Investor attitudes toward banking companies have improved since late 1998 because of an improved near-term economic outlook and a reduction in financial market volatility. However, a recent increase in ratings downgrades of bank and finance company long-term debt suggests growing concern over bank exposures to such areas as subprime lending and emerging markets. Despite relatively strong aggregate industry performance, profit variability among individual commercial banks has increased because of new chartering activity and pressures in consumer and commercial lending. As a result, for the first time since 1992, the worst performing 5 percent of all commercial banks were unprofitable last year.

This article was prepared and coordinated by the staff of the Analysis Branch of the Division of Insurance. Contributions and feedback from analysts across the Division were essential to its completion.

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Regional Perspectives

- **Atlanta Region economic growth continued to outpace that of the nation into early 1999.**

- **Atlanta Region commercial bank and thrift returns remained reasonably strong in the fourth quarter, but earnings momentum may be slowing.**

- **Several banks in the Region with significant consumer loan exposure are located in or near counties with high rates of personal bankruptcy, and this situation could imply higher credit risk for some institutions should the economy weaken.**

Atlanta Region Economic Growth Continues to Outpace That of the Nation

Economic growth in the Atlanta Region and the nation remains strong, especially given the age of the current expansion. In February 1999, the current expansion, at 95 months, became the second-longest since World War II, according to the ***National Bureau of Economic Research.*** The longest expansion, 105 months, occurred in the 1960s. By comparison, expansion in the 1980s endured for 91 months. The current period of growth has been fueled by several factors, including low interest rates and inflation, strong real income growth, and sustained high levels of consumer confidence. Furthermore, economic growth in the Atlanta Region continues to outpace national performance. Employment in the Region in February 1999 was up 3.1 percent from one year earlier, compared with 2.2 percent growth nationwide. Nonetheless, growth may have moderated slightly after reaching a peak during the summer of 1998, when year-over-year job growth in the Atlanta Region and the nation measured 3.7 percent and 2.7 percent, respectively.

Bank Performance Remained Strong in the Fourth Quarter, but Earnings Momentum May Be Slowing

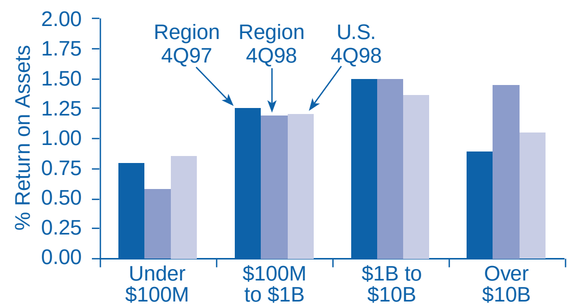
The Atlanta Region commercial bank return on assets (ROA) of 1.40 percent in the fourth quarter of 1998 comfortably outpaced the national average of 1.11 percent. Four states—**Georgia, North Carolina, South Carolina,** and **Virginia**—reported above-average returns in the quarter, while **Alabama, Florida,** and **West Virginia** lagged behind their regional and national peers.

The gap between large and small bank performance widened in the fourth quarter. Large banks (assets over $1 billion) benefited from noninterest income gains, lower reserve provisions, and profitable credit card banking operations. Meanwhile, small banks (assets under $1 billion), which account for 95 percent of the Region's institutions, continued to be hurt by declining net interest margins and limited fee income production. Banks in the Atlanta Region had limited direct exposure to the troubled foreign markets that led to trading losses and asset write-downs for some of the industry's largest institutions in the second half of 1998. Chart 1 illustrates Atlanta Region bank returns by asset size.

Although performance remains strong overall, earnings momentum may be slowing. The percentage of unprof-

CHART 1

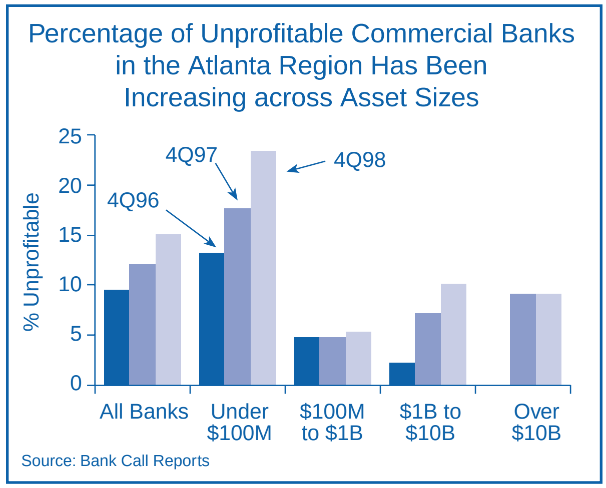
Atlanta Region Large Banks Outperformed the Nation in the Fourth Quarter of 1998, While Small Bank Returns Lagged behind National and Year-Ago Levels



Source: Bank Call Reports

itable commercial banks in the Atlanta Region has been edging higher on a comparative-quarter basis over the past three years. In the fourth quarter of 1998, 15 percent of the Region's banks were unprofitable, versus 12 percent in the fourth quarter of 1997 and 9.5 percent in 1996. As seen in Chart 2, the upward trend in unprofitable institutions has been consistent across asset sizes, although the constraining factors differ for large and small banks. The ratio of unprofitable small banks has been influenced by heavy *de novo* activity, as more than half of the unprofitable institutions with assets under $100 million in the fourth quarter of 1998 were chartered within the past three years. Conversely, unprofitable banks with assets over $1 billion generally have been affected by restructuring and merger-related expenses.

CHART 2



The Region's thrift sector also showed signs of slowing earnings in the second half of 1998. Savings institutions reported an aggregate fourth-quarter ROA of 0.54 percent, down from 0.63 percent a year ago and below the national level of 0.76 percent. In fact, the group's fourth-quarter return was the lowest since the Savings Association Insurance Fund (SAIF) recapitalization charge in the third quarter of 1996. Results were weaker in part because of restructuring charges at some large thrifts, while declining interest spreads continued to weigh heavily on the entire sector. About 13 percent of the Region's thrifts were unprofitable in the fourth quarter, up slightly from 12.5 percent one year earlier.

A review of full-year 1998 earnings for Atlanta Region insured bank and thrift institutions (excluding *de novos* chartered in the past three years) found that only about 40 percent reported a higher ROA in 1998 than in 1997, whereas 58 percent reported a lower return, and 2 percent reported no change. Despite an apparent earnings slowdown, however, the condition of banks and thrifts in the Atlanta Region remains strong. As discussed below, institutions in most states enjoy reasonably strong earnings and low levels of delinquent and charged-off loans. Concentrated lending exposures, for the most part, remain confined to real estate construction and development funding in metropolitan **Atlanta** and agricultural lending in southern Georgia and Alabama. Consumer loan allocations also are above average in parts of Georgia, Alabama, and the Virginias (see ***Emerging Consumer Credit Risk Could Affect Insured Institutions in the Atlanta Region***).

Alabama banks rebounded from a weaker third quarter to report a fourth-quarter 1998 ROA of 1.07 percent. However, a lower net interest margin and higher overhead costs held the aggregate return below the year-ago level of 1.21 percent.

Real estate and commercial loans have increased as a percentage of assets over the past year at banks with assets over $1 billion, while smaller institutions report slightly lower levels of real estate loans and a higher allocation to the consumer sector. The rising share of real estate loans is not entirely surprising, given Alabama's stable economic growth and increases in construction activity. Commercial construction in the state through the third quarter of 1998 stood at 8.4 million square feet, which was higher than the total for 1997. The largest share of building is occurring in the **Birmingham, Huntsville,** and **Montgomery** metropolitan areas. **Dothan** and **Decatur** have seen gains in commercial construction activity as well.

Asset quality at Alabama's commercial banks remains strong, although small bank delinquencies and charge-offs have risen in recent quarters as a result of continued pressure on the state's agriculture, pulp and paper, and apparel industries. Agriculture's performance was mixed during 1998, as a string of severe weather patterns resulted in substantial crop damage. Most heavily damaged was the state's corn crop, which, at 12.6 million bushels, was 42 percent smaller than in 1997. The agricultural outlook for 1999 remains relatively dim, as market prices for some of the state's primary commodities are well below year-ago levels, and the ***U.S. Department***

of Agriculture projects continued price weakness. Active consumer lending by some small banks in counties with high personal bankruptcy rates also may have contributed to the increase in loan delinquencies and charge-offs.

Alabama's thrift sector performed well in 1998. Thrifts posted a fourth-quarter return of 0.81 percent, compared to 0.48 percent in the same period in 1997. Higher fee income and slightly lower provision expenses contributed to the improved performance. Loan composition at Alabama thrifts shifted moderately away from consumer loans and into real estate in the fourth quarter, following several quarters in which the consumer allocation had been increasing. Loan delinquencies declined in 1998, although the more severe noncurrent category (90+ days past due and nonaccrual) edged slightly higher. Reserve coverage of noncurrent loans has generally trended lower since mid-1997.

Banks in **Florida** reported a fourth-quarter 1998 ROA well above the 1997 level, but at 1.07 percent the return was the third-lowest in 12 quarters. Florida's banking landscape remains highly competitive, particularly with the recent acquisition of the state's largest bank by an out-of-state organization. A number of banks are aggressively entering Florida hoping to benefit from its strong economy and attract customers displaced by merger activity. Job growth in the state has risen by more than 3 percent annually since 1993, which is a figure well ahead of national performance. A strong state economy has led to increased *de novo* activity, and this activity has further intensified competition. Competitive pressures and a flattened yield curve contributed to a decline of 16 basis points in net interest margins of small banks from the fourth quarter of 1997 to the same period in 1998—a decline that was fully reflected in the group's ROA. Asset quality remains strong in the state, with delinquent loans reaching a three-year low in the fourth quarter.

Commercial lending is increasing in **Orlando, Miami, Jacksonville,** and **Tampa,** as strong growth continues in metropolitan areas. Orlando's theme parks are currently on their "biggest building binge since Walt Disney arrived," according to a recent article in the ***St. Petersburg Times.*** Office construction also has remained strong in the Orlando area, with over a half-million square feet of new space added to the market in the first half of 1998. Higher levels of construction also are evident in the growing Miami, Jacksonville, and Tampa markets.

Florida's thrifts reported a lower fourth-quarter ROA than in 1997, largely attributable to a lower net interest margin. The state's thrift net interest margin was the lowest in the Region in the fourth quarter of 1998 at only 2.90 percent, as asset yields lagged behind the regional average by 21 basis points. Twenty-six percent of Florida's thrifts were unprofitable in the fourth quarter of 1998—the highest level since the SAIF recapitalization charge in the third quarter of 1996. Asset quality measures remain strong, however, as Florida thrifts had the Region's lowest past-due loan ratio in the fourth quarter, 1.51 percent. Recently, Florida's thrifts have reduced their consumer loan allocation in favor of real estate and commercial credits, an action that is consistent with what banks have done in light of the state's vibrant economy.

Georgia's banking sector continues to benefit from a strong state economy, as evidenced by a fourth-quarter 1998 ROA of 1.42 percent. Large banks and credit card institutions contributed heavily to the strong return, although a number of unprofitable *de novos* held the small bank ROA below the year-ago level. Loan composition remained stable during the year, although small banks reported a slight shift from real estate to consumer loans. As discussed below, a number of Georgia banks with significant consumer loan exposure are located in areas that have high rates of personal bankruptcy, a situation that could imply higher credit risk.

Booming real estate markets around metropolitan **Atlanta** have resulted in construction and development lending exposure significantly above the national average for banks in that area. Commercial construction starts in metro Atlanta were up 8.6 percent through the third quarter of 1998 from one year earlier. Residential construction activity also saw strong gains in 1998, with total permit issuance rising more than 16 percent from the previous year.

Aside from real estate, several South Georgia institutions report above-average lending exposure to the troubled agricultural sector. Delinquent farm and farmland loans have increased sharply over the past two quarters for banks in that area as a result of depressed commodity prices, lower export demand, and severe weather damage to 1997 crops. Economic conditions throughout much of Georgia's farm belt have been worsened by continued losses in textile and apparel employment. Weakness in the agriculture and textile and apparel industries is reflected in the **Albany** metropolitan area, where employment fell 0.4 percent in 1998.

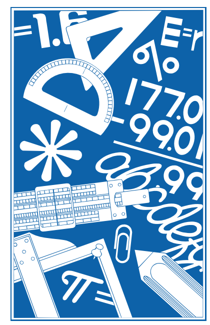
Georgia's fourth-quarter thrift ROA improved to 0.59 percent in 1998 from 0.04 percent in 1997 as a result of sharply lower overhead spending. In fact, overhead ratios in the third and fourth quarters of 1998 were the lowest in 12 quarters for the group. This fact helped offset continued declines in the net interest margin. Loan delinquencies increased from a year ago, although the noncurrent portion moderated somewhat. Loan composition at Georgia's thrifts shifted away from the consumer and commercial sectors and toward real estate-backed products in 1998.

North Carolina banks, led by large Regional and super-Regional organizations, reported a strong 1.53 percent fourth-quarter ROA. Aggressive acquisition activity has solidified North Carolina's position as one of the nation's premier banking centers, with over $650 billion in assets at year end. The state's banking sector is quite concentrated, however, with 4 banks holding 95 percent of the assets and 63 banks controlling the remaining 5 percent. As a result, aggregate data are not always representative of the majority of North Carolina banks. For example, institutions in the state with assets under $100 million reported an ROA of –1.07 percent in the fourth quarter of 1998. This negative return does not necessarily reflect poor operating performance, but rather a high concentration of *de novo* banks that have not yet achieved sustainable profitability. Of 16 banks in the state with assets under $100 million that were unprofitable in the fourth quarter, 14 had been open less than two years. The next-largest group of banks (assets between $100 million and $1 billion) fared better, with an ROA of 1.14 percent, but that was the group's lowest quarterly return in three years. A lower net interest margin and a slight drop in fee income accounted for the decline. Banks with assets over $1 billion reported stronger returns, primarily because of higher fee income and a more stable net interest margin relative to smaller banks.

North Carolina banks report few credit concentrations, although commercial loan growth has occurred as construction starts have risen in many markets. **Charlotte, Raleigh-Durham,** and **Greenville** are seeing the bulk of the state's construction activity. Although for the most part absorption has kept pace with new construction, pockets of overbuilding may be developing in some markets. If planned projects materialize, particularly in Charlotte and Raleigh-Durham, vacancy rates could rise.

North Carolina's thrift industry is the largest in the Atlanta Region and is nearly as large as the state's banking sector in terms of institutions. Higher overhead and a lower net interest margin reduced the group's ROA to 0.34 percent in the fourth quarter of 1998 from 0.86 percent a year ago. Fee income rose slightly during the year but still measured less than half of the regional thrift average in the fourth quarter, at 0.44 percent of earning assets. Asset quality measures remain very strong. Delinquencies were a modest 1.74 percent of loans at year-end, and charge-offs have not exceeded 0.05 percent of loans in the past nine quarters.

South Carolina banks posted a solid fourth-quarter ROA of 1.29 percent and continue to benefit from the state's growing economy. Job growth in the state reached 3.9 percent in 1998, pushing the unemployment rate down to 3.5 percent. Unlike most banks elsewhere in the Atlanta Region, South Carolina banks have seen only a modest decline in their net interest margin from one year ago. Moreover, banks in the state were able to expand fee income while holding overhead costs steady in 1998. Only banks with assets under $100 million reported a lower fourth-quarter return in 1998, as a result of margin compression and *de novo* activity. Asset quality remained very strong across asset sizes in the fourth quarter, with delinquencies well below the regional average.



South Carolina thrifts also are prospering, reporting the Region's highest ROA of 1.19 percent in the fourth quarter of 1998. The group continues to operate with high efficiency, as the overhead expense ratio has exceeded 3 percent only twice in the past 12 quarters. Also, like banks, thrifts in the state have been less affected by net interest margin compression than those in other states in the Region. Credit quality indicators remain strong and are little changed from a year ago.

Virginia banks performed well in the fourth quarter of 1998, posting an ROA of 1.41 percent. Credit card bank profitability contributed to the high return, while results were reduced somewhat by merger-related charges at the state's largest bank. Small banks reported the weakest quarterly return, at 0.52 percent; however, of 11 unprofitable banks in that category, 8 were *de novos* open less than one year.

Asset quality indicators remain strong across asset sizes. Credit concentrations remain relatively low, with moderate construction lending exposure in the **Norfolk** and **Northern Virginia** metropolitan markets as well as pockets of above-average consumer loan exposure in some central and western counties.

Virginia's thrifts posted a fourth-quarter return above the year-ago level, although still relatively weak at 0.44 percent. Performance has been hurt by poor results at the state's largest thrift, which primarily conducts operations outside the state. Asset quality measures are strong and have improved from a year ago. Robust economic activity has led to higher real estate and commercial loan allocations in recent quarters. The number of thrifts in the state declined in 1998 by 30 percent, from 28 to 20, as a result of merger and acquisition activity.

Fourth-quarter 1998 returns were lower at both large and small banks in **West Virginia,** as the aggregate ROA fell 77 basis points from 1997 to 0.52 percent. However, the measure was affected by a substantial quarterly loss at one large institution. The percentage of unprofitable banks in the state rose to 12 percent in the fourth quarter of 1998 from 5 percent one year earlier. Unlike most states in the Region where unprofitables reflect a number of *de novos,* only 3 of 11 unprofitable West Virginia banks in the fourth quarter were chartered within the past three years. Factors contributing to losses at some "seasoned" institutions included merger-related charges, asset write-downs, and loan charge-offs. Some commercial banks, mostly in the western half of the state, reported above-average loan exposure to the consumer sector where delinquencies and charge-offs have been increasing. Meanwhile, the state has the Region's lowest commercial loan portfolio allocation, a situation consistent with an overall rate of economic activity below that of the Region. In 1998, employment in the state rose 1.6 percent, a full percentage point below the national average.

West Virginia's thrift industry is small, with seven institutions comprising assets of less than $1 billion. The group's fourth-quarter ROA was essentially unchanged from a year earlier at 0.56 percent. Lower funding costs offset a decline in asset yields during the year, while net overhead expenses rose slightly. Past-due loans increased relative to total loans in 1998, although there was a slight decline in the level of severely delinquent loans.

Emerging Consumer Credit Risk Could Affect Insured Institutions in the Atlanta Region

Consumer spending accounts for two-thirds of the nation's economy. With the economy now entering an impressive ninth year of expansion, it is not surprising that consumer spending is at an all-time high. Consumer spending, however, has been increasing faster than gains in disposable income since 1996. In 1998, real personal consumer expenditures in the United States rose by 4.9 percent, compared with a 3.2 percent rise in disposable income. According to a ***Federal Reserve Bank of St. Louis*** report, the disparity between consumer spending and income helped push the U.S. household debt[1]-to-income ratio to its highest level ever in the first half of 1998. On the positive side, declining interest rates and a growing trend toward consolidating high-priced consumer debt into fixed low-rate mortgages have allowed consumers' overall debt-service burden to increase more slowly than their outstanding debt. Nonetheless, as households borrow more and save less, lenders become less protected by existing assets and current income, as well as increasingly dependent on future employment, income, and asset appreciation that can only be assured by a continued strong economy. Portfolios with a high volume of unsecured loans or advances to borrowers of marginal or subprime credit quality are particularly vulnerable.

The following section looks at consumer credit exposure at insured community banks[2] in the Atlanta Region. The FDIC defines a "consumer lender" as having a ratio of total consumer loans, including residential mortgages, to assets of 50 percent or more. However, given the risk differential between residential mortgages[3] (lower risk) and other consumer loans such as credit cards, auto loans, and other personal loans (higher risk),

[1] Household debt includes first and second mortgages, credit card balances, auto loans, and other loans for consumer purposes.

[2] Insured community banks include commercial banks headquartered in the Atlanta Region. For this analysis, credit card specialty banks and all institutions with assets over $1 billion were excluded, as their activities often extend well beyond Regional boundaries. *De novo* institutions open less than one year also were excluded.

[3] Recent evidence suggests that loss rates on subprime and high loan-to-value mortgages are higher than on traditional residential mortgages. However, these products cannot be discerned from Call Report data and are therefore not a focus of this analysis.

the following analysis focuses primarily on nonmortgage consumer loans.

Table 1 shows that consumer loans at insured commercial banks in the Atlanta Region have been falling relative to assets since 1995. Total consumer loans, including residential mortgages, declined from nearly 33 percent of assets in 1995 to less than 30 percent in 1998. However, the year-end level was still above the national average.

At the same time, nonmortgage consumer loans have fallen from over 11 percent of assets in the mid-1990s to around 9.5 percent in 1998. Atlanta Region institutions also remain comparatively more exposed to this segment than those of the nation as a whole. A few factors may help to explain the downward trend in the consumer portfolio allocation. First, the data in Table 1 exclude institutions with more than $1 billion of assets, as well as all credit card specialty lenders. Thus, the data ignore the potentially large consumer lending activity of 55 commercial banks and 11 credit card specialty banks headquartered in the Region. (The exclusion of these institutions was necessary because Call Reports do not collect geographic lending data, and the activities of these institutions extend well beyond Regional boundaries.) Second, the Region's continued strong economy has sustained high demand for larger and potentially more attractive real estate and commercial and industrial loans at many institutions. A third possible explanation may be that credit unions and nonbank finance companies are becoming increasingly competitive with insured institutions and may have captured some of the consumer market in recent years.

A 1998 nationwide survey[4] of household finances conducted by ***National Decision Systems, Inc.*** (NDS), summarized in Table 2 (page 23), found total household debt levels in the Atlanta Region to be less than the national average when measured as a percentage of household income. However, the survey also found that

[4] The household consumer finance survey is conducted annually by National Decision Systems, Encinitas, California. The survey addresses general household banking practices; borrowing habits (credit cards, mortgages, lines of credit, auto loans and leases, etc.); investable assets (checking and savings accounts, certificates of deposit, and other investments); insurance products; and household income and demographic information.

Table 1

Consumer Loans Are Declining as a Percentage of Assets in the Atlanta Region, but Nonmortgage Exposure Remains above the National Average

Year	Consumer Loans (Including Mortgages) Institutions (#)	Non-mortgage Loans to to Assets (%)	Non-mortgage Consumer Loan Assets (%)	Noncurrent Non-mortgage Consumer Yield (%)	Non-mortgage Consumer Loan Loans (%)	Non-mortgage Consumer Loan Charge-offs (%)	Non-mortgage Consumer Loan Growth (%)
1990	1,482	32.36	12.85	11.83	0.86	1.02	0.68
1991	1,473	32.10	11.73	12.03	0.89	1.22	(4.37)
1992	1,451	31.91	10.76	11.31	0.71	1.13	(2.87)
1993	1,382	31.57	10.44	10.67	0.57	0.78	4.86
1994	1,304	32.94	11.20	10.20	0.52	0.59	10.37
1995	1,222	32.96	10.74	10.83	0.61	0.74	5.36
1996	1,134	31.70	10.02	11.07	0.74	0.91	6.65
1997	1,095	31.29	9.54	11.19	0.79	0.99	3.72
1998	1,028	29.81	9.55	11.24	0.85	1.13	4.30
U.S. 1998	8,162	25.94	7.98	—	—	—	—

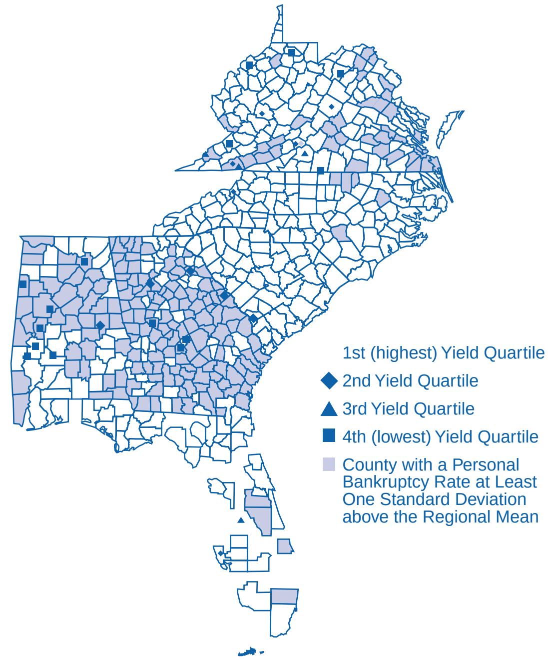
Data reflect insured commercial banks in the Atlanta Region with assets less than $1 billion and excluding credit card banks. *De novo* institutions open less than four quarters from each year-end have been excluded.
Noncurrent consumer loans include loans past due 90 or more days and nonaccruals. Consumer loan charge-offs are net of recoveries. Growth rates are merger-adjusted.
Source: Bank Call Reports

nonmortgage consumer debt represented a larger share of household income in the Atlanta Region than in the nation as a whole. The fact that both Call Report data and the NDS survey show above-average levels of nonmortgage consumer debt in the Atlanta Region is notable because delinquency and charge-off rates for this portfolio segment have been rising in the Region since 1994. In fact, these ratios are nearing levels reached during the 1990–91 recession. Given high employment, rising household incomes, record levels of unrealized financial-market wealth, and low interest rates, these would appear to be the "best of times" for U.S. consumers. For that reason, upward trends in delinquencies and charge-offs raise some concern, as an economic slowdown (lower income and employment growth) or an increase in interest rates (higher interest burden) could weaken consumers' ability to service an unprecedented level of personal debt.

In view of some signs of weakening consumer credit quality, particularly in the nonmortgage segment, it is important to identify insured commercial banks that are actively involved in this type of lending. For this analysis, we used a threshold of nonmortgage consumer loans-to-assets of 20 percent—roughly twice the regional average and nearly three times the national average. This process identified 70[5] Atlanta Region commercial banks, with assets totaling $11.6 billion, as having significant nonmortgage consumer loan exposure at the end of 1998. These institutions were concentrated in four states: Georgia (20), Virginia (16), Alabama (12), and West Virginia (11) (see Table 3, page 24). A majority of the institutions, particularly in Georgia and Alabama, were located in areas where personal bankruptcy rates also were well above average. Historically, there has been a strong positive correlation between personal bankruptcy rates and consumer loan charge-offs at insured institutions (see ***February 1998 Bank Trends: A Time Series Model of the U.S. Personal Bankruptcy Rate***). The shaded areas of Map 1 indicate counties where nonbusiness bankruptcy rates were at least one standard deviation above the Regional average in 1998. These bankruptcy data imply potentially higher consumer credit risk in parts of Georgia, Alabama, and, to a lesser extent, Virginia. The level of debtor protection afforded under state law can have a large effect on the number of bankruptcy filings; however, a higher propensity for bankruptcy in certain markets nonetheless may portend increased risk to local consumer lenders.

Map 1

Counties with High Bankruptcy Rates and Banks with High Consumer Loan Exposures Are Concentrated in Georgia, Alabama, Virginia, and West Virginia



Source: Bureau of the Census, Administrative Offices of the U.S. District Courts (Regional Financial Associates)

In addition to bankruptcies, consumer loan yields earned by banks in a particular area may provide some indication of the level of credit risk perceived by lenders in that market. This assumes, of course, that banks are able to overcome competitive pressures and price credits according to risk. Nonmortgage consumer loan yields for 58 of the 70[6] banks in the Atlanta Region with high exposure to this product are shown in Map 1. Grouping these banks into quartiles based on 1998 yields, we found that more than half of the banks in the top yield quartile were headquartered in Georgia. No other state in the Region had more than two banks in the top quartile. This may mean that lenders in Georgia's

[5] Twenty-two of the 70 banks met the FDIC's definition of a "consumer lender" at year-end.

[6] Banks that have assets under $25 million and file Call Report form 034 do not report income from consumer loans as a separate item. Twelve of the 70 banks met these criteria; therefore, only 58 yields are shown in Map 1.

high-bankruptcy areas recognize, and charge for, potentially higher consumer credit risk. But, if risk pricing is in effect, the fact that consumer loan yields at some Georgia banks were substantially higher than the Regional average could indicate aggressive risk taking by some institutions. At the opposite end of the spectrum, nearly half of the banks in the lowest-yield quartile were headquartered in Alabama, and all were either in or adjacent to counties with above-average personal bankruptcy rates. The presence of several low-yielding banks in areas where bankruptcies are high raises the question of whether those institutions are able to charge appropriately for credit risk in their consumer portfolios. However, a look at credit quality and overall performance measures at these low-yielding institutions as of year-end 1998 did not reveal any significant operating weakness. It is important to note that factors other than credit risk, such as geographic pricing patterns, differences in the types of consumer loan products offered, or differences in state usury laws may account for some of the variations in yields across the Region. For example, high usury limits in Georgia (capped at 60 percent per annum) have attracted several credit card banks and nonbank consumer finance companies to the state. These higher interest rate limits also may foster an overall higher market rate of interest in Georgia, a situation that could help explain the concentration of high yields in the state.

As a third potential indicator of consumer credit risk, in addition to bankruptcies and yields, we looked at household debt-to-income levels as determined by the 1998 NDS survey of household finances (see Table 2). Consistent with the Region's above-average nonmortgage consumer loan exposure summarized in Table 1, the NDS survey found that the average household in six of the seven states in the Atlanta Region had a nonmortgage debt-to-income ratio that was above the national average in 1998. The Region's highest ratios of *total* household debt[7]-to-income were in Virginia, West Virginia, and Georgia, while the highest nonmortgage consumer debt-to-income ratios were reported in West Virginia and Alabama. Credit card debt-to-income levels were higher in West Virginia and Alabama as well. Households with high levels of debt relative to income may find it difficult to continue to service those debts in an economic downturn, especially in less economically diverse areas, where employment and income tend to be more sensitive to economic shocks.

Consumer loan delinquencies and charge-offs validate, to some extent, the higher credit risks implied by the bankruptcy, yield, and debt-to-income data above. As

[7] The inclusion of credit card balances of "convenience" users may result in a slight overstatement of household debt.

Table 2

Nonmortgage Consumer Debt-to-Income Levels in the Atlanta Region Are above the U.S. Average

State	Total Household Debt (Including Mortgages) to Household Income (%)	Nonmortgage Consumer Debt to Household Income (%)	Credit Card Debt to Household Income (%)
West Virginia	65.9	20.1	4.3
Alabama	63.7	18.2	4.0
South Carolina	64.2	17.6	3.9
North Carolina	64.0	16.9	3.7
Florida	64.4	16.7	3.9
Georgia	65.7	16.5	3.8
Virginia	73.5	16.2	3.7
Atlanta Region	66.0	16.9	3.8
U.S.	68.5	16.3	3.8

Household debt includes all bank and nonbank borrowings. Ratios reflect a debt-equivalent balance for auto lease obligations, calculated from NDS survey data.
Source: National Decision Systems 1998 Survey of Household Finances

shown in Table 3, the charge-off rate among the 20 Georgia banks with significant nonmortgage consumer loan exposure was very high, at 4.08 percent in 1998. While the ratio reflects large losses at a couple of banks, one in four banks reported consumer charge-offs in excess of 2 percent, and nearly half incurred losses of more than 1 percent for the year. This finding is consistent with the positive correlation between personal bankruptcies and consumer loan charge-offs referenced above. Meanwhile, Alabama reported the Region's highest percentage of noncurrent consumer loans, 1.71 percent at year end, possibly linked to high personal bankruptcies and nonmortgage consumer debt-to-income levels. Although there were fewer counties with high bankruptcy rates in West Virginia, the state had the Region's highest ratio of household nonmortgage debt-to-income and ranked third in terms of consumer loan delinquencies and charge-offs in 1998. Credit quality measures were stronger in Virginia despite several counties having bankruptcy rates above the Regional average.

In addition to currently active nonmortgage consumer lenders, a number of commercial banks in the Atlanta Region that do not report high exposures have been increasing their consumer portfolio allocation. In some instances, given continued industrywide erosion of the net interest margin, this change in allocation could signal a strategic shift to an historically higher-risk loan type in search of higher yields. To identify institutions possibly moving into the consumer lending arena, we looked for a consumer loans-to-assets ratio of between 10 and 20 percent that had increased by more than 100 basis points in both 1997 and 1998. Twenty-five commercial banks in the Region met these criteria at year-end 1998. Most were concentrated in Georgia and Alabama, each with eight banks, while Virginia and West Virginia followed with three and two banks, respectively.

The risk indicators discussed above—bankruptcies, yields, household debt-to-income levels, and delinquencies and charge-offs—imply potentially higher consumer credit risk in parts of Georgia, Alabama, West Virginia, and, to a lesser extent, Virginia. The Region's most active consumer lenders with assets less than $1 billion, as well as a majority of institutions that are approaching significant levels of consumer loan exposure, are concentrated largely in these same states. Given some weakening trends in consumer credit quality, particularly in light of the favorable current economic environment, it is important that institutions actively serving this sector maintain underwriting integrity, establish adequate reserves, and ensure sufficient monitoring and collection efforts.

Atlanta Region Staff

Table 3

Banks with Significant Nonmortgage Consumer Loan Exposure Are Concentrated in Four States

State	Nonmortgage Consumer Lenders* (#)	Nonmortgage Consumer Loans (% of Assets)	Nonmortgage Consumer Loan Yield (%)	Nonmortgage Consumer Loans Noncurrent (%)	Nonmortgage Consumer Loan Charge-offs (%)
Georgia	20	29.90	13.51	1.50	4.08
Virginia	16	29.10	8.87	0.54	0.52
Alabama	12	23.66	8.86	1.71	1.20
West Virginia	11	23.88	8.95	0.83	1.50
Florida	6	30.39	9.98	0.81	1.31
South Carolina	4	26.69	7.76	0.38	2.37
North Carolina	1	20.37	9.12	0.14	0.88

* Insured commercial banks with a ratio of nonmortgage consumer loans to assets of 20 percent or more.
Notes: Credit card banks, institutions with assets of more than $1 billion, and *de novos* open less than one year are excluded. Twenty-two of the 70 banks meet the FDIC's definition of a "*consumer lender*," which requires a ratio of total consumer loans, including residential mortgages, to assets of at least 50 percent. Noncurrent loans include loans past due 90 or more days and nonaccruals. Charge-offs are net of recoveries.
Source: Bank Call Reports

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