Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION — SECOND QUARTER 1999

FDIC
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DIVISION OF
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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

◆ ***Economic and Banking Conditions***—**While the Region's economy remains healthy, some indicators suggest that its recent robust growth may be difficult to sustain. The industrial sector, in particular, is showing signs of declining vigor. While unemployment remains low, job growth is slowing unevenly across the Region. Banks and thrifts reported generally healthy financial conditions in the fourth quarter, but aggregate results reflect a modest decline in some performance measures.** ***See page 16.***

◆ ***Weak Agricultural Conditions Continue to Warrant Attention***—**Ongoing weakness in commodity prices, declining farmland values in specific areas, and emerging repayment problems pose risks to insured institutions active in agricultural lending. Agricultural banks with significant concentrations of credit in areas where farmland values are declining may be particularly exposed.** ***See page 19.***

◆ ***New Law Allows Cancellation of Private Mortgage Insurance and Imposes Requirements on Mortgage Lenders***—**The Homeowners' Protection Act of 1998, which becomes effective on July 29, 1999, is intended to prevent consumers from paying more private mortgage insurance premiums than necessary and to facilitate the cancellation of such insurance. Failure to meet the Act's requirements may expose insured institutions to potential liabilities.** ***See page 21.***

By the Chicago Region Staff

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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.

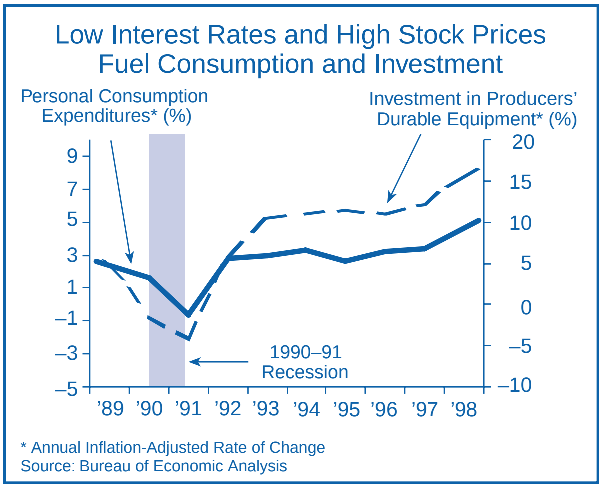
Consumer Spending and Business Investment Are Key to Economic Strength

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

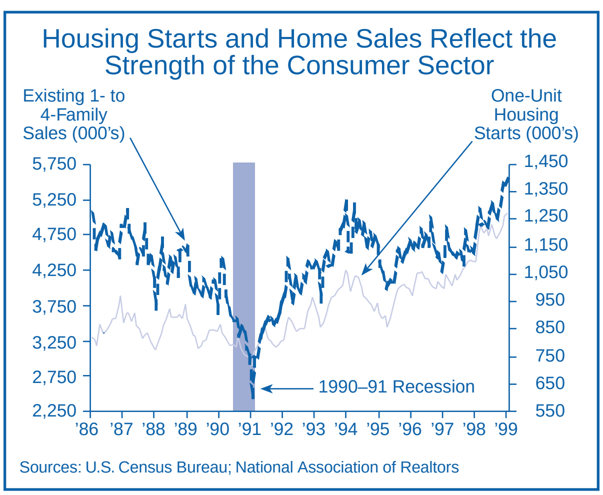


dence index to its highest values since the late 1960s. Increases in new home construction reflect these favorable conditions. Almost 1.5 million new homes were completed during 1998—the highest level in ten years—while a record 4.8 million existing homes were sold (Chart 2). U.S. automobile sales reached 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



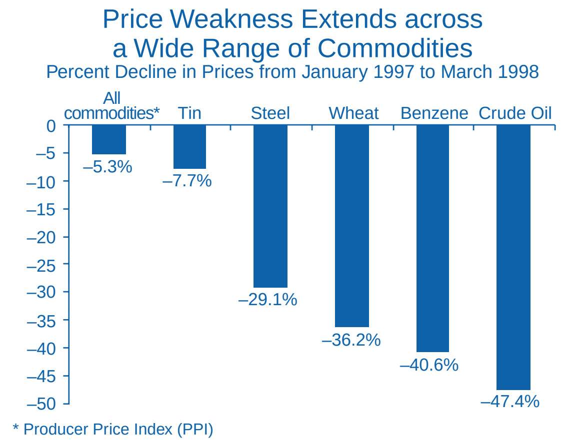
Conditions Vary across Industry Sectors

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



* Producer Price Index (PPI)
Source: *Journal of Commerce,* Bureau of Labor Statistics

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.

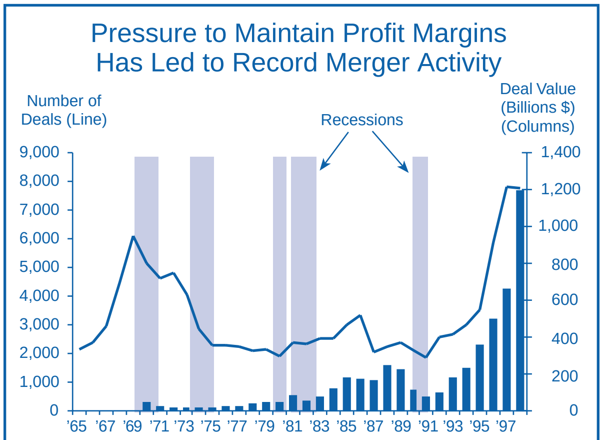
One reason the overall U.S. economy has proven so resilient in the face of weakness in the manufacturing sector is that firms have been able to restructure to cut costs and improve their market positions. Global overcapacity in industries such as oil and autos has been a driving force behind the record 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



Source: Houlihan Lokey's Mergerstat

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.

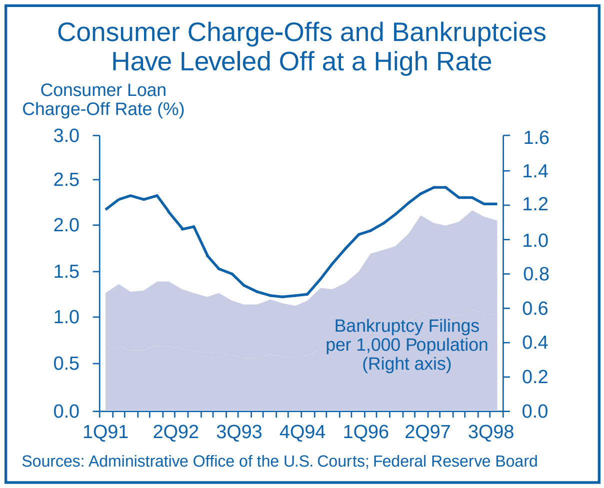
Consumer Lending

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

CHART 5



"reloading" of credit card debt would further strain the financial flexibility of consumers.

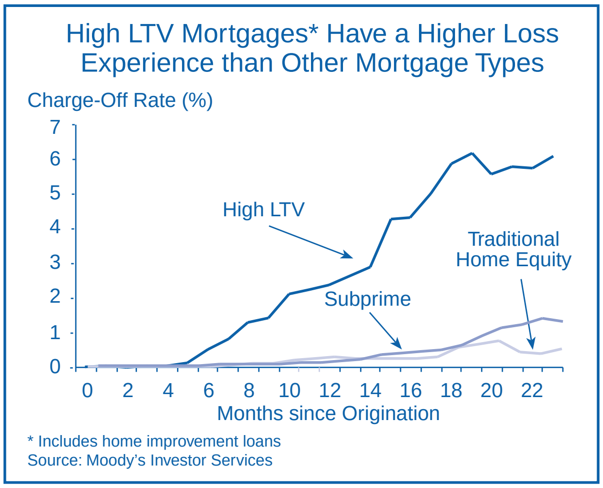
High Loan-to-Value Mortgage Products and Subprime Lending Transform Consumer Lending

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

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

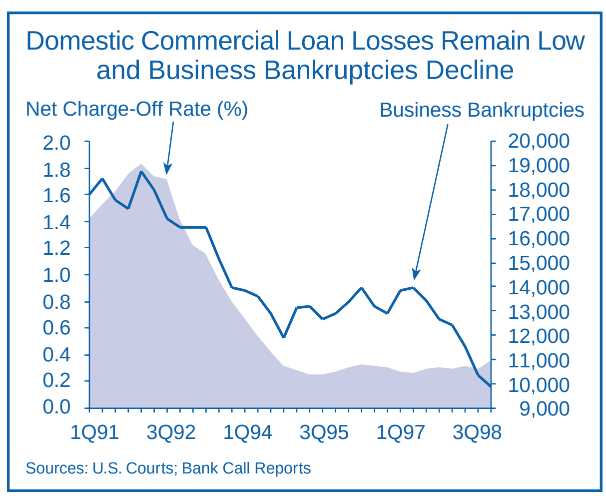
[7] For example, the ***Office of the Comptroller of the Currency's*** "1998 Survey of Credit Underwriting Practices" indicated that 33 percent of the banks offering home equity loans eased standards, compared with only 7 percent that tightened standards. The report is available at http://www.occ.treas.gov/cusurvey/scup98.pdf.

[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.

CHART 7



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).

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

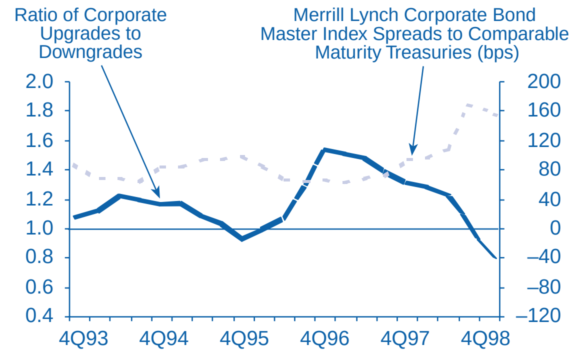
[12] See ***Federal Reserve Board*** Senior Loan Officer Opinion Surveys for November 1998 and January 1999, http://www.bog.frb.fed.us/boarddocs/snloansurvey/.

[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.

CHART 8

Corporate Bond Ratings and Required Yields Reflect Greater Market Uncertainty



Sources: Moody's Investor Service; Merrill Lynch

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

[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.

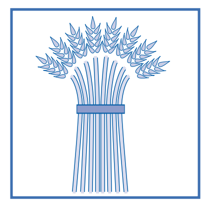
The study also identified some instances of aggressive loan structures, including pricing at extremely thin margins, waiving or limiting personal guarantees, waiving cash equity requirements, and lending on thin collateral margins. Borrowers who secured the most aggressive loan terms were typically larger 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

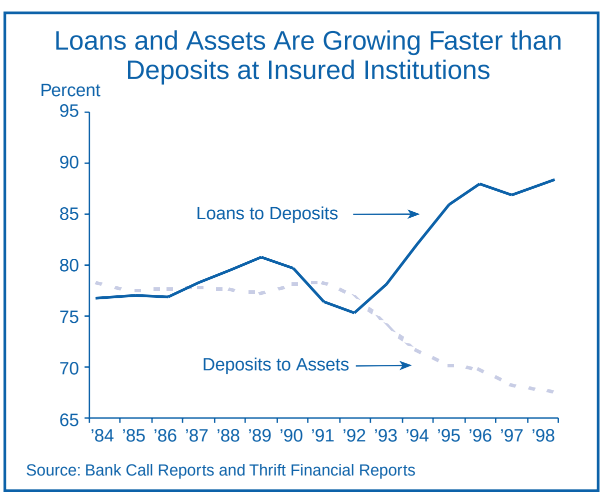
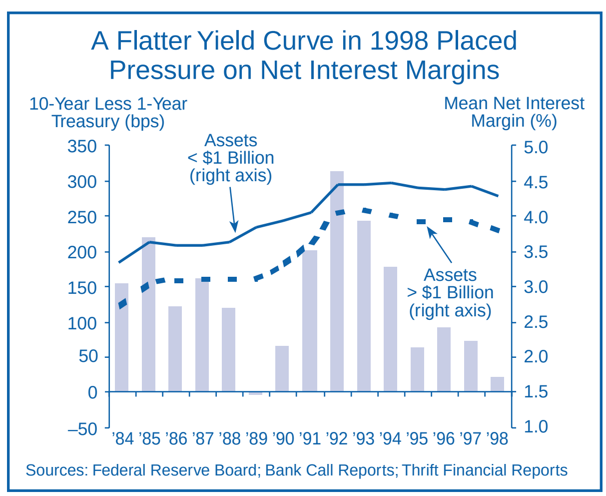


CHART 10



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

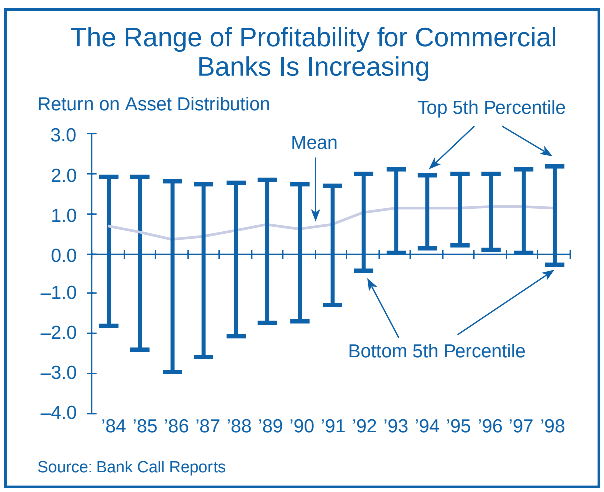
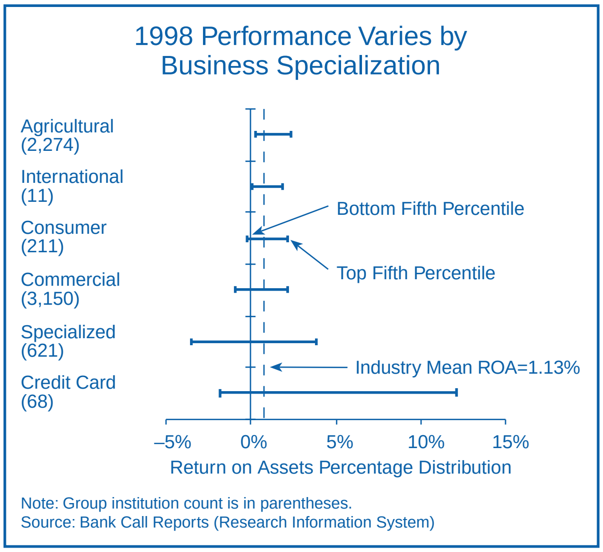


CHART 12



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.

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

[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.

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

- **While the Region's economy remains healthy, some indicators suggest that its recent robust growth may be difficult to sustain in the coming quarters.**

- **The Region's banks and thrifts reported generally healthy financial conditions, but aggregate results reflect some moderation in recent performance trends.**

- **Ongoing weakness in commodity prices, declining farmland values in specific areas, and emerging repayment problems continue to warrant attention in the agricultural sector.**

- **A new law allows cancellation of private mortgage insurance and imposes requirements on mortgage lenders.**

Regional Economic and Banking Conditions

The Region's Economy Reflects Crosscurrents

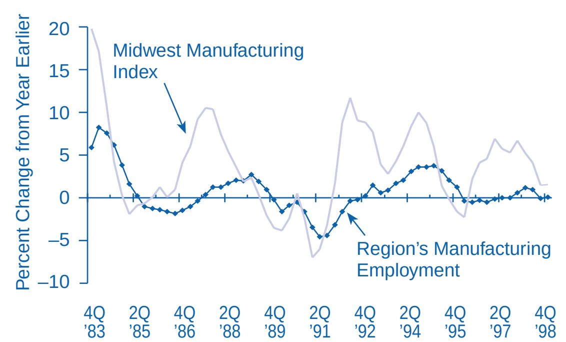
The current economic expansion entered its ninth year in March 1999, making it the second longest expansion in the past 50 years. Yet, as typically happens in an aging expansion, some indicators suggest that the Region's robust economic health may be difficult to sustain in the coming quarters. For example, the shrinking pool of workers available for hire is a factor behind slower job gains. Current indicators do not suggest that a recession is imminent, and the level of economic activity could remain fairly high for some time. *However, additional improvements—such as significantly lower unemployment rates or an increase in hiring by manufacturers—may be both small and hard to achieve.* In addition, sustained weakness in commodity prices may hurt communities in the Region that depend heavily on earnings from corn, soybean, and small hog operations.

Industrial Sector Experiences Declining Vigor. While some important manufacturing industries, like motor vehicles, continue to post strong sales, overall growth in the industrial sector is slowing. The ***Midwest Manufacturing Index*** (MMI), calculated by the Federal Reserve Bank of Chicago, demonstrates that a slowdown is under way in the broader manufacturing sector (see Chart 1). This index, based on 16 manufacturing industries important in the Region, has expanded at a rate of only 2.1 percent annually since mid-1998. This pace is considerably slower than during the 23 months ending in May 1998, when, at its slowest, the MMI index expanded by 3.7 percent annually (relative to the same month a year earlier).

Part of the current slowdown can be attributed to strikes against the General Motors Corporation (GM) in the summer of 1998. However, weakness exists in other sectors as well. The steel and farm equipment industries have experienced sharp output declines recently, while production of chemicals and of paper and related products has fallen, although less sharply. At the same time, the food processing industry, fabricated metals firms, and producers of industrial and electrical machinery and equipment experienced continued, but slower, growth. Although tight labor markets and low unemployment have enabled some laid-off workers to find replacement jobs, communities with a heavy exposure to affected industries likely will experience some weakening of activity in the retail, service, and other sectors as well.

CHART 1

Growth Slows for Both Midwest Manufacturing Index and Region's Manufacturing Employment



Sources: Bureau of Labor Statistics and Federal Reserve Bank of Chicago, via Haver Analytics, Inc.

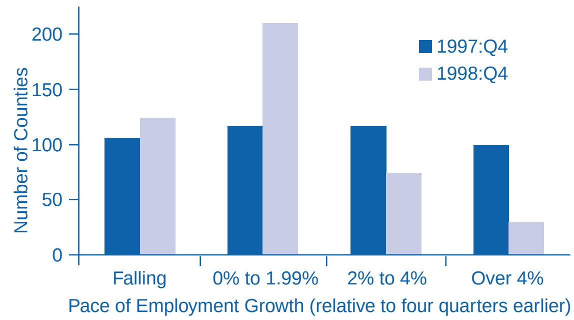
Peaks in the MMI's growth rate typically precede those in the Region's manufacturing employment (see Chart 1). Following this pattern, manufacturing job growth peaked in early 1998, about ten months after growth in the MMI peaked. The recent sustained slowing in the MMI's growth rate suggests that factory employment growth likely will remain tepid through mid-1999, at least.

As growth in the industrial sector has slowed, so too has growth in household and business incomes. Household income rose about 4.5 percent in the Chicago Region last year—about eight-tenths of a percentage point slower than in 1997. If stock prices fall dramatically or interest rates rise while income growth slows, a slump in consumer confidence and a curtailment of households' willingness and ability to spend freely could follow. Such events, in turn, could weaken the current expansion's viability.

Although regional data are not available for business profits, the marginal gain in operating profits at the national level at year-end 1998 likely was mirrored by many firms in the Region. Among producers of nondurable goods such as chemicals, rubber and plastics, paper products, and food, fourth-quarter profits nationally were 37 percent lower than at year-end 1997, the first significant decline since 1992. Durable-goods firms—those producing metal products, vehicles, equipment and machinery, for example—saw operating profits pick up at year-end after midyear declines. However, the quarterly pattern partly reflects the impact of strikes against GM. When average profits in 1998 for durable-goods manufacturers are compared with those in 1997, a slim gain of 1 percent was realized. *Reduced profitability has contributed to an increase in job layoff announcements since mid-1998. It also may serve as a warning sign that some business borrowers' repayment abilities could be coming under pressure.*

CHART 2

Distribution of Counties' Employment Growth Shifted in 1998



Source: Bureau of Labor Statistics, via Haver Analytics, Inc.

Job Growth Is Uneven across the Region. Since midyear 1998, the Region's unemployment rate has hovered around 3.9 percent, about half a percentage point lower than the national rate. Low unemployment is one factor behind the temperate job growth of 1.8 percent in 1997 and 1.9 percent in 1998. Another is the recent reduction in employment by manufacturing firms, especially among durable-goods producers, which is illustrated in Table 1.

Although the recent pace of job growth has been fairly stable for the Region as a whole, the pace has been uneven across its counties as well as across its industries. During 1997, for example, employment growth was 2 percent or higher in nearly half of the 437 counties in the Region, as shown by the dark bars in Chart 2. In contrast, this share fell to only 24 percent, or 103 counties, in 1998 (see light bars in Chart 2).

The most dramatic shift in job growth among counties took place in **Michigan** and partly reflects the strikes

TABLE 1

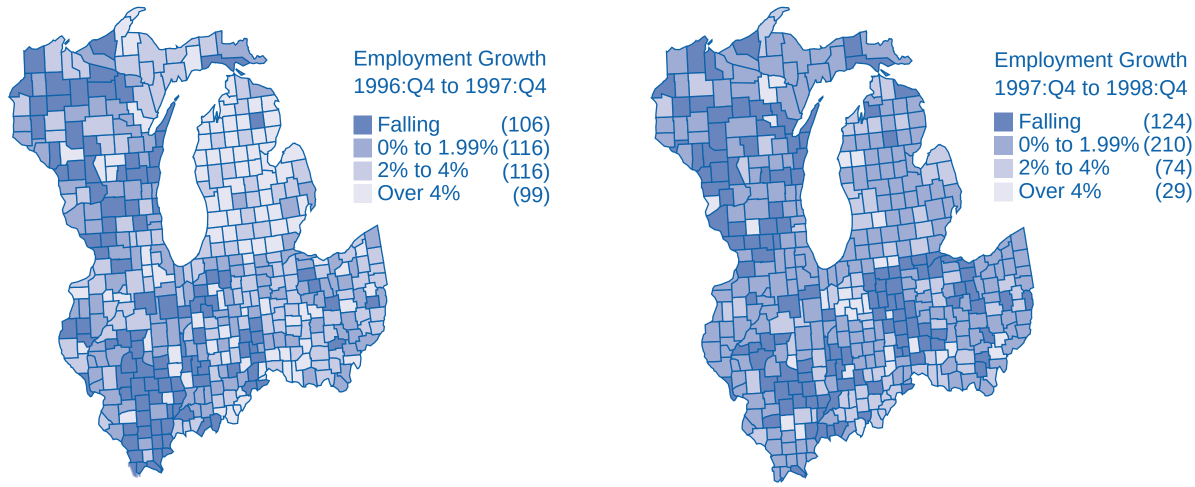
MANUFACTURING JOB LOSS OCCURRED IN FOUR OF THE REGION'S STATES (THOUSANDS OF JOBS, MARCH 1998 TO MARCH 1999)

	REGION	IL	IN	MI	OH	WI
ALL MANUFACTURING	–33.1	–5.5	1.4	–9.6	–14.8	–4.6
DURABLE-GOODS SECTOR	–29.0	–5.3	0.5	–9.4	–11.5	–3.3
NONDURABLE-GOODS SECTOR	–4.1	–0.2	0.9	–0.2	–3.3	–1.3
ADDENDUM: MARCH 1999 MANUFACTURING EMPLOYMENT AS PERCENTAGE OF MARCH 1998 LEVEL	99.2%	99.4%	100.2%	99.0%	98.7%	99.3%

SOURCE: BUREAU OF LABOR STATISTICS, VIA HAVER ANALYTICS, INC.

MAP 1

Slowdown in Job Growth Is Widespread



Note: The darker the shading, the weaker the job growth. Figures in parentheses reflect number of counties in the range.
Source: Bureau of Labor Statistics, via Haver Analytics, Inc.

against GM and their spillover effects on GM suppliers and various communities. Only 10 of 83 counties in the state had sluggish or no growth in 1997 (see Map 1, left) but 60 counties were in this situation in 1998 (see Map 1, right). **Ohio** posted the second biggest shift, with 76 percent of its 88 counties experiencing sluggish job growth or decline in late 1998, up from 41 percent a year earlier. *These developments suggest that slower economic growth is affecting an increasing number of communities, even though job growth in the Region as a whole remains fairly steady.*

Housing Activity Remains Robust. New residential construction and home resales continue to be buoyed by low unemployment, favorable interest rates, and households' rising net worth from appreciation of real estate and financial assets. Residential construction permits in the Region jumped by 12 percent in 1998. Home resales also rose by 12 percent, and the median sales price rose by nearly 8 percent. The sustained strength in residential construction and sales is generating spillover demand for home furnishings, appliances, landscaping, and the like, all of which contribute to a community's economic health. Only Michigan fell short of posting double-digit growth in both permits for new single-family homes and home resales in 1998 (see Table 2). The widespread weakening in job growth in the state may have contributed to the relatively weaker performance of its housing market.

TABLE 2

RESIDENTIAL HOUSING REBOUNDED (PERCENT CHANGE FROM 1997:Q4 TO 1998:Q4)

	IL	IN	MI	OH	WI
Single-Family Permits	10.5	12.8	9.8	14.2	15.6
Resales of Homes, Condos, and Co-ops	15.8	13.8	8.5	10.3	10.9

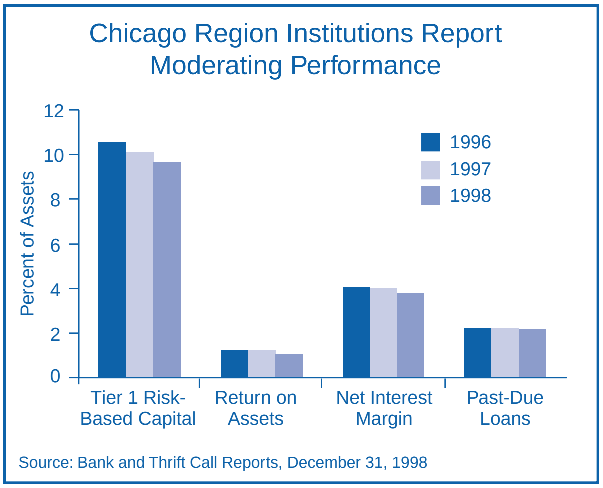
Sources: Bureau of the Census and National Association of Realtors, via Haver Analytics, Inc.

Associated with these developments, 1- to 4-family mortgages held by insured institutions in the Region rose by 5.6 percent ($10.8 billion) between year-ends 1997 and 1998. Reflecting a sharp shift in borrower preference, long-term, fixed-rate mortgages at the Chicago Region's banks accounted for 66 percent of total mortgages at year-end 1998, up from 56 percent a year earlier. This shift likely is challenging some institutions' ability to manage their asset-liability mix and interest rate exposure.

Bank and Thrift Performance Results Moderate

The Region's banks and thrifts reported generally healthy financial conditions in the fourth quarter of 1998 (see Chart 3). However, aggregate results reflect a modest decline in some key performance measures.

CHART 3



The Region's banks reported a return on assets (ROA) ratio of 1.08 percent for the year ending December 31, 1998, down from 1.38 percent a year earlier. The decline in aggregate performance was driven chiefly by a narrowing net interest margin (NIM). The aggregate NIM among the Region's banks fell to 3.96 percent at year-end from 4.24 percent a year earlier. A decline of 50 basis points in the yield on earning assets more than offset a decline of 23 basis points in the cost of funds. Compression in the NIM over the year was most prevalent in the Region's largest (total assets greater than $10 billion) and smallest (total assets under $100 million) banks, where, in aggregate, interest spreads declined 30 and 28 basis points, respectively. Noninterest income continues to bolster net income for many insured institutions; however, an increase in the aggregate level of noninterest income in the fourth quarter was offset by a larger increase in noninterest expenses. On the whole, banks continue to report relatively high capital ratios; however, aggregate Tier 1 and total risk-based capital ratios at year-end were at their lowest levels since 1990 and 1991, respectively.

Aggregate performance of the Region's thrifts improved over the previous year. The Region's thrifts reported an average ROA of 0.83 percent at year-end, compared with 0.65 percent the previous year. An increase in the level of noninterest income offset a slight decline in the net interest income.

Weak Agricultural Conditions Continue to Warrant Attention

Farmers, in general, were in good financial condition before last year, and many have the financial flexibility to withstand a period of poor agricultural conditions. However, the wherewithal of some farmers may be tested this year, as the ***United States Department of Agriculture*** (USDA) forecasts continued low commodity prices in 1999. According to USDA forecasts, prices of corn and soybeans, two field crops especially important to **Illinois** and **Indiana**, are expected to decline by as much as 20 percent from last year.

The dairy sector, which was one of the strongest farm sectors in 1998, stumbled earlier this year when the basic formula price for milk took a steep and unexpected decline. The decline in milk prices was due to better weather conditions, herd expansion, and higher milk output, which have eliminated shortages. The USDA is projecting milk prices to rebound as the year unfolds, and prices are expected to average between those seen in 1997 and 1998. As a result, returns for dairy farmers may be lower in 1999 than in 1998.

Insured institutions in the Chicago Region reported total outstanding agricultural loans (agricultural production loans plus loans secured by farmland) equaling $13.0 billion as of year-end 1998. Nearly 70 percent, or 1,419 insured institutions, in the Region hold some agricultural loans. Most agricultural financing is held by larger, diversified financial institutions, which held agricultural loans totaling $8.7 billion, or 67 percent of total outstanding agricultural loans in the Region. *Because their loan portfolios are often quite diversified, these institutions may be able to withstand some deterioration in the agricultural segment without significant damage to their overall portfolio quality or earnings.*

The Region's 348 agricultural banks[1] held $4.3 billion in agricultural loans, with almost 63 percent of this amount held by Illinois' 241 agricultural banks. The average

[1] An agricultural bank is defined as any institution where the sum of agricultural production loans and loans secured by farmland exceeds 25 percent of total loans.

agricultural bank had total assets of $58.8 million. More than 180 agricultural banks, with total assets of $11.1 billion, reported farm loan exposures over 200 percent of Tier 1 capital (see Table 3). In aggregate, agricultural banks headquartered in counties in central and northwestern Illinois and in the western corridor of **Wisconsin** have particularly high agricultural loan exposures relative to capital (see Map 2).

As a group, agricultural banks thus far have maintained profitability despite competitive pressures and depressed crop prices. Agricultural banks in the Region reported an ROA of 0.97 percent in the fourth quarter of 1998. The IR aggregate NIM was 3.89 percent, compared with 4.06 percent at small nonfarm banks.[2] The narrower margin may reflect the strong competition agricultural banks face from nonbank competitors. However, the trend in agricultural banks' NIM does not indicate any significant margin erosion over the past 12 quarters.

Agricultural banks continue to report high capital levels and few credit quality problems as of year-end 1998. The average core capital (leverage) ratio for agricultural banks of 10.67 percent has been stable over the past 12 quarters. Net loan charge-offs have been relatively static on a year-over-year basis as well. Total past-due loan levels rose to 2.27 percent of total loans from 2.03 percent a year earlier but have remained within a fairly narrow range over the past 12 quarters.

[2] A small nonfarm bank is defined as any institution with total assets less than $100 million that does not meet the definition of an agricultural bank.

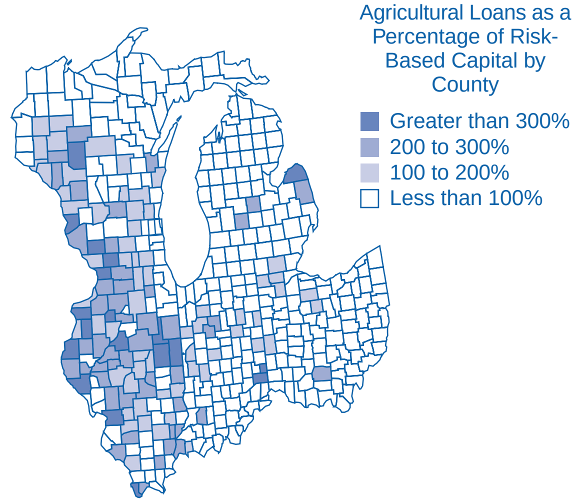
Table 3

Some Agricultural Banks Have Significant Exposure of Capital		
Agricultural Loans to Tier 1 Capital	Number of Banks	Total Assets ($ millions)
Over 300%	54	3,230
200 to 300%	128	7,880
100 to 200%	139	7,825
Under 100%	27	1,362
Total	348	20,297

Source: Bank and Thrift Call Reports, December 31, 1998

Map 2

Agricultural Banks' Loan Concentrations Are Highest in Illinois



Source: Bank and Thrift Call Reports, December 31, 1998

Typically, financial institutions do not immediately show the effects of one year, or even two consecutive years, of poor agricultural conditions. For farm borrowers who experience difficulties because of a poor crop year or low prices, loans are often "carried over" into operating loans for the subsequent year or are restructured to reflect "current" status. As a result, current reported measurements of asset quality might not reveal a rising risk profile in agricultural loan portfolios. As evidence, results from a February 1999 survey by the ***Federal Reserve Bank of Chicago*** reveal that farm loan repayments declined for the seventh consecutive quarter, with the index reaching its lowest point since 1985. Bankers in Illinois and Indiana were among those who reported the greatest weakness in repayments. Weaker repayments could be an indication that past-due and nonperforming loan data may understate farm borrowers' difficulties.

Given the heightened risk in the agricultural sector, growth in the allowance for loan losses among the Region's 348 agricultural banks did exceed agricultural loan growth during the year ending December 31, 1998. However, among the 87 agricultural banks in the highest quartile for agricultural loan growth over the past year, a small number reported a decline in reserve balances over the same period and maintained a reserve to total loan ratio that was less than the median for all agricultural banks.

Continued low commodity prices may impede farmers' ability to demonstrate adequate cash flow for both current operating and carried-over loans. Inadequate cash flow may force banks to base lending decisions on the value of available farm collateral, like land and machinery. A survey by the ***Federal Reserve Bank of Chicago*** indicates that the depressed agricultural economy has begun putting downward pressure on land prices in selected areas. Bankers in Illinois reported an annual decline in farmland values of 4 percent in 1998, with central Illinois values down by 8 percent. As a whole, bankers in Indiana reported no change in farmland values in 1998; however, those in northern Indiana reported a slight decline of 1 percent. *Institutions making lending decisions based on the value of farmland in these areas are most at risk for potential asset quality problems should cash flow difficulties combine with declining farmland values.*

Ongoing weakness in commodity prices, emerging repayment problems, and declining farmland values in specific areas pose risks to insured institutions active in agricultural lending. Agricultural banks with significant concentrations of credit located in areas where farmland values are declining may be particularly exposed. Prudent risk management among agricultural lenders will become increasingly important if weak agricultural conditions persist. Farm lenders will have to determine whether individual farmers have sufficient financial cushion to withstand a prolonged period of low commodity prices, continue to monitor cash flow, and avoid overreliance on land or equipment collateral. In addition, bankers need to ensure that reserve balances reflect all significant factors that affect repayment and estimated credit losses, including continuing weakness in the agricultural sector. In a broader context, lenders should consider the wider economic effect of weak farm conditions on the local community and commercial borrowers.

New Law Allows Cancellation of Private Mortgage Insurance and Imposes Requirements on Mortgage Lenders

The Homeowners' Protection Act of 1998, which becomes effective on July 29, 1999, was intended to prevent consumers from paying more private mortgage insurance (PMI) premiums than necessary and to facilitate the cancellation of such insurance when predefined equity levels are reached. The key provisions of the Act generally require financial institutions and other mortgage holders to terminate PMI when a mortgage reaches a loan-to-value ratio of 78 percent. Furthermore, borrowers may request termination of PMI when a mortgage reaches a loan-to-value ratio of 80 percent. Loan-to-value calculations are based on the value of the residential real estate at the time of loan origination. The automatic cancellation provisions apply only to loans made after July 29, 1999.

The Act also contains provisions regarding initial and annual disclosures that inform borrowers of their right to cancel PMI and the procedures for doing so. Terms of the disclosures depend on whether the loan has a fixed or adjustable rate and whether the borrower or lender pays the insurance. For loans made before the July 29, 1999, effective date, servicers must notify borrowers that they may request cancellation and must provide contact information.

Increases in property value do not have to be considered in determining when PMI termination is allowed or mandatory. Prepayments, however, must be considered for borrower-initiated cancellations of insurance. Generally, insurance must be cancelled at a borrower's request if

- the loan-to-value ratio is less than 80 percent,
- the loan has not been more than 30 days past due in the past 12 months or more than 60 days past due in the past 24 months, and
- the property value has not declined from its original value.

Mortgage lenders, servicers, or insurers found in violation of the law will be liable to the borrower for actual damages, cost of the action, reasonable attorney fees, and statutory damages up to $2,000 per individual. The Act limits class action lawsuits for the same violation to the lesser of $500,000 or 1 percent of the liable party's net worth. The reputational risk for noncompliance may prove greater than any legal or monetary penalties. *Mortgage lenders and servicers should ensure that requisite systems are in place to meet the Act's requirements and to minimize potential liabilities for noncompliance.*

Chicago Region Staff

References

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The Homeowners' Protection Act of 1998. U.S. Public Law 105-216. 105th Cong., 2d sess., 6 August 1998. *http://thomas.loc.gov/*

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