Regional Outlook

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Regional Perspectives

◆ ***The Region's Economic and Banking Conditions*—The Region's institutions reported generally healthy financial conditions during the first half of 2000. Large institutions offset higher funding costs with increased noninterest income, while community institutions benefited from slightly higher net interest margins. The Region's large banks continued to report weakening in commercial and industrial loan credit quality.** ***See page 3.***

◆ ***The Region's Loan Growth Is Centered in Traditionally Higher-Risk Categories*—Over the past four years, the Region's commercial banks have reported a shift into higher-yielding, potentially higher-risk commercial loans as lenders attempt to maintain earnings in the face of increasing competition and margin pressure.** ***See page 4.***

◆ ***Some of the Region's Housing Markets Show Signs of Overheating*—Communities surrounding the Region's larger urban areas, primarily Baltimore, New York City, and Washington, D.C., where job growth has been strong, reported significant levels of home price appreciation that have exceeded increases in household incomes. By most measures, the current housing boom has been more modest than that of the 1980s.** ***See page 6.***

By the New York Region Staff

In Focus This Quarter

◆ ***Emerging Risks in an Aging Economic Expansion*—This article focuses on the potential risks of current economic conditions to insured depository institutions. Although the current conditions may appear to be ideal, some imbalances are emerging: rising energy prices, tight labor markets, a less robust stock market, a large trade deficit and strong U.S. dollar, rising household debt burdens, increased corporate leverage and rising potential default risk, and, in some metropolitan areas, overheated housing and commercial real estate markets. At the same time, aggregate risk within the banking industry appears to have risen, as evidenced by softening profitability, growing reliance on noncore funding, heightened levels of interest rate risk, and increasing concentrations in traditionally higher-risk loan categories. A confluence of these trends could heighten the vulnerability of some insured institutions.** ***See page 11.***

By the Division of Insurance Staff

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REVISION:

The article "Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding" in the Third Quarter 2000 issue of the ***Regional Outlook*** has been revised to correct a data-related error. The revision affects Chart 4 and Chart 11 of the report. Please see www.fdic.gov/bank/analytical/regional/ro20003q/correction.html for revised versions of Chart 4 and Chart 11, along with an additional explanation of how the revision affects the article.

Regional Perspectives

- **During the first half of 2000, the New York Region's insured institutions reported favorable financial conditions, but large banks faced continued margin pressure and weakening commercial and industrial loan credit quality.**

- **The credit risk profile of the Region's commercial banks is increasing as loan volume is rising and growth is centered in traditionally higher-risk loan categories.**

- **Housing markets in some of the Region's major cities may be overheating; however, price appreciation has been more modest than during the 1980s housing boom.**

Region's Economic and Banking Conditions

Bank Profitability Is Stable but Pressures Persist

The New York Region's insured institutions[1] reported relatively stable profitability during the first half of 2000. However, higher interest rates compared with a year ago pressured net interest margins (NIMs), as funding costs increased for all banks. Intense competition for core deposits over the past several years also has contributed to margin compression. Erosion of banks' core deposit base has resulted in increased reliance on noncore funding sources, which are generally more expensive than traditional bank deposits. Furthermore, noncore funding sources typically are more interest rate sensitive. As a result, banks' liquidity and interest rate risk management could be challenged, particularly during periods of rising interest rates or unstable financial markets, when access to liquidity sources may become more difficult.

Performance measures continued to highlight the differences in revenue models between the Region's large institutions and community banks. Large banks generate significant noninterest income, while smaller banks' earnings are more dependent on spread income. Their more diversified revenue stream helped the large institutions (assets greater than $10 billion) maintain profitability levels in the past year despite higher funding costs. Large banks reported a stable median return on assets (ROA) for the first half 2000 compared with a year ago, as increased noninterest income offset a decline in the NIM (see Table 1, next page). Noninterest income increased less in the first half of 2000 than the year-ago period, reflecting competition for fee-based services and softness in the financial markets.

[1] Excludes institutions in operation less than three years and credit card banks. The banking analysis uses median figures.

The ROA for the Region's community banks (assets less than $1 billion) declined slightly over the same period, as higher operating expenses diluted the effect of an improved asset yield and NIM. After a downtrend for the past two years, the Region's community banks reported a slightly higher NIM during the first six months of 2000 compared with a year ago; higher asset yields more than offset increased funding costs. Loan growth, which occurred primarily in the typically higher-yielding, higher-risk commercial loan categories, may have contributed to community banks' improved asset yield. The median loan-to-asset ratio for the Region's community banks continued upward, increasing from 61 percent in second quarter 1999 to 64 percent in second quarter 2000, with growth concentrated in commercial and industrial (C&I), commercial real estate (CRE), and construction and development (C&D) loans. The overall growth rate for these categories was almost double that of residential loans over the past year. Unlike large banks, community banks did not benefit from increased noninterest income. The median ratio of noninterest income-to-earning assets reported by the Region's community banks was flat compared with a year ago, and less than one-third the level reported by large banks.

Credit Quality of Large Banks' C&I Loan Portfolios Weakens

Credit quality in most loan categories remained favorable, except for C&I loans held by the Region's large banks; during second quarter 2000, the C&I charge-off rate reached its highest level since 1993. Although increasing, the C&I charge-off rate reported by the Region's large banks remained substantially below the rate during the recession of the early 1990s.

Deterioration of large banks' C&I loans could be the result of less disciplined underwriting from 1996 through 1998, when results of the ***Federal Reserve Board's*** *Senior Loan Officer Opinion Surveys on Bank Lending Practices* indicated general easing of C&I lending standards nationwide. While more recent surveys[2] indicate that the nation's banks have tightened underwriting standards, warning signs remain. Rating agencies reported that downgrades of syndicated loans and corporate bonds exceeded upgrades during the first eight months of 2000. Moreover, while downgrades were primarily limited to health care, manufacturing, and entertainment companies in 1999, they extended across more industries in 2000. Furthermore, the dollar amount of adversely classified large syndicated loans under the ***Shared National Credit (SNC) program*** increased for the second consecutive year, rising from $37.4 billion in 1999 to $63.3 billion in 2000.[3] The percentage of criticized loans to total loans reviewed has risen from a decade low of 1.3 percent in 1998 to 3.3 percent in 2000 but is below the 10 percent peak reached in 1991. Defaults on corporate bonds and spreads on high-yield bonds have also increased, further indicating weakening commercial credit quality. A less liquid secondary market for corporate debt could make it more difficult for companies to refinance or restructure loans, which could affect the credit quality of the Region's loan portfolios.

Commercial Loan Growth Increases Banks' Credit Risk Profiles

The Region's commercial banks have reported loan growth centered in traditionally higher-risk loan categories. During the past four years, the Region's commercial banks experienced the greatest annual growth rates in commercial (including C&I and CRE) loans (see Chart 1). In fact, commercial loans accounted for over half the

Table 1

Summary of Banking Performance*

	Assets Greater than $10 Billion			Assets between $1 Billion and $10 Billion			Assets Less than $1 Billion		
	Jun '00	Jun '99	Jun '98	Jun '00	Jun '99	Jun '98	Jun '00	Jun '99	Jun '98
ROA	1.28	1.28	1.13	1.05	1.13	1.11	0.90	0.92	0.99
NIM	3.55	3.75	3.96	3.59	3.60	3.81	3.98	3.91	4.06
Noninterest Income/AEA	1.64	1.56	1.43	0.69	0.77	0.73	0.49	0.48	0.47
Noninterest Expense/AEA	3.13	3.25	3.28	2.60	2.53	2.66	2.91	2.84	2.94
C&I Past-Due Ratio	1.73	1.36	1.38	1.28	1.52	1.77	0.93	1.15	1.29
Past-Due Ratio	1.56	1.59	1.90	1.24	1.39	1.79	1.52	1.76	2.08
Charge-Off Rate	0.26	0.30	0.31	0.12	0.10	0.15	0.03	0.04	0.05
Core Deposits/Assets	46.62	45.31	52.78	60.20	61.27	61.51	73.18	75.73	77.23
Loans/Assets	61.08	60.77	59.10	61.89	58.52	60.65	64.25	61.19	61.29
Reserves/Loans	1.42	1.51	1.77	1.13	1.16	1.27	1.02	1.05	1.10
Tier 1 Leverage Ratio	6.61	6.80	6.21	7.74	7.75	7.97	9.69	9.57	9.73
Tier 1 RBC Ratio	8.76	8.88	8.28	11.60	11.97	12.86	16.34	16.94	17.45

* For the six-month period ending June 30. Median data excluding institutions in operation less than three years and credit card banks.
AEA = average earning assets, Past-Due Ratio = Loans past due 30 days or more plus nonaccrual loans divided by gross loans, RBC = Risk-based capital
Source: Bank and Thrift Call Reports

[2] Federal Reserve Board. May and August 2000. *Senior Loan Officer Opinion Surveys on Bank Lending Practices.*

[3] Joint release by the Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation, *Bank Regulators' Data Show Continued Increase in Adversely Classified Syndicated Bank Loans.* October 10, 2000. The SNC program includes examiners from the three federal regulatory banking agencies: the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation. The SNC program reviews the credit quality of loans that are at least $20 million and shared by three or more insured institutions. Adversely classified loans include syndicated loans that have been rated Substandard, Doubtful, or Loss because of significant credit problems or default.

Region's total loan growth during this time.[4] Furthermore, although residential loans continue to account for the largest percentage of the Region's loans, the level has declined. In second quarter 1996, the median ratio of residential loans to total loans for the Region's commercial banks was just over 43 percent, while the median ratio of commercial loans to total loans was 31 percent. Four years later, the concentration levels of commercial and residential loans were almost equal, each approximating 39 percent of total loans.

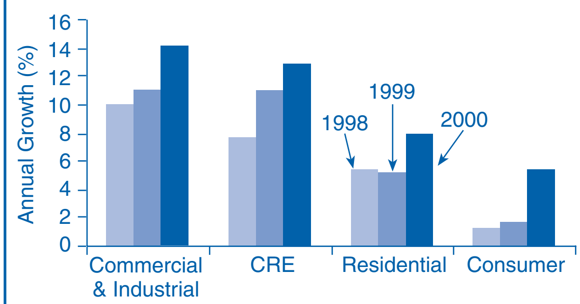
The growth in commercial loan volume reflects a shift into higher-yielding, potentially higher-risk loans as banks attempt to maintain earnings in the face of increasing competition and margin pressure. The decline in the proportion of residential loans held in bank portfolios also may reflect improved liquidity and efficiency in the secondary market for mortgages. The growth of the secondary mortgage market has facilitated banks' sale of mortgages to investors, giving banks that originate mortgages an alternative to holding these typically lower-yielding loans on their balance sheets.

Banks with Riskier Loan Profiles Report Higher Reserves but Lower Capital Levels

As C&I loan quality shows signs of weakening, banks that have significant concentrations in C&I credits may be more vulnerable if credit quality problems persist. Commercial banks that reported an above-average growth rate and concentration level of C&I loans (C&I lenders)[5] reported higher median loan loss reserve ratios but lower capital ratios than the Region's other banks (non-C&I lenders)[6] (see Table 2). Higher loan loss reserve ratios help mitigate the effect of credit losses on bank earnings. However, banks with lower capital ratios have less cushion to absorb additional losses. Also, although not shown in the table, the gap between the capital ratios of these two groups has widened during the past two years as capital ratios of the C&I lenders have declined more than those of non-C&I lenders. While banks' capital ratios have declined nationwide, a greater decline among banks that are potentially increasing credit risk profiles poses heightened concern.[7]

Chart 1

Commercial and Industrial and Commercial Real Estate Loans Show the Highest Growth in the Region



Note: Excludes credit card banks and banks in operation less than three years. Bars represent the median annual growth rates for the period ending June 30 of each year, adjusted for mergers.
Source: Bank Call Reports

Table 2

C&I Lenders Report Higher Levels of Reserve Coverage but Lower Capital Ratios...

Ratio	C&I Lenders	Non-C&I Lenders*
Reserves/Loans	1.28	1.21
Reserves/Past-Due Loans	203.81	185.27
Provisions/Charge-Offs	146.78	101.91
Leverage Ratio	8.38	9.68
T1 RBC	11.42	15.16

Data as of June 30, 2000.
* Banks with below-average growth and concentration in C&I loans.
C&I = commercial and industrial, T1 RBC = Tier 1 risk-based capital ratio
Source: Bank Call Reports

[4] Loan growth was computed as the difference in total loans from June 30, 1996, to June 30, 2000, for the Region's commercial banks, adjusted for mergers.

[5] C&I lenders are commercial banks with above-average growth and concentration in C&I loans according to the following criteria: a C&I loan growth rate above 14.55 percent (the median growth rate for the Region's banks between the 1999 and 2000 second quarters) and a concentration of C&I loans to total loans above 12.96 percent (the median ratio for the Region's banks as of June 30, 2000). The distribution of C&I lenders mirrored the geographic and asset size distribution of all commercial banks in the Region. New York and Pennsylvania were home to the largest share of the C&I lenders, and approximately 80 percent of the C&I lenders were commercial banks with less than $1 billion in assets. Banks less than three years old and credit card banks were excluded from the analysis, and the data are adjusted for mergers.

[6] Non-C&I lenders are commercial banks that reported an annual C&I loan growth rate and ratio of C&I loans to total loans below the median reported by the Region's commercial banks as of June 30, 2000.

[7] A comparison of banks that have above-average CRE and C&D loan growth and concentrations with those that have below-average growth and concentrations showed similar but less noteworthy differences.

Furthermore, higher operating costs may be constraining the earnings benefit that typically accrues to lenders that assume greater credit risk. Although C&I lenders reported a higher median asset yield and NIM during the second half of 2000, they also reported a lower median ROA (see Table 3). Higher overhead (perhaps because C&I lending can be more labor intensive than mortgage lending) contributed to the lower median ROA, as did higher provisions for loan losses. Moreover, should credit quality continue to weaken, banks may need to increase provisions for loan losses, further pressuring profitability.

TABLE 3

... AND HIGHER YIELDS BUT LOWER ROA

RATIO	C&I LENDERS	NON-C&I LENDERS*
ROA	1.08	1.15
ASSET YIELD	7.97	7.69
NIM	4.43	4.29
OVERHEAD/AVERAGE ASSETS	3.31	3.04
PROVISIONS/AVERAGE ASSETS	0.17	0.09

DATA AS OF JUNE 30, 2000.
* BANKS WITH BELOW-AVERAGE GROWTH AND CONCENTRATION IN C&I LOANS.
ROA = RETURN ON ASSETS, C&I = COMMERCIAL AND INDUSTRIAL, NIM = NET INTEREST MARGIN
SOURCE: BANK CALL REPORTS

A Slowing Economy Could Heighten Credit Risk

Although economic conditions were favorable throughout most of the Region during the first half of 2000, some analysts think that the nation's economy may be slowing. Less robust economic growth could have implications for commercial loan credit quality. Levels of reserve coverage that appear adequate in a robust economy could become less so in a slowing economy, particularly for institutions that have a larger proportion of higher-risk commercial loans and lower capital ratios. Commercial loans can affect an institution's earnings more seriously because they generally result in greater losses per dollar than consumer and residential loans.[8] Although recent surveys indicate more disciplined underwriting by banks, a prolonged period of economic and financial market weakness nevertheless could negatively affect credit quality.

Some of the Region's Housing Markets Show Significant Price Appreciation

During the past several years, the wealth of new jobs and high level of consumer optimism have stimulated demand for housing around the Region. Recently, communities surrounding the Region's larger urban areas, primarily **New York City, Baltimore,** and **Washington, D.C.,** where job growth has been strong, reported the most significant price appreciation. Price increases in these areas had been relatively modest during the mid-1990s but rose sharply as the 1990s came to a close. Home prices in many of these areas increased at double-digit rates during the first six months of 2000, far exceeding both the general inflation rate of approximately 3 percent and the average price increase for homes nationally.

While residential property prices in the Region's largest metropolitan areas have appreciated faster than the national average, home prices in some of the Region's smaller cities have increased more slowly than the national average. In fact, the median housing price declined in parts of upstate **New York** over the past several quarters. Slower employment gains and limited population growth compared with the rest of the Region and the nation have subdued demand for homes in these areas. In **Philadelphia,** housing prices declined over the past year, despite employment gains. Like many areas in eastern **Pennsylvania,** the city has experienced population loss and a generally sluggish economy. At the other end of the state, in **Pittsburgh,** figures from the ***National Association of Realtors*** show that prices for single-family homes essentially have held steady for the past two years.

Shortage of Available Homes Has Contributed to Price Appreciation

During the first half of the 1990s, the Region experienced a relatively low level of new home construction, as its economy slowly recovered from the recession of the early 1990s. In some of those years, the number of new residential housing permits dropped at double-digit rates. The number of permits issued increased moderately toward the end of the 1990s, as the economy recovered from the recession and demand for new homes increased

[8] ING Barings. September 2000. *Credit Quality Climbing the Wall of Worry.*

in many of the Region's metropolitan statistical areas (MSAs). However, the level of permits increased a scant 2.2 percent in 1999 and declined in 2000, as higher interest rates curtailed new development.

Despite the vibrant economy and strong demand, construction of new single-family homes generally has been modest in the Region's larger cities. High construction costs and the lack of developable lots have limited the supply of new homes. According to ***Economy.com,*** home inventories were particularly low in New York City, **Long Island, Bergen** and **Passaic counties,** and **Trenton, New Jersey** (see Chart 2).[9] According to a recent report, New York City was one of the two tightest housing markets in the country, along with Los Angeles.[10]

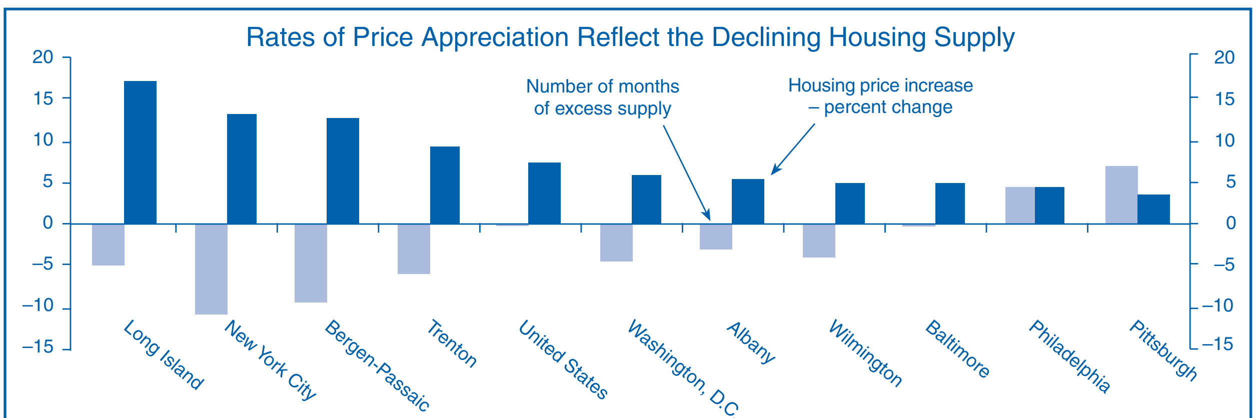
As a result of the limited supply and strong demand, home prices in some of the Region's major markets have been rising three to four times faster than household incomes over the past year (see Chart 3, next page).[11] Areas experiencing the greatest price increases relative to income include communities adjacent to Baltimore and New York City (including New Jersey and Long Island). These areas represent some of the Region's largest metropolitan areas and boast the strongest economic growth.

Recent Price Appreciation Is Pressuring Affordability of Homes

Measures of housing affordability show that it is becoming more difficult to afford a home. The ***National Association of Realtors' Composite Housing Affordability Index,*** which measures a household's ability to purchase a single-family home, indicates that during the first seven months of 2000, homes became less affordable or more costly relative to household income across the nation. Increased home prices relative to household income, coupled with higher mortgage rates, which rose more than 150 basis points between October 1998 and June 2000, contributed to the decline in home affordability.

Affordability measures for the Region's cities also have increased since 1999, reflecting higher housing prices and interest rates, factors that also affect the national affordability measure. Unlike in 1990, however, most of the Region's cities have become more affordable relative to the nation (see Table 4, next page).[12] Only New

CHART 2



Note: Housing prices are percent change first quarter 1999 to first quarter 2000.
Sources: Excess supply data: Economy.com analysis; housing prices: Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association

[9] This analysis was presented at the spring 2000 Economy.com Outlook Conference.

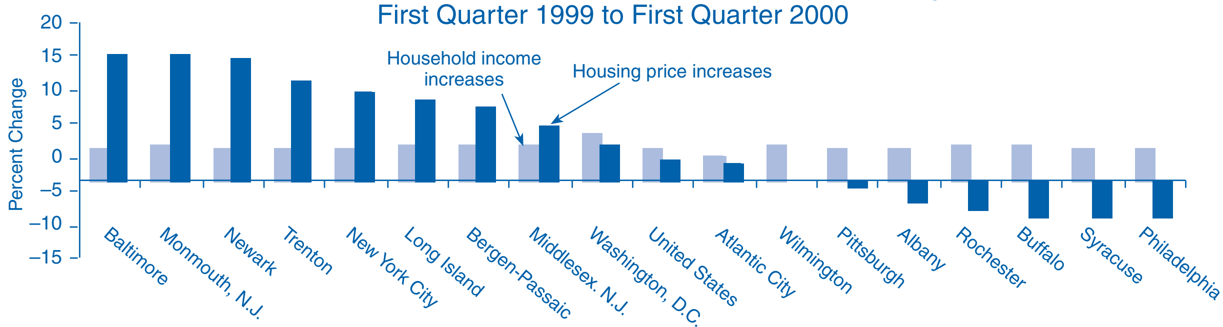
[10] Credit Suisse First Boston. August 2000. *August Housing Monthly*.

[11] Household income data are from the Bureau of the Census. Economy.com develops quarterly estimates. Amounts include all wages but not income from capital gains.

[12] The regional housing affordability measure was calculated internally. The measure assumes that 80 percent of the purchase price of the home is financed at the prevailing 30-year fixed conventional mortgage rate provided by the Federal Home Loan Mortgage Corporation. The measure uses the median price of a single-family home for each metropolitan area published by the National Association of Realtors and estimates of household income from Economy.com. The regional measure does not include income from capital gains. A higher number means that the purchase of a home is more expensive, or less affordable, relative to household income in that area.

CHART 3

Housing Price Appreciation Substantially Exceeds Increases in Household Income in Baltimore, Parts of New Jersey, and Long Island: First Quarter 1999 to First Quarter 2000



Sources:National Association of Realtors, U.S. Bureau of the Census. Quarterly esimates income poivided by Economy.com.

York City and Bergen County, New Jersey, a New York City suburb, were less affordable (a higher index number) in 2000 than the nation. Because these cities are home to many Wall Street commuters, home prices reflect the substantial wealth effect of the vibrant financial markets over the past several years. Affordability measures for the Region and the nation remain lower than 1990 levels, however, in part because of generally lower interest rates today than a decade ago.

Rapid Price Increases May Stress Household Budgets

One consequence of rising home prices, particularly if they are increasing substantially faster than household income, is that they may place additional financial stress on prospective homeowners, who may be faced with higher debt servicing costs. According to the ***Federal Reserve Board,*** in first quarter 2000, the debt service burden for the nation (the ratio of consumer debt payments to disposable personal income) reached the highest level since first quarter 1988.[13] A higher consumer debt service burden means households have less income to cushion against increased or unexpected financial responsibilities. If the economy slows, household incomes may decline (or net worth may be reduced), and households may increase borrowings to compensate for the loss of income. In that situation, debt burdens could grow at a time when jobs and livelihoods are less secure.

[13] Data indicated that, nationally, consumer debt service burdens have risen disproportionately more for lower-income households (incomes less than $25,000) and mid-income households (incomes between $25,000 and $50,000) than for higher-income households. Debt service burdens by household income level were not available at the state level. [Federal Reserve Board, Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances.]

TABLE 4

After Becoming More Affordable in the 1990s, Homes Became Less Affordable in 2000

Metro Area	1990	1999	2000
Albany	28	16	18
Atlantic City	30	NA	18
Baltimore	22	14	18
Bergen–Passaic, N.J.	36	22	29
Buffalo	24	13	14
Long Island	26	18	22
Monmouth–Ocean, N.J.	27	20	23
New York City	38	24	29
Philadelphia	16	11	12
Pittsburgh	34	19	21
Rochester	20	13	14
Syracuse	22	13	14
Trenton	28	14	NA
Washington, D.C.	27	17	18
Wilmington	25	14	16
United States	**24**	**20**	**23**

Shaded areas are less affordable than the nation.
Data represent percentage of income needed to purchase a median-priced house in the second quarter of that year.
NA = not available
Sources: National Association of Realtors, Economy.com, Federal Home Loan Mortgage Corporation

Debt service burdens also have risen in the Region since the end of the recession in 1992 (see Table 5). Although increasing, except for **Delaware** and **Maryland,** the Region's state debt service burdens were below the national average at the end of 1999. Higher housing prices and a greater percentage of renters have contributed to a lower rate of home ownership in New York and New Jersey. Lower home ownership rates could cause state debt service burdens to be underestimated because rent and lease payments are not included in this measure. High per capita incomes in these states also contributed to the lower debt service burden ratio. Nonetheless, the Region's debt service burdens are increasing, raising concern about consumer credit quality.[14]

TABLE 5

SINCE 1995, DEBT SERVICE BURDENS HAVE BEEN INCREASING IN THE NATION AND IN MOST STATES IN THE REGION

STATE	1992	1995	1999
DELAWARE	15.1	14.7	15.0
MARYLAND	14.8	15.8	16.2
NEW JERSEY	12.5	13.1	12.8
NEW YORK	10.2	10.4	10.7
PENNSYLVANIA	11.3	12.1	13.2
UNITED STATES	**11.7**	**12.7**	**13.5**

DATA REPRESENT FOURTH QUARTER OF THE YEAR.
DEBT SERVICE BURDEN IS DEFINED AS HOUSEHOLD DEBT SERVICE AS A PERCENTAGE OF DISPOSABLE INCOME.
DEBT BURDEN INCLUDES MORTGAGE AND CONSUMER INSTALLMENT DEBT.
SHADED AREAS ARE THOSE WHERE DEBT BURDENS ARE GREATER THAN THOSE OF THE NATION.
SOURCE: ECONOMY.COM ESTIMATES

Region's Recent Housing Boom Has Been More Modest than in the 1980s

Although housing prices have increased sharply in parts of the Region, the strength and duration of the Region's current housing boom has been more modest than during the period that preceded the 1990–1991 recession. Even in the Region's larger cities and adjacent areas, substantial price appreciation has occurred only during the past 12 months. In contrast, in many of the Region's cities, price appreciation during the housing boom of the late 1980s lasted for several years.[15] During that period, home prices in some of the Region's areas increased at double-digit rates every year, compared with single-digit rates nationally. During the latter half of the 1990s, the percentage increase of home prices in the Region was generally less than half that of the 1980s. Moreover, recently, home prices in many of the Region's cities have increased less than the national average.

Sales of existing single-family homes in the Region also indicate a more modest housing boom than in the 1980s. Data from 33 MSAs in the Region and the nation show that sales of single-family homes picked up substantially during the latter half of the 1990s. In the nation, however, housing sales volume exceeded the 1980s peak in 1993, while in the Region, sales volume lagged the 1980s peak (see Chart 4, next page). The data also show a greater percentage decline in home sales in the Region than the nation toward the end of 1999 and through the first half of 2000, which coincided with a period of rising interest rates and softness in the equity markets. Because much of the Region's housing is located near communities dependent on a vibrant Wall Street, instability in the stock market and rising interest rates may have contributed to reduced home sales. A study linking rising interest rates to changes in the Region's gross state product showed that the Region appears more sensitive than the nation to changes in interest rates.[16]

Region's Housing Markets Experiencing Significant Price Appreciation, although Not on Par with the 1980s

Historically, residential real estate markets have been susceptible to boom-and-bust economic cycles. During the 1980s, several areas of the nation, including Texas and New England, experienced an economic boom, strong residential real estate development, and substantial home price appreciation. Subsequent regional recessions took a heavy toll on these residential markets.[17] Many parts of the New York Region also experienced significant price appreciation during the late 1980s

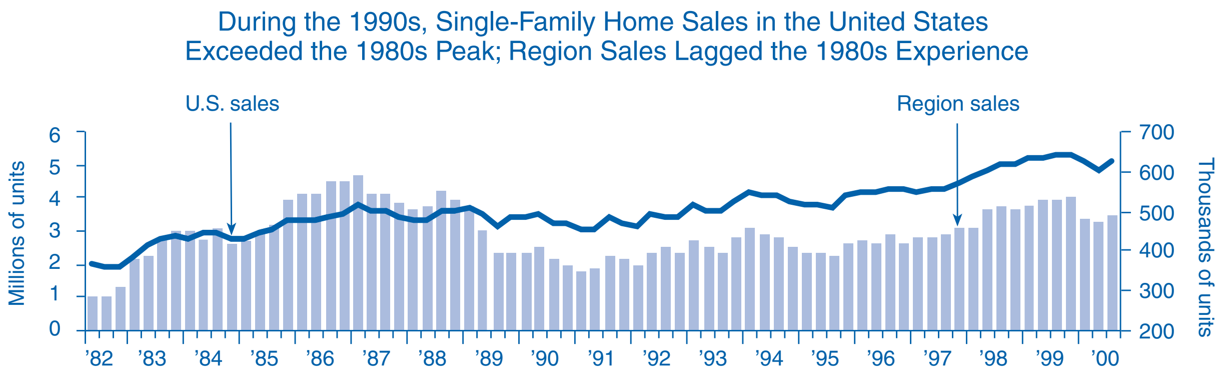
[14] Chen, Celia. June 30, 2000. "Risky Debt Service Burdens." www.Dismal.Com.

[15] Analysis includes information for 21 of the Region's MSAs, using housing price data supplied by the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association.

[16] "Higher Interest Rates May Curtail the Region's Economic Expansion." *Regional Outlook,* fourth quarter 1999.

[17] For more information regarding residential real estate markets throughout the nation, see "Rising Home Values and New Lending Programs Are Reshaping the Outlook for Residential Real Estate." *Regional Outlook,* third quarter 2000.

CHART 4



Note: 2000 is through the first half of the year only.
Sources: National Association of Realtors, U.S. Bureau of the Census, Economy.com

through the early 1990s, as the economy expanded and incomes improved. Home price appreciation reflected a booming economy, but it put increasing budgetary pressure on residents who wished to purchase new homes. Some businesses were unable to locate or expand in parts of the Region because it was difficult for workers to find affordable housing. High-housing-cost areas were particularly vulnerable to a relatively mild national recession in the early 1990s that harmed the Region more severely.

Presently, some of the Region's largest metropolitan areas are again experiencing significant home price appreciation, reflecting strong economic conditions and a limited supply of new homes. Although by most measures the Region's current housing boom is not as strong as that of the late 1980s and early 1990s, price increases may be forcing consumers in some areas to stretch budgets and increase debt service burdens. These areas, particularly the communities in New York and New Jersey that are within commuting distance of Wall Street, are increasingly dependent on strong financial markets. With consumers' portfolios flush with huge bonuses and capital gains, double-digit home price appreciation can be accommodated. Should the financial markets become anemic for an extended period, however, the risk of housing price deflation would increase. In that event, consumer credit quality could be strained, and bank collateral values on residential mortgages could be tested.

New York Region Staff

Emerging Risks in an Aging Economic Expansion

- **The economy and the banking and thrift industries are reporting generally healthy conditions. However, the economic expansion is aging, and it is unlikely that the vigor experienced during the first half of 2000 can be sustained.**

- **Likewise, record banking and thrift industry profits, healthy capital cushions, and good asset quality of recent years may not be sustainable. Declining net interest margins, rising commercial loan losses, tighter liquidity, and riskier asset composition are among the warning signs that industry performance may have peaked for this business cycle.**

- **Specific areas of concern include growing reliance on noncore funding; heightened interest rate risk; increased exposure to market-sensitive revenues; deteriorating credit quality; rising leverage among businesses and households; and signs of imbalance in some residential and commercial real estate markets.**

Although no readily apparent situations or imbalances suggest that a recession or widespread banking problems will develop in the near term, warning signs are present. A highly competitive banking industry shapes the environment in which pressures on insured institutions are unfolding. The presence of a large share of newly chartered banks in some areas appears to be raising the risk profile among all institutions in certain markets. Publicly owned companies remain under intense pressure to grow earnings and increase shareholder value. In addition, local banking environments exist in which a confluence of risks is generating heightened vulnerability for all participants, even during healthy economic times. Complacency in these environments may have negative repercussions for many insured institutions going forward.

Imbalances Are Appearing amid a Healthy Macroeconomic Environment

The performance of the U.S. economy contributes to the opportunities and risks financial institutions face. The current cyclical expansion, now nine and one-half years old, is displaying signs of aging while setting a record for longevity. A consensus forecast calls for moderate real gross domestic product (GDP) growth through 2001, following robust gains in the first half of 2000. Current conditions might be called a “soft landing,” in which real GDP growth slows to a sustainable noninflationary rate of 2.5 to 3.5 percent, and unemployment hovers around recent rates.

Although the current macroeconomic environment might appear to be the best of all possible worlds, areas of concern exist. One is that sustained prosperity tends to foster higher levels of risk taking, overconfidence, and complacency. For example, the turmoil in world foreign exchange and financial markets during 1997 and 1998 illustrates how dramatic imbalances can develop and trigger disruptive adjustments even during healthy economic times.

Currently, no specific situation or imbalance seems to threaten the viability of the expansion. However, as detailed below, several likely will contribute to slower economic growth. Situations that warrant monitoring include the following:

- The repercussions from higher energy prices are unfolding. Historically, oil price shocks have weakened several other long-lived economic expansions.

- Short-term interest rates rose over the past year while longer-term rates declined, resulting in a modest inversion of the yield curve. This relationship may inhibit the profitability of some lenders’ practice of borrowing short term and lending longer term and also complicate the interest rate risk management process for some insured institutions.

- Continuing low unemployment suggests that demand for additional workers will go unfilled, thus limiting economic growth or triggering bidding wars that increase workers’ compensation and, potentially, inflation.

- Stock market sentiment is no longer strongly bullish. A pullback from high valuations and optimism could trigger negative repercussions on consumers’ net worth and spending as well as on the level of business investment.

- A large international trade deficit and strong U.S. dollar may be an unsustainable combination over the long run. Meanwhile, repatriated profits of U.S. corporations are being trimmed by the dollar's strength relative to the euro and other currencies.

- Household debt burdens are historically high, with leverage rising the most in recent years among low- and middle-income households. These households' access to credit has increased as lenders competed more fiercely for customers.

- Corporations are more highly leveraged, and potential default risk rose in the past year across a range of industries. Meanwhile, downgrades of publicly traded corporate debt issues are exceeding upgrades by a 2 to 1 ratio.

- In some metropolitan areas, overheated housing markets are developing, in which home prices are rising dramatically and exceeding gains in median incomes.

- Potential signs of excess commercial real estate construction are appearing in several urban areas where banks' construction loan growth also is strong.

Economic indicators of what lies ahead are not clear-cut, and each possible scenario contains a set of potential challenges for insured institutions and regulators. Should economic growth slow considerably, current vulnerabilities, such as highly leveraged borrowers' debt loads and overheated housing markets, could worsen significantly. As evidenced by the rash of bank failures during the 1980s, it doesn't always take a national recession for problems to develop. Alternatively, sustained rapid growth might foster new vulnerabilities and allow current imbalances to intensify or build up. For example, speculative construction could accelerate, stock market volatility could increase, or ballooning trade deficits could generate turmoil in foreign exchange markets.

Signs of Strain Are Also Appearing amid Healthy Banking and Thrift Industries

With the long economic expansion as a backdrop, insured institutions in the aggregate are performing very well. However, the record profits attained in recent years may not be sustainable. The losses posted recently by several large institutions are striking examples of increased appetite for risk resulting in significant financial loss during a period of strong economic growth. While these are isolated instances, they are indicative of the increasingly competitive environment facing the financial services industry.

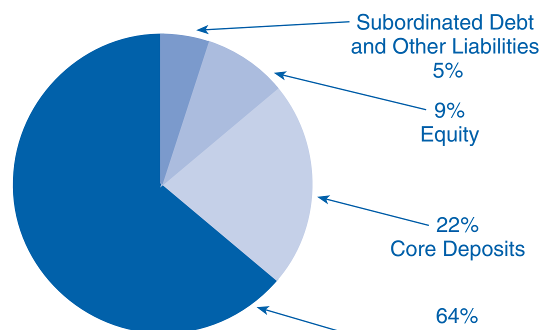
Overall industry profitability is beginning to soften, led primarily by rising commercial loan losses at large institutions and declining net interest margins in institutions of all sizes. Credit card loss rates, which had been steadily falling since late 1997, have stalled in recent quarters, suggesting that recent increases in interest rates and energy costs not only are affecting businesses but also are taking a toll on some consumers. Other signs suggesting that aggregate risk within the system has risen include the growing reliance on noncore funding to support asset growth, heightened interest rate risk at many institutions, growing concentrations in traditionally higher-risk loan classes, and a shift in institutions' overall asset mix toward higher-risk categories. A brief discussion of these risks follows.

Funding Patterns Heighten Liquidity Concerns

Lackluster core deposit growth is placing pressure on bank earnings and contributing to rising liquidity risk in the banking system. During the past five years, the compounded annual rate of core deposit growth for all insured institutions was just 2.8 percent. Assets over this time grew at a 6.6 percent rate. Accordingly, a significant portion of the industry's growth has been funded by noncore sources (see Chart 1). The higher cost and rate sensitivity of these funds put downward pressure on net interest margins, particularly in a rising rate environment.

CHART 1

Most of $2 Trillion of Asset Growth since 1995 Was Funded with Noncore Funds



Source: Bank and Thrift Call Reports, June 2000 and June 1995

To compensate for higher funding costs, the industry has pursued growth in higher-yielding asset classes that are traditionally both riskier and less liquid. For example, almost 37 percent of the asset growth in the past five years has come from nonresidential real estate and commercial and industrial loans.

For institutions that fund illiquid assets with wholesale sources, any adverse events that trigger a lack of confidence in the institution may result in higher funding costs, thus placing further pressure on margins. In efforts to obtain funding, an institution also may pledge a greater portion of its best quality assets as collateral, further reducing liquidity. Finally, in instances where funding needs have exceeded available liquidity, the forced sale of illiquid assets to meet funding outflows could result in losses if market conditions are unfavorable. Presumably, the FDIC, as insurer, would suffer greater losses if such an institution failed, because it would be relying on proceeds from the liquidation of less liquid, and potentially lower-quality, assets to satisfy the claims of insured depositors.

Subprime lenders, in particular, tend to rely heavily on noncore funding to pursue aggressive growth strategies. Chart 2 illustrates the extent to which noncore funding exceeds the level of liquid assets for this group. The chart suggests the difficulty these institutions may encounter if forced to convert assets to meet funding outflows. Although subprime lenders may use noncore sources to fund riskier assets to a greater extent than the industry at large, this illustration exemplifies a systemic trend that is raising liquidity risk industrywide and is increasing risk to the insurance funds.

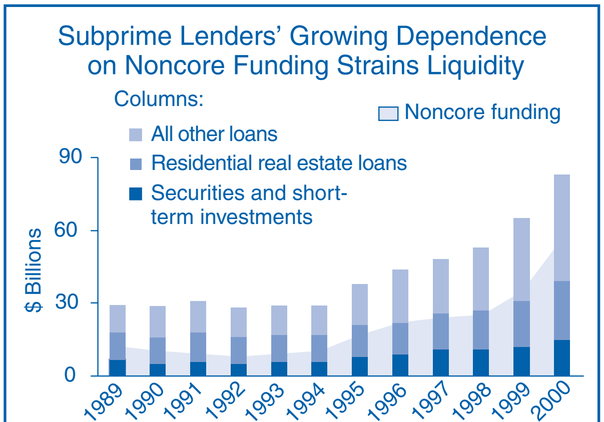
Increasing Levels of Interest Rate Risk Challenge Some Institutions

The refinancing boom of the late 1990s spurred a significant shift into longer-maturity assets for many insured institutions. During this period, a vast majority of mortgage borrowers opted for longer-term, fixed-rate loans, which they obtained at historically low rates. A great deal of the higher-rate or adjustable-rate loans that borrowers refinanced were held in the portfolios of insured institutions, which contributed to a general lengthening of the maturity of assets held at insured institutions.

The trend toward longer-term, fixed-rate assets has been particularly pronounced among mortgage lenders. For example, state-chartered savings banks, which are traditionally mortgage lenders, have experienced a dramatic increase in long-term assets. As of June 30, 2000, almost 45 percent of the median savings bank's earning assets were not scheduled to reprice for five years or longer (see Chart 3).

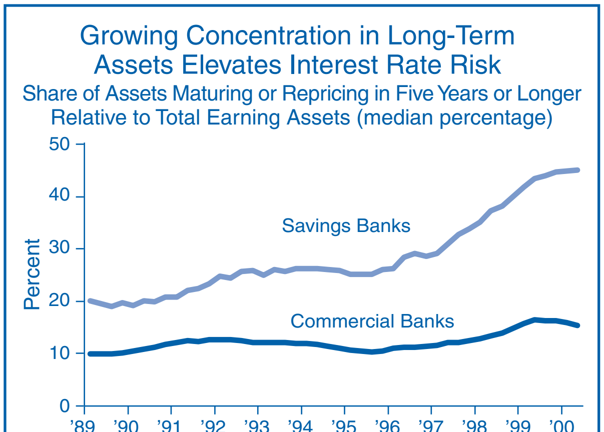
Fixed-rate mortgage-related assets at federally chartered thrifts have risen similarly. From year-end 1995 through first quarter 2000, the percentage of fixed-rate mortgage-related assets at thrifts with assets less than $1 billion rose from 49 percent to 60 percent of mortgage-related assets. Some thrifts and savings banks, therefore, have significant exposure to rising rates from low-yielding long-term assets.

CHART 2



Source: FDIC Division of Supervision and Bank and Thrift Call Reports (data are merger adjusted)

CHART 3



Source: Bank Call Reports, excluding Thrift Financial Report filers

While most commercial banks do not have as high exposure to rising rates as savings banks, some may have taken on significant risk. The median savings bank has a ratio of long-term assets to earning assets that corresponds to the ratio level for the 93rd percentile of commercial banks. Although the 93rd percentile is in the tail of the commercial bank distribution, almost 600 commercial banks have a concentration in long-term assets that exceeds that of the median savings bank. These institutions may be exposed to significant interest rate risk as well.

While assets have lengthened considerably for many institutions, there has not been a corresponding extension of liabilities. To the contrary, funding pressures are tending to make bank liabilities more rate sensitive. These diverging trends generate concern, especially in a rising interest rate environment. That is, rate increases drive up the cost of funds more rapidly than earning asset yields at institutions with liability-sensitive interest rate risk postures. In a significantly higher interest rate environment, many institutions' current postures likely would cause heavy margin erosion.

Most institutions that have high concentrations in long-term assets also have strong capital and an asset mix that contains lower credit risk than that of many other institutions. Among savings banks, interest rate risk primarily arises from significant concentrations in residential mortgage loans, whereas the typical commercial bank's exposure is more likely to arise from large holdings of long-term securities. However, some institutions with concentrations in long-term assets also may have lower capital levels, a higher-risk asset mix, or poor earnings. Rising rates could weaken these institutions and make it more difficult for them to weather adverse economic or other developments.

Dependence on Market-Sensitive Revenues Increases Earnings Volatility for Some Institutions

During the recent generally favorable conditions in financial markets, the share of revenue earned from business lines susceptible to financial market volatility has increased substantially for some of the industry's largest institutions. Among these revenue sources are fees and gains from asset management, brokerage, investment banking, venture capital, and trading activities. The 19 institutions most active in these lines of business earned over 26 percent of their net operating income from such sources in the second quarter of 2000. Other large institutions also have reported a growing dependence on these volatile sources of revenue.

Turbulence in the financial markets has led to greater earnings volatility for some of these institutions. Stress in the financial markets could weaken the demand for underwriting services or significantly reduce trading revenues or venture capital gains. Furthermore, the same factors that are causing volatility in the financial markets could hamper loan growth and lead to slower revenue growth from core business lines. Should increased earnings volatility from exposure to market-sensitive revenues combine with slower revenue growth from core business lines, some institutions could face significant earnings challenges.

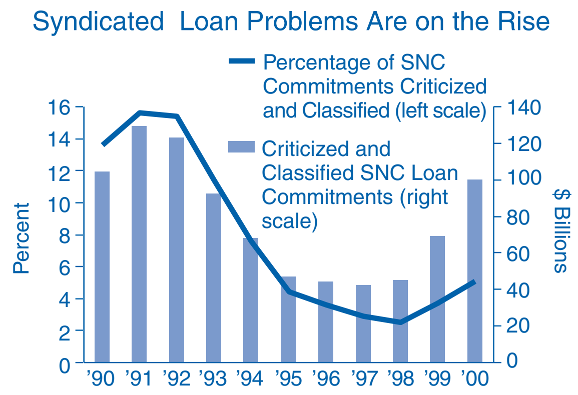
The Rising Level of Problem Business Loans Is Centered in Large Banks

Second quarter 2000 commercial and industrial (C&I) credit quality indicators at banks deteriorated for the eighth consecutive quarter. Noncurrent C&I loans—those on nonaccrual status plus those 90 days or more past-due—rose 13 percent over first quarter 2000 levels to $14.5 billion, or 1.4 percent of total C&I loans. Noncurrent loan levels for the period ending June 2000 were 40 percent higher than the year-earlier level. Net C&I loan loss rates also continue to edge higher but remain well below those experienced by banks in the late 1980s and early 1990s.[1]

Large banks, particularly those active in syndicated lending, are bearing the brunt of deteriorating C&I loan quality. Recent increases in criticized and classified shared national credits (SNCs), which are loans exceeding $20 million that are shared among three or more lending institutions, are illustrated in Chart 4. In the 2000 SNC review, criticized and classified credits increased 44 percent over 1999 levels to 5.1 percent of total SNC commitments. Furthermore, the bulk of the increase was in the more severe *classified* categories, which now comprise 64 percent of total criticized and classified credits, compared with 54 percent at the year-earlier review.

[1]During second quarter 2000, banks posted an annualized net C&I loss rate of 0.67 percent, up from 0.55 percent for second quarter 1999. For comparison purposes, net quarterly annualized C&I loss rates averaged 1.11 percent from fourth quarter 1991 to fourth quarter 1993.

CHART 4



Note: C&I = commercial and industrial; SNC = shared national credit
Source: Shared National Credit Program

C&I loan quality indicators continue to deteriorate despite generally favorable economic conditions. Three factors explain much of this deterioration: certain weak industries, rising corporate debt burdens, and the seasoning of syndicated loans underwritten from 1997 to 1998, when many banks significantly eased business lending standards.

Industry Sector Weaknesses

The financial stresses facing healthcare and entertainment companies (cinema operators in particular) have been well publicized. While the healthcare and entertainment sectors have contributed significantly to the decline in commercial credit quality, problems within these two sectors do not account for the full extent of the increase in noncurrent loans and problem SNC loans. Both of these sectors are within the broader services sector, which experienced a $4.6 billion increase in criticized and classified credits from the 1999 to the 2000 SNC review. However, this increase accounts for only 15 percent of the $30.8 billion increase in criticized and classified SNCs overall.[2] The expected default probabilities evident in market-based information can be used to identify other industry sectors experiencing financial stress. ***KMV LLC*** has developed a model that uses publicly available information to estimate the likelihood of default of individual firms.[3]

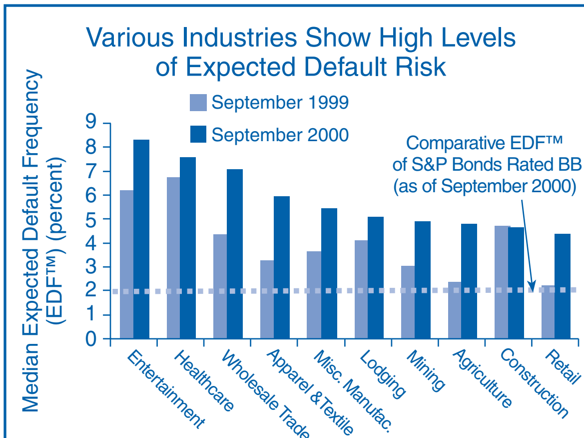
KMV's model is used by many lenders to monitor and evaluate obligor risk and credit risk trends. Applied to the analysis of industries, the output of KMV's model is just one of a number of indicators that suggest weaknesses in certain industry sectors.

Sectors that include a high proportion of firms with high default probabilities (median one-year default probabilities exceeding 4 percent) are shown in Chart 5. Using entertainment as an example, the bars in the chart show that in September 2000, one-half of publicly held entertainment firms had greater than an 8 percent chance of defaulting on their obligations within one year. In September 1999, this same proportion of entertainment companies had a substantially smaller (6 percent) chance of defaulting within a 12-month period. The median likelihood of default for all the industries shown in the chart far exceeds that of ***Standard & Poor's***-rated, BB-grade (sub-investment-grade) obligors as of September 2000, as indicated by the dotted line in the chart.

Rising Corporate Debt Burdens

U.S. corporate debt burdens, as measured by the debt-to-net-worth ratio for nonfarm, nonfinancial businesses, continue to increase. This ratio reached 83 percent in the second quarter of 2000, up from 72 percent as of year-end 1996. Although debt burdens remain below the 1988–1992 average of almost 87 percent, U.S. businesses are nevertheless becoming increasingly vulnerable to rising credit costs and disruptions in credit availability.

CHART 5



Source: Credit Monitor™ ©2000, KMV LLC, all rights reserved

[2] See the interagency release of SNC results at www.occ.treas.gov/ftp/release/2000-78a.pdf.

[3] KMV Credit Monitor® uses information from a firm's equity prices and financial statements to derive KMV's Expected Default Frequency (EDF™), which is the probability of the firm defaulting within a one-year period. The main determinants of a firm's likelihood of default: the firm's asset value, the volatility of the firm's asset value, and the degree of financial leverage.

Seasoning of 1997–1998 Vintage Loans

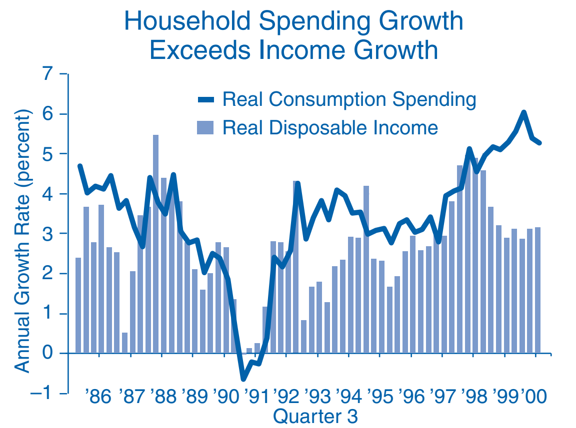
Results of recent supervisory surveys suggest that banks are tightening terms and conditions on loans to small-, middle-, and large-market obligors. However, this tightening follows a relaxation of standards in prior years that has contributed to a heightened level of risk in banks' loan portfolios.[4] Not coincidentally, the period between 1995 and 1998 saw a sharp rise in the proportion of lower-graded, higher-risk credits categorized as leveraged transactions by ***Loan Pricing Corporation.*** Leveraged loan originations—those priced at 150 basis points or more over the London Inter-Bank Offer Rate (LIBOR)—rose from 12 percent of total syndicated loan originations in 1995 to 31 percent in 1999. According to a recent ***Standard and Poor's*** commentary, many banks have acknowledged that 1997 and 1998 vintage credits are beginning to produce higher problem loan levels.[5]

Household Sector's Leverage Is High, and Imbalances Are Appearing

Consumers are enjoying the benefits of the economic expansion, as jobs are plentiful, home ownership remains generally affordable, and credit seems to be readily available for financing motor vehicles and other major purchases. These conditions contributed to record high sales of cars and light trucks during the first nine months of 2000, helping sustain the consumer spending growth shown in Chart 6. One corollary of high vehicle sales, however, is softening prices for used vehicles. Consequently, some lessors—including banks—are realizing lower-than-expected residual values on leased vehicles, which, in turn, are triggering losses in their lease portfolios. This situation illustrates one problem that lenders can encounter even in good economic times.

Spending growth remained robust in recent quarters even as gains in disposable income slowed. The gap between income and spending growth is "financed" as households draw down savings, tap capital gains, refinance mortgages, assume more debt, or undertake some combination of these measures.

CHART 6



Source: Bureau of Economic Analysis via Haver Analytics, Inc.

From 1995 through 1998, and likely since then, the increase in both leverage and debt servicing burdens has been concentrated among low- and middle-income households. Among families holding debt in 1998, debt payments exceeded 40 percent of disposable income for nearly 20 percent in the $10,000 to $24,999 income group and nearly 14 percent in the $25,000 to $49,999 group.[6] One concern is that these debt-laden families may have inadequate financial resources to make payments should adverse conditions or job loss occur. In such instances, lenders could be doubly affected if households draw on their credit card and home equity lines of credit, further compromising their repayment ability, in order to sustain spending in excess of income. The recent rise in credit card losses in banks' card portfolios and rising losses in the portfolios of subprime lending specialists may indicate that strains among some households are spilling over to lenders. ***Moody's Investors Service*** expects credit card losses to rise through 2001, according to a recent analysis of prospects for the U.S. credit card industry.

Overheated residential real estate markets in several metropolitan statistical areas (MSAs) may be another warning of economic imbalances. Dramatic gains in home resale prices in San Francisco stand out (see Chart 7), but this market is not alone in experiencing appreciation considerably higher than income growth. In some markets, where financial-services or information-technology workers are concentrated, bidding wars for properties may reflect the fact that affordability is

[4] See Federal Reserve Board's *Senior Loan Officer Opinion Survey on Bank Lending Practices for May and August 2000* and Surveys of Credit Underwriting Practices for 1999 and 2000 from the Office of the Comptroller of the Currency.

[5] "U.S. Bank Loan Portfolios Reflect Rise in Corporate Bond Defaults." July 20, 2000. *Standard and Poor's Commentary*.

[6] Kennickell, Arthur B., Martha Starr-McCluer, and Brian J. Surette. January 2000. "Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances." *Federal Reserve Bulletin*. Vol. 86, 1–29.

enhanced by gains in wealth rather than in income. Even so, similar surges in home resale prices in the past often were not sustainable. The subsequent years of stagnant or falling collateral values caused financial stress among some homeowners and their lenders. Further concern about residential real estate lenders arises because pockets of speculative construction under way in some markets may produce units that become increasingly difficult to sell at anticipated asking prices.

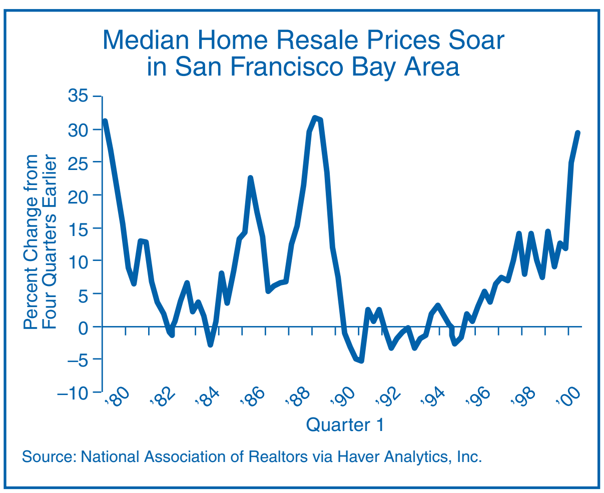
Construction and Development Loan Growth Is Accelerating

Commercial real estate (CRE) construction across all property sectors has grown during this expansion, with office construction particularly active. The amount of office space completed in mid-2000 was the largest since 1989 and is projected by ***Torto Wheaton Research*** to continue rising. Not surprisingly, construction and development (C&D) loan volume, growth rates, and concentrations are trending upward rapidly. While total private real estate spending grew about 6.5 percent over the four quarters ending midyear 2000, C&D loans at insured institutions rose by 26 percent. C&D loan growth has remained above 20 percent since 1997, and the aggregate volume of C&D loans is the highest since 1989.

Such growth is contributing to higher concentrations of C&D loans relative to Tier 1 capital. At current levels, concentrations do not begin to approach those of the late 1980s. However, several metropolitan areas have a large percentage of insured institutions reporting high and rising concentrations. Table 1 (next page) shows MSAs with at least 15 nonspecialized community banks[7] and at least one-third of those institutions reporting concentrations in C&D loans equal to at least 100 percent of Tier 1 capital. The Atlanta MSA stands out. Sixty-five percent of Atlanta's 85 nonspecialized community institutions reported C&D loans exceeding 100 percent of Tier 1 capital on June 30, 2000, and 35 percent reported a concentration exceeding 200 percent. The aggregate C&D concentration for all 85 institutions in the MSA was 156 percent, the highest among MSAs with at least 15 institutions of similar size and nature. Several other markets also include significant shares of institutions with high concentration levels.

Nine of the 16 markets highlighted in Table 1 not only have a relatively high percentage of C&D loan exposure but also appear vulnerable to overbuilding in two or more property types.[8] While these markets show no clear signs of emerging economic stress, lenders there clearly may be at greater risk should economic or real estate conditions sour. Other concerns regarding CRE lending arise from a recent ***Office of the Comptroller of the Currency*** survey, which reports heightened credit risk in CRE portfolios and predicts it will increase through 2001. In addition, respondents to a midyear 2000 FDIC survey of examiners reported more frequent comments about excess office and retail space.

CHART 7



Increasing Share of De Novo Institutions Raises the Stakes in Some Markets

A common element among the metropolitan markets listed in Table 1 (next page) is the presence of newer institutions. In 10 of the 16 markets, at least 20 percent of the nonspecialized community institutions are less than three years old. The drive to build market share among these institutions, particularly if they are publicly traded entities, is increasing the competitive pressure on banks and thrifts in these markets. In some instances, the aggregate cost of deposits within the MSAs has risen faster than in the nation as a whole, risk

[7] The term "nonspecialized community bank" refers to institutions with total assets under $1 billion that are not specialty institutions such as credit card or trust banks.

[8] See "Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding," *Regional Outlook,* third quarter 2000, which identifies markets where new construction is high relative to existing stocks of space.

TABLE 1

HIGH C&D LOAN EXPOSURE APPEARS IN VARIOUS MSAS		
MSAS WITH 15 OR MORE NONSPECIALIZED COMMUNITY INSTITUTIONS*	SHARE (%) OF INSTITUTIONS* WITH C&D CONCENTRATIONS > OR = 100% OF TIER 1 CAPITAL	AGGREGATE C&D LOANS RELATIVE TO AGGREGATE TIER 1 CAPITAL (AS %) IN THIS MSA*
ATLANTA, GA	**65**	**156**
PHOENIX–MESA, AZ	**56**	**131**
MEMPHIS, TN–AR–MS	52	154
PORTLAND–VANCOUVER, OR–WA	**47**	**146**
OAKLAND, CA	47	163
NASHVILLE, TN	44	103
RIVERSIDE–SAN BERNARDINO, CA	42	110
SAN DIEGO, CA	41	90
GRAND RAPIDS–MUSKEGON–HOLLAND, MI	40	81
SEATTLE–BELLEVUE–EVERETT, WA	**39**	**98**
SALT LAKE CITY–OGDEN, UT	**38**	**56**
FORT WORTH–ARLINGTON, TX	**38**	**110**
DALLAS, TX	**36**	**95**
LAS VEGAS, NV–AZ	**35**	**119**
LEXINGTON, KY	34	80
DENVER, CO	**33**	**113**

*SAMPLE INCLUDES INSTITUTIONS WITH TOTAL ASSETS UNDER $1 BILLION THAT ARE NOT SPECIALTY INSTITUTIONS SUCH AS CREDIT CARD OR TRUST BANKS.
NOTE: BOLDFACE INDICATES MAJOR MSAS IDENTIFIED AT RISK FOR EXCESS COMMERCIAL REAL ESTATE CONSTRUCTION IN REGIONAL OUTLOOK, THIRD QUARTER 2000.
C&D = CONSTRUCTION AND DEVELOPMENT, MSA = METROPOLITAN STATISTICAL AREA
SOURCE: BANK AND THRIFT CALL REPORTS FOR JUNE 30, 2000

profiles are being elevated, and aggregate leverage ratios are falling, despite the influx of capital from the new institutions. Highly competitive environments have the potential to increase risk taking by negatively affecting underwriting standards and balance sheet composition.

Farm Sector Challenges Continue

Much of the agricultural industry is experiencing stress because of low commodity prices, compounded in some areas by low yields resulting from weather- or disease-related problems. Strong global competition and high worldwide production during the past several years have resulted in large crop inventories, depressed prices, and limited prospects for a price turnaround in the near term. In the aggregate, record levels of government payments have helped the nation's farms maintain a generally stable financial condition but have not eliminated the stress in this sector. In fact, the ***U.S. Department of Agriculture*** projects that at least one in four farm businesses in several regions[9] will not cover net cash expenses in 2000, suggesting that the viability of highly leveraged farmers may be in question.

Fortunately, the aggregate condition of nearly 2,100 insured agricultural banks—institutions with 25 percent or more of loan portfolios in agricultural credits—remains healthy. Generally, agricultural banks continue to report favorable asset quality, earnings, and capital positions. However, they are experiencing somewhat elevated levels of noncurrent loans compared with nonagricultural institutions. Agricultural banks are disproportionately represented among the weakest 25 percent of institutions nationwide in terms of noncurrent

[9] These are USDA's Basin and Range, Mississippi Portal, Fruitful Rim, and Southern Seaboard regions. See www.ers.usda.gov/briefing/farmincome/fore/regional/regional.htm.

loan levels. In addition, rising levels of carryover debt at farm banks may translate into higher losses in the future if commodity prices remain low.

The strains in the farm sector also have implications for nonfarm banks in agricultural areas. In several agriculture-dependent states, such as Montana and the Dakotas, for example, where farmers' earnings are depressed and the economies not well diversified, nonagricultural banks are reporting higher noncurrent levels than insured institutions elsewhere in the nation.

Summary

The long-lived economic expansion has contributed to the banking and thrift industries' record levels of profitability and asset quality. However, as the expansion has matured, both consumer and corporate leverage has risen considerably. Bank liquidity is becoming increasingly strained by lackluster core deposit growth, which has been insufficient to fund strong loan demand. This trend has resulted in a decided shift into higher-risk asset classes to mitigate margin pressures arising from the greater reliance on noncore-funding sources. Furthermore, interest rate risk has risen significantly for many institutions, and after nearly a decade of improving asset quality, the level of problem loans is increasing.

Clearly, high levels of profitability in recent years have been achieved, in part, by an increased appetite for risk. Concern arises because insured institutions' current profitability is being negatively affected by some recent trends, despite the sustained economic expansion. And, while capital levels have remained fairly stable, the amount of risk being leveraged on the industry's capital base is on the rise. Just as a rising tide is said to float all boats, a strong economy can mask potential problems that will become evident should the economic tide turn, particularly in institutions or markets where above-average risk is concentrated. Insured institutions' safety and soundness may be most vulnerable in situations where banks and thrifts are exposed to multiple challenges, whether because of strategic decisions or because of repercussions from economic and banking forces beyond their control.

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