Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION — SECOND QUARTER 1999

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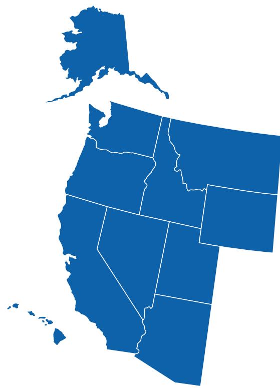
REGION



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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***—**The San Francisco Region's economy continues to outperform that of the nation despite a marked slowdown in the growth of high-tech manufacturing employment…The Region's slowdown in high-tech manufacturing can be directly attributed to the Asian crisis and overcapacity in several key technology markets…Several states and metropolitan statistical areas, because of their dependence on exports to Asia and the tendency of high-tech companies to "cluster" in certain areas, are more at risk to the slowdown…Community banks in metropolitan areas with high-tech clusters tend to have higher construction and commercial real estate loan exposures than community banks elsewhere in the Region and the nation.** *See page 16.*

By the San Francisco 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.

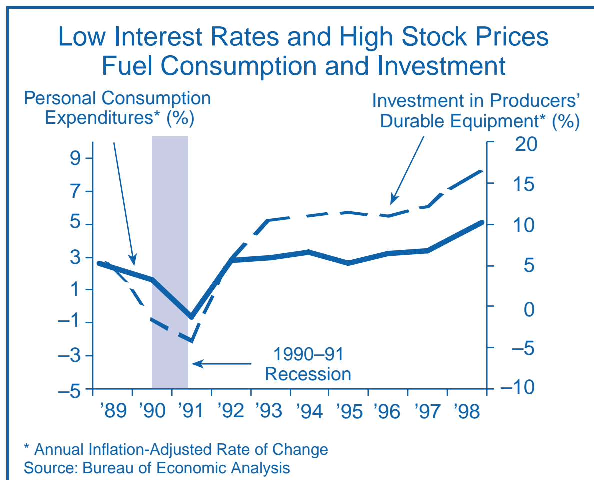
Consumer Spending and Business Investment Are Key to Economic Strength

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-

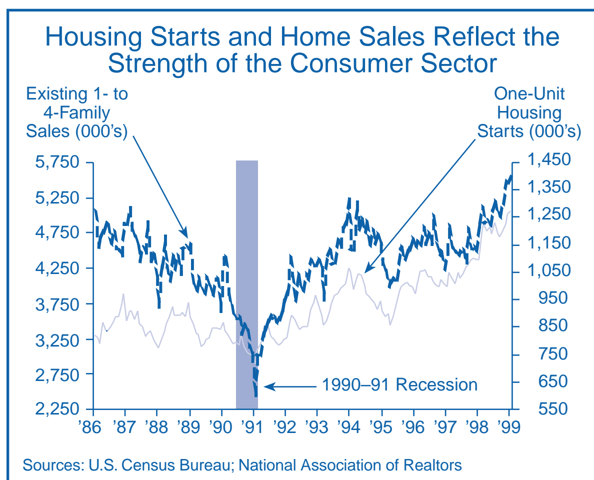
CHART 1



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.

CHART 2



Conditions Vary across Industry Sectors

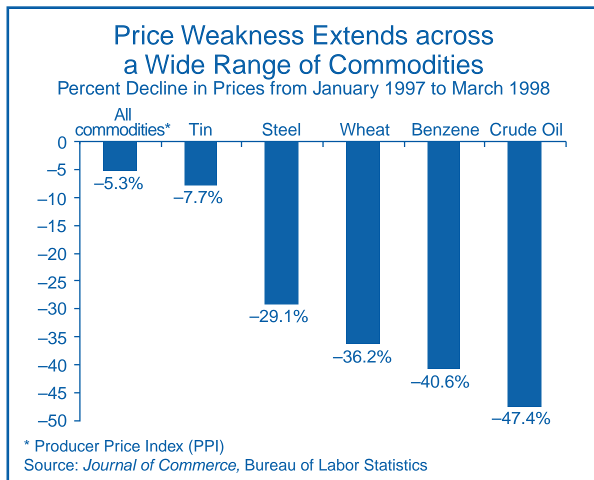
While overall conditions in the U.S. economy are good, certain sectors have been undergoing significant strain because of low commodity prices and weak foreign demand.

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-

[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.

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

CHART 3



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

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

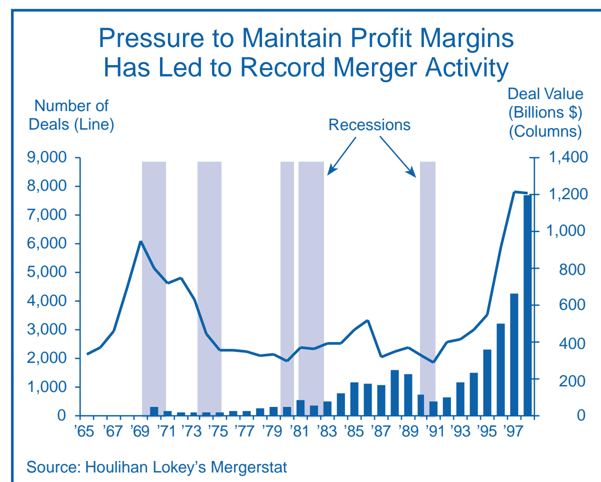
One reason the overall U.S. economy has proven so resilient in the face of weakness in the manufacturing sector is that firms have been able to restructure to cut costs and improve their market positions. Global overcapacity in industries such as oil and autos has been a driving force behind the record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

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

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

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

CHART 4



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

The Outlook for the Global Economy Remains Uncertain

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

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

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

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

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

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

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

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

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

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

Risks Remain despite a Positive U.S. Economic Outlook

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

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

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

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

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

Trends Affecting Banking Lines of Business

Overview

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

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

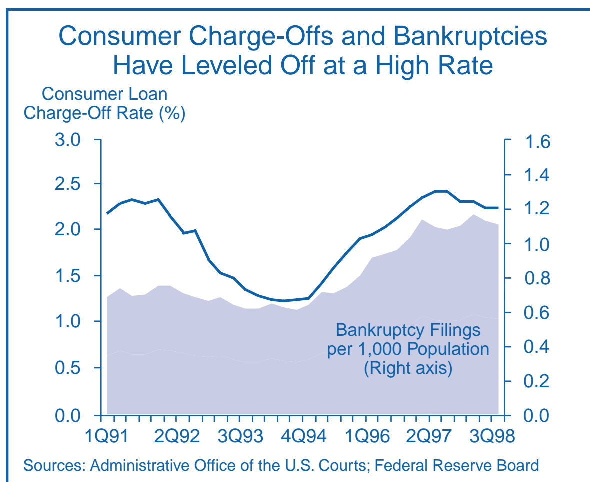
Consumer Lending

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

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

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

CHART 5



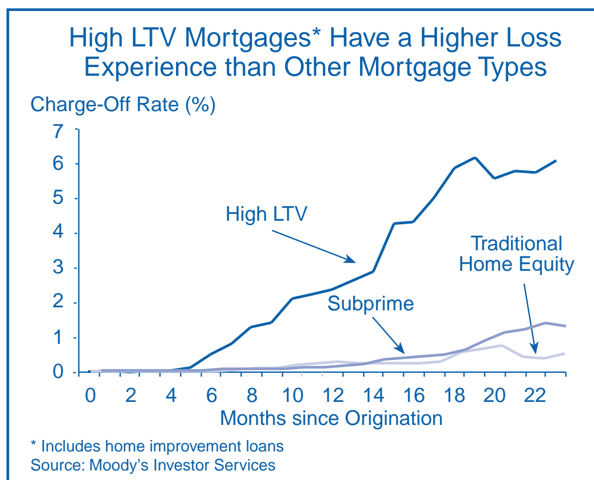
High Loan-to-Value Mortgage Products and Subprime Lending Transform Consumer Lending

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

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

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

CHART 6



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

Commercial Lending

Commercial Loan Performance Remains Strong but Corporate Financial Strains Are Developing

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

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

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

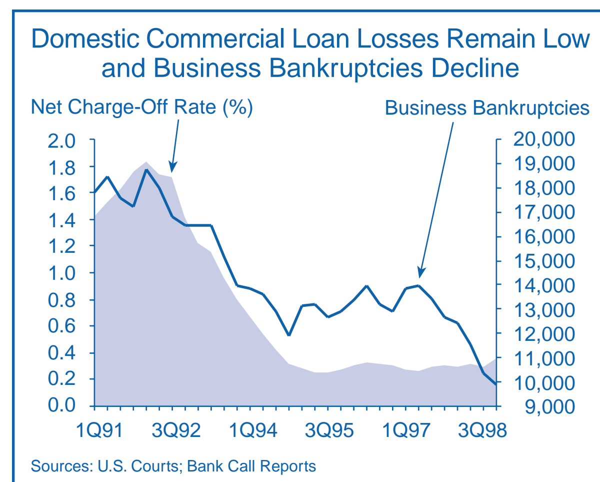
[7] For example, the ***Office of the Comptroller of the Currency's*** "1998 Survey of Credit Underwriting Practices" indicated that 33 percent of the banks offering home equity loans eased standards, compared with only 7 percent that tightened standards. The report is available at http://www.occ.treas.gov/cusurvey/scup98.pdf.

[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



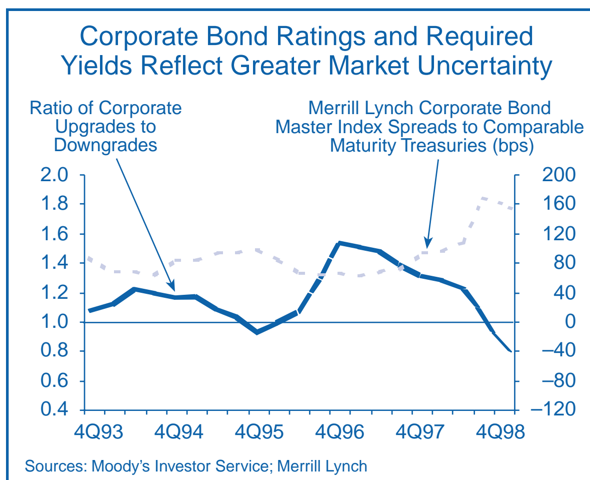
also reflected in the level of corporate bond defaults, which ***Standard and Poor's*** reported at 48 ($10.8 billion in affected debt) in 1998, up 182 percent from 1997 levels (up 150 percent in dollar volume terms).[11]

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).

CHART 8



Commercial Real Estate and Construction Lending

Construction Loan Growth Accelerates as Overbuilding Pressures Increase in Certain Markets

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

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

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

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

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

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

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

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

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

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

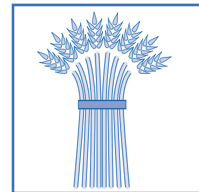
The study also identified some instances of aggressive loan structures, including pricing at extremely thin margins, waiving or limiting personal guarantees, waiving cash equity requirements, and lending on thin collateral margins. Borrowers who secured the most aggressive loan terms were typically larger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

Agricultural Lending

Farm Banks Threatened by Falling Commodity Prices

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

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



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

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

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

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

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

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

Funding and Interest Rate Risk

Deposit Funding Becomes More Difficult to Obtain

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

Interest Rate Changes Pose Asset/Liability Management Challenges

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

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

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

CHART 9

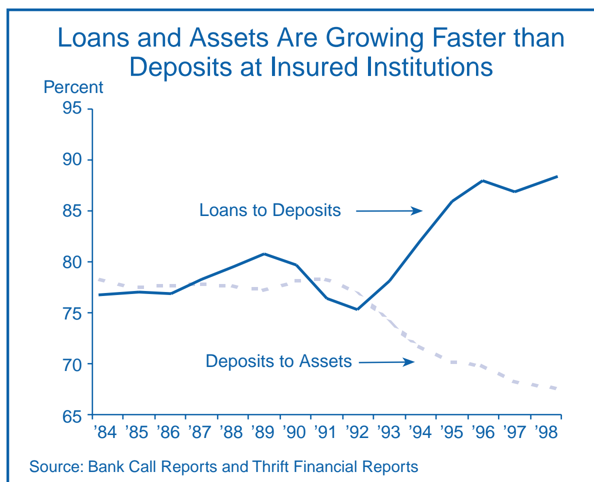
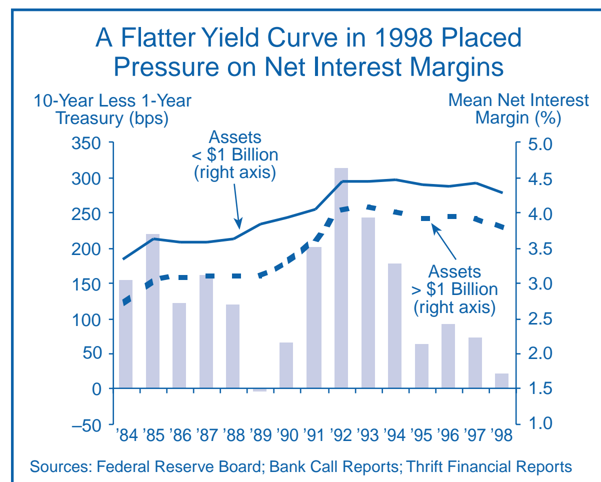


CHART 10



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

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

Indicators of Industry Performance

Market Signals for the Banking Industry Are Mixed

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

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

Bank Performance Remains Strong but Earnings Variability Is Increasing

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

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

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

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

CHART 11

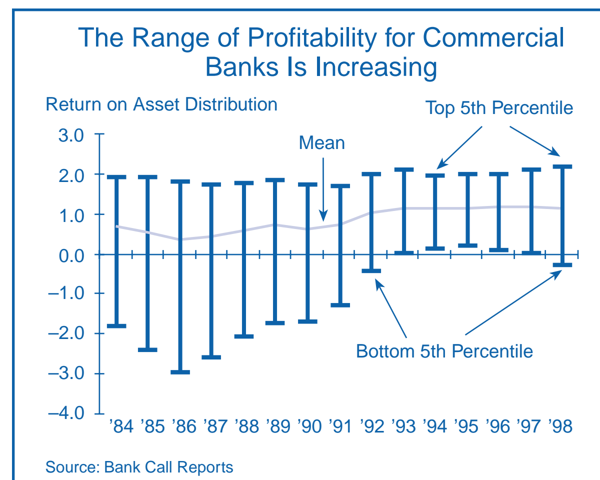
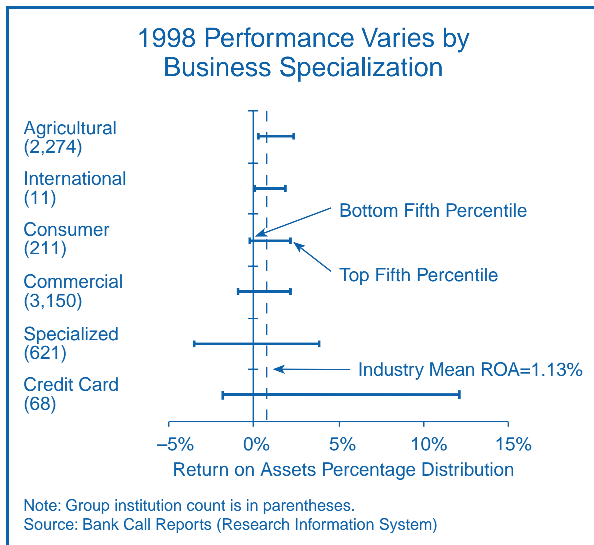


CHART 12



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

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

[23] Banks with at least 50 percent of managed loans in managed credit card receivables and at least 50 percent of managed loans in total managed assets.
[24] Banks with consumer loans and single-family mortgages in excess of 50 percent of assets that do not meet separate credit card or mortgage lending concentration thresholds.
[25] Banks with total assets less than $1 billion, and less than 40 percent of assets held in loans, that do not fall in other business specialties. Members of this group include *de novo* banks and more seasoned banks with low loan activity, such as trust companies.
[26] Banks with 25 percent or more of assets in commercial and commercial real estate loans.

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

Summary

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

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

trending downward. Finally, sustained weak commodity prices are placing strains on farmers and could eventually lead to higher agricultural loan delinquencies.

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

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

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

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Regional Perspectives

- **The San Francisco Region's economy, although slowing due to a downturn in employment in high-technology manufacturing, continues to outperform that of the nation.**
- **The Region's slowdown in employment in high-technology manufacturing is primarily attributed to the Asian crisis and overcapacity in several technology sectors.**
- **Several metropolitan statistical areas (MSAs) in the San Francisco Region, which have large "clusters" of high-technology firms, are vulnerable to the slowdown in high-technology manufacturing.**
- **Community banks in the Portland, Salt Lake/Provo, Sacramento, and San Jose MSAs with high-technology clusters have high exposures to construction and commercial real estate loans.**

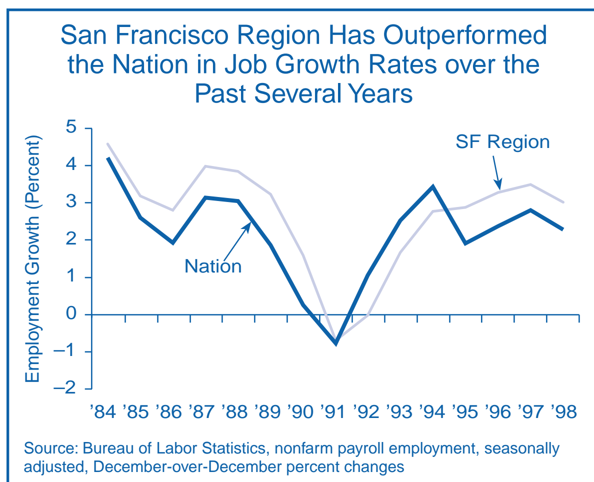
High-Technology Slowdown Dampens Region's Robust Growth

Robust Job Growth in 1998, but at a Slower Pace than in 1997

Although the San Francisco Region experienced a significant slowdown in the manufacturing sector during 1998, it continued to outperform the nation in overall job growth (see Chart 1). In the 12 months ending December 1998, the Region added jobs at a seasonally adjusted 3.0 percent rate—well above the nation's 2.3 percent rate. The Region's economic performance reflects strength in a number of industrial sectors, as can be seen in Chart 2. The construction, services, financial services, and transportation and public utilities sectors all reported 3.0 percent or more growth in 1998, following strong growth in 1997. Weakness in global markets appears to have stopped the rapid growth in manufacturing jobs and led to a decline in mining employment. Most important, weakening exports and surging imports appear to have resulted in a 0.3 percent loss in durable goods manufacturing jobs in 1998, a sharp contrast with the 5.9 percent increase in 1997.

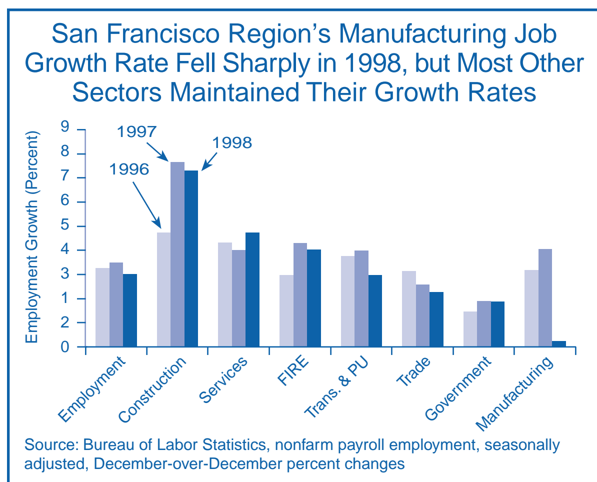
Despite its overall strength, performance varied widely across the Region in 1998. Although a number of areas with large dependence on high-technology manufacturing reported weakness, three states remained among the nation's fastest at adding jobs. **Nevada** (ranked second), **Arizona** (third), and **California** (sixth) added jobs at annual rates of 3.3 percent or better in 1998, significantly outperforming the nation in job growth (see Chart 3, next page). Strong job growth contributed to

Chart 1



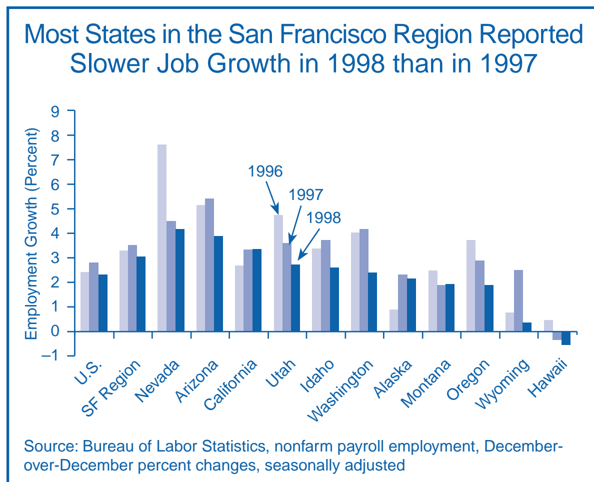
Source: Bureau of Labor Statistics, nonfarm payroll employment, seasonally adjusted, December-over-December percent changes

Chart 2



Source: Bureau of Labor Statistics, nonfarm payroll employment, seasonally adjusted, December-over-December percent changes

CHART 3



Source: Bureau of Labor Statistics, nonfarm payroll employment, December-over-December percent changes, seasonally adjusted

strong personal income growth and declining unemployment in the Region.

In 1998, six states in the Region added jobs at a rate similar to the nation's 2.3 percent increase: Utah (2.7 percent), **Idaho** (2.6 percent), **Washington** (2.4 percent), **Alaska** (2.1 percent), **Montana** (1.9 percent), and **Oregon** (1.9 percent). Utah and Oregon had experienced rapid high-tech job growth prior to 1998, when both were among the fastest-growing states in the Region. Despite weakness in the energy sector, caused by the significant reduction in oil prices in 1998, Alaska's job growth rate was nearly as fast as the nation's. Montana's job growth held steady in 1998; increases in services and financial sector jobs were offset by declines in mining and construction jobs.

Wyoming and Hawaii, however, continue to lag well behind both the Region and the nation in economic performance. Wyoming's job growth rate fell from 2.5 percent in 1997 to 0.4 percent in 1998, ranking it forty-eighth in the nation. Low energy prices in 1998 were reflected in job losses in the state's key mining sector. Most other sectors of the economy, except for financial services and the service sector, reported slow job growth. Hawaii, which remained mired in a recession during 1998, was one of only two states in the nation to lose jobs. Hawaii continued to report widespread weakness across most sectors of its economy. It also continues to be hurt by softness in Japanese tourism and reduced spending by visitors.

Most Insured Financial Institutions Reported Solid Profits for 1998

The Asian crisis, which was primarily responsible for losses in the Region's manufacturing jobs, did not materially affect the 1998 performance of most insured financial institutions. Commercial banks and savings institutions without direct international exposure, as well as credit card specialty banks,[1] benefited from the Region's strong economy and reported solid profits. The Region's generally strong economic performance over the year is also reflected in the strong asset quality reported by financial institutions. The 1.82 percent past-due loan ratio posted for year-end 1998 is the lowest in the decade for the Region. Furthermore, 41 new banks opened for business during 1998. The industrywide trend toward consolidation continued, as 58 of the Region's institutions were eliminated through mergers and acquisitions. The Region's first bank failure in over a year occurred during 1998.

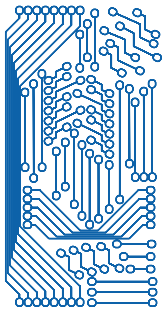
For certain banking companies with international, subprime, and agricultural exposures, 1998 was not so kind. For example, the primary reason the Region's aggregate return on average assets (ROA) declined from the 1.19 percent reported for 1997 to 1.07 percent for 1998 was the problems experienced by a few large commercial banks with significant international exposure. Another illustration of the negative spillover effects of international problems is the poor relative performance of Hawaii's community banks.[2] These banks reported an ROA of only 0.22 percent and a high 5.12 percent past-due loan ratio because of Hawaii's continuing recession, which has correlated with Japan's prolonged recession. In addition, the Region's subprime lending specialists saw their ROA drop from 1.09 percent in 1997 to 0.59 percent in 1998, when larger subprime lenders had problems profitably securing loans during the third and fourth quarters because of capital market turbulence. Finally, while Montana's agricultural banks[3] continue to

[1] A credit card specialty bank is an institution with credit card loans and secured receivables outstanding greater than 50 percent of its total loans, and total loans greater than 50 percent of total assets.
[2] A community bank is a commercial bank with less than $1 billion in total assets, excluding specialty credit card banks. Also excluded are industrial loan companies and other special-purpose lenders common in the Salt Lake City and Phoenix MSAs.
[3] An agricultural bank is an institution with agricultural loans greater than 25 percent of total loans.

report strong profits, their aggregate past-due loan ratio increased from the 3.96 percent reported in 1997 to 4.52 percent as of December 1998. Several years of depressed commodity prices, particularly wheat prices, are beginning to erode asset quality at these smaller agricultural banks.

A High-Tech Slowdown Has Hit the Region's Important Manufacturing Sector

The emerging story in the San Francisco Region's economy in 1998 was the sudden downturn in manufacturing, especially the high-tech sector. This trend is an important concern because both the Region as a whole and several metropolitan areas are heavily dependent on manufacturing and high-tech for both jobs and exports. The main driver of the observed weakness in manufacturing appears to be the Asian crisis (see ***Strong Economic Growth Is Expected to Continue in the San Francisco Region despite Potential Fallout from the Asian Crisis,*** Second Quarter 1998 ***Regional Outlook***) and overcapacity in the high-tech sector. Weakness in the Asian economies that started in 1997 is reflected in both a slowdown in U.S. exports to Asia and the increased competitiveness of Asian products following 1997 currency devaluations. After economic struggles of the Asian Ten nations in the second half of 1997 and 1998, the Region's manufacturing sector reported significant downturns in 1998 in both exports and jobs.[4] Moreover, the weakness has been even more pronounced in several states and MSAs in the Region that have especially large high-technology job clusters. At least in part because of expanding high-tech industries prior to 1998, several of these MSAs experienced rapid growth in their residential and commercial real estate (CRE) markets. Consequently, community bank exposure to construction and CRE lending has risen far above national averages in **Portland, Salt Lake/Provo, Sacramento,** and **San Jose.**



The Region's high-tech sector is important because of the number of jobs and the amount of income it generates. According to the latest ***Survey of Manufacturing (1996)*** by the Census Bureau, high-technology accounted for more than 438,000, or nearly 15 percent, of the Region's 3.0 million manufacturing jobs.[5] Elsewhere in the nation, only 6 percent of manufacturing jobs were in these high-tech industries. Moreover, the survey showed that the Region accounted for more than 32 percent of the nation's computer manufacturing jobs and nearly 37 percent of the electronic component manufacturing jobs, despite accounting for about 18 percent of non-farm payroll employment nationally. Finally, the high-tech sector is slowing at the same time that another key industry in the Region, aerospace, is contracting.

The slowdown in high-technology is also significant since high-tech manufactured goods are the Region's leading export products. High-tech goods exported to Asia were the fastest-growing segment of the U.S. export market prior to 1997. As shown in Table 1, in 1997, half of the Region's $165 billion in exports were high-tech products, according to the ***International Trade Administration's (ITA) Exporter Location*** series. Elsewhere in the nation, high-tech accounts for only about 37 percent of exports. Within the Region, high-tech goods accounted for especially large shares of exports from Arizona (77 percent), Idaho (68 percent), and California (61 percent). Other states with high-tech clusters and export exposures include Oregon (39 percent) and Utah (32 percent). Furthermore, each of these states has one or more MSAs with high-tech clusters that are even more dependent on high-technology for both jobs and exports than the state is.

The Asian Crisis Hits Home

The Asian crisis also has exacerbated the high-technology sector's ongoing problems with worldwide overcapacity, especially in semiconductors, leading to layoffs, postponements, and cutbacks. Falling prices, typical for the industry but now also driven by the Asian currency devaluations of 1997, have added to a need on the part of domestic producers to control costs to remain competitive in both domestic and foreign markets. Moreover, the retrenching is taking place at the same time sub-$1,000 personal computers (PCs) that provide cheap access to the Internet have diverted sales from high-end producers, causing another shift within the industry.

[4] China, Hong Kong, Indonesia, Japan, Malaysia, the Philippines, Singapore, South Korea, Taiwan, and Thailand.

[5] High-tech employment is defined here as jobs related to computers and office equipment, communication equipment, electronic components and accessories, and measuring and control devices.

Table 1

Despite a Weak Manufacturing Sector, Banking Performance Remains Favorable

		San Jose	Phoenix	Portland	Salt Lake City/ Provo	Sacramento	S.F. Region	U.S.
Employment Growth[1] December '97- December '98	Total Nonfarm Payroll (%)	1.0	4.7	1.7	2.7	3.5	2.9	2.2
	Manufacturing (%)	–3.0	2.1	–2.9	0.7	–2.1	0.0	–1.2
	Durable (%)	–3.5	2.2	–2.7	0.7	–2.5	–0.5	–1.1
1997 Exports[2]	Total Exports ($B)	29.1	11.1	8.9	3.0	1.7	165.2	687.6
	% High Tech	94.9	81.8	42.4	N/A	N/A	50.0	40.0
Community Bank Performance Indicators[3] Year-End 1998	ROA (%)	1.25	1.03	1.24	1.71	0.71	1.29	1.24
	Tier One Leverage Ratio (%)	7.86	8.45	12.36	11.40	8.47	10.21	9.51
	Past Due Ratio (%)	0.58	0.69	1.39	2.26	2.32	2.20	2.26
	Commercial RE/Assets[4] (%)	31.66	17.97	26.42	34.12	33.65	25.59	16.45
	Construction RE/Assets (%)	11.79	5.40	7.81	15.84	12.60	5.71	3.30

[1] Source: Bureau of Labor Statistics; not seasonally adjusted.
[2] Source: International Trade Administration; High tech is defined to include industrial machinery, computers, electric and electronic equipment, scientific and measuring instruments.
[3] Source: Bank Call Reports
[4] Commercial real estate represents the sum of nonfarm, nonresidential, multifamily, and construction real estate.

The rapid expansion in the Region's high-tech manufacturing jobs came to a halt in 1998 as exports to Asia fell. First-quarter 1998 high-tech exports from the Region to the Asian Ten nations were down 12.3 percent from the same quarter in 1997. Total exports to these nations declined by 10.7 percent during the same period. Detailed high-tech employment figures for the Region are not available; however, combined data for California, Washington, and Oregon show the weakness. All three states reported losses in high-tech jobs. In 1998 high-tech jobs in these three states fell by a total of 11,200 jobs, after 24,000 jobs were added in 1997. For the Region as a whole, the slowdown in high-technology was most evident in the figures for durable goods manufacturing, the job category that includes most high-tech manufacturing jobs. Durable goods manufacturing jobs fell by 6,600 jobs (–0.3 percent annual rate) in 1998, after posting a 112,600 job increase (5.9 percent increase) in 1997.

MSAs with High-Tech Clusters Face Higher Risks

The slowdown in high-technology is even more important at the state and metropolitan area levels because of the tendency for high-tech firms, both manufacturers and service providers, to cluster around high-tech centers to take advantage of efficiencies for both producers and employees. High-tech clusters provide access to suppliers along with the benefits of high-tech financing, local information, and technology spillovers that enhance productivity. Workers in these markets also benefit from a wider supply of high-tech employers, which increases job opportunities.[6] Examples of MSAs with high-tech clusters, discussed in more detail later, include San Jose, **Phoenix,** Portland, Salt Lake City/Provo, and Sacramento.[7] High-tech expansion during 1995 through 1997 benefited these clusters; however, the weakness in exports starting in the second half of 1997 has had a negative effect on the job growth rates in these MSAs during 1998.

[6] High-tech firms typically include the availability of skilled pools of labor and proximity to universities in their location decisions, along with a favorable business environment, cost of living, and availability of transportation. Many high-tech start-ups choose to locate in an established high-tech center because of the availability of financing as well as the other advantages a high-tech cluster provides.

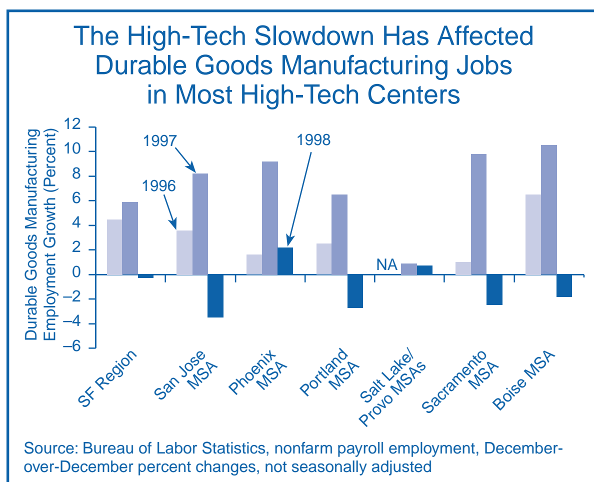
[7] Each of these areas is home to a number of community banks. The Boise MSA, which also has a sizable high-tech cluster, was dropped from the analysis because only a few community banks are headquartered there.

MSAs with high-tech clusters may face a greater risk than those that are less dependent on high-technology, especially if a prolonged high-tech slowdown dampens exports and jobs in the industry. San Jose, Portland, Sacramento, and **Boise** all experienced rapid job growth in durable goods manufacturing in 1997, but they lost jobs in 1998 when high-tech began to weaken (see Chart 4). Other high-tech centers, namely Phoenix and Salt Lake/Provo, added jobs in durable goods manufacturing at a slow pace in 1998. Slowing in overall job growth also was more pronounced in the high-tech MSAs than in the remainder of the Region.

The slow or negative growth in these MSAs in 1998 may be an area of concern because the high-tech sector has a history of wide swings in employment growth rates compared with most other types of employment (see Chart 5). For example, the standard deviation of the annual job growth rates for California's high-tech sector from 1973 to 1998 is nearly three times that for total employment less high-tech jobs.

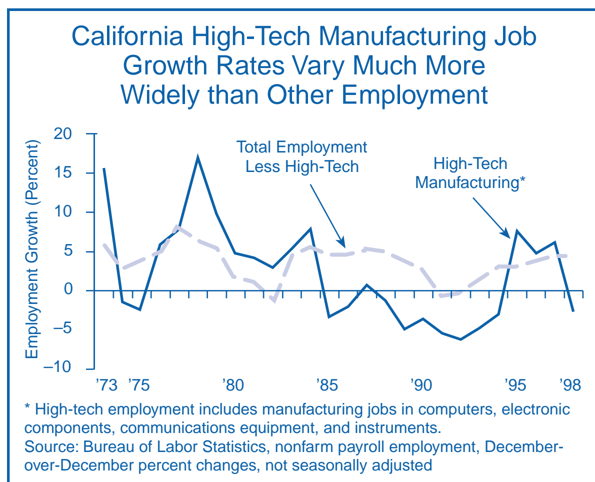
The combination of the Asian situation, the 1998 downturn in high-tech jobs, and an industry with a history of large variations could be especially important in states and MSAs with large high-technology clusters. These MSAs typically are dependent on both high-tech employment and exports. Moreover, rapid commercial real estate (CRE) development in most of these MSAs during the upswing in high-tech has resulted in some community banks having a relatively high level of exposure to commercial real estate loans compared with their peers elsewhere in the Region or nation (see Table 1). Thus, the slowdown in high-tech, combined with softening in commercial real estate in some of these

CHART 4



Source: Bureau of Labor Statistics, nonfarm payroll employment, December-over-December percent changes, not seasonally adjusted

CHART 5



* High-tech employment includes manufacturing jobs in computers, electronic components, communications equipment, and instruments.

Source: Bureau of Labor Statistics, nonfarm payroll employment, December-over-December percent changes, not seasonally adjusted

markets (see ***Regional Outlook,*** First Quarter 1999, ***Several of the Region's Metropolitan Areas May Be Vulnerable to Overbuilding as a Result of Rapid Commercial Real Estate Development***), could adversely affect local economic performance and insured institutions that have been heavily involved in construction and CRE lending.

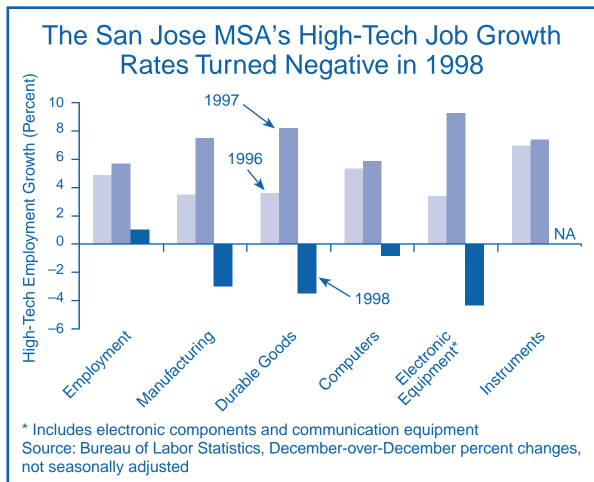
The following paragraphs review high-tech conditions and bank exposure in five San Francisco Region MSAs with well-developed high-technology clusters. The MSAs (listed by size) are San Jose, **Phoenix-Mesa, Portland-Vancouver, Salt Lake City-Ogden** and **Provo-Orem** together, and Sacramento.

Silicon Valley Slowdown Affects the Bay Area

The slowdown in San Jose's manufacturing sector in 1998 dampened employment growth in the MSA as well as in the entire San Francisco Bay Area[8] and was a key factor in forecasts of slow growth in years ahead. As shown in Chart 6, high-technology's weakness in the San Jose MSA was widespread. Computers, defense electronics, and electronic components (semiconductors) all reported job losses in 1998 after adding jobs in 1997. As a consequence of the deterioration in high-tech jobs, employment in durable goods manufacturing fell 3.5 percent in the 12 months ending December 1998. Measured by total job growth, San Jose fell from being one of the Region's fastest-growing MSAs to one of its slowest-growing MSAs. The San Francisco Bay Area also reported softening in job growth trends.

[8] The Bay Area as defined here includes nine counties located in the following MSAs: San Francisco, San Jose, Santa Rosa, Oakland, and Vallejo-Fairfield-Napa.

CHART 6



* Includes electronic components and communication equipment
Source: Bureau of Labor Statistics, December-over-December percent changes, not seasonally adjusted

Moreover, as high-tech slows and the Bay Area's economy cools, there do not seem to be many signs of a rapid turnaround. With the Asian crisis lingering, exports falling, and key sectors of the industry still facing overcapacity, ***Regional Financial Associates*** (RFA) projects a job growth rate of only 1 percent for the San Jose MSA in 1999.

The decline in San Jose's manufacturing sector is significant because it is the world's most important high-technology center. High-tech plays an enormous role in the health of the San Jose MSA, as well as that of the larger San Francisco Bay Area. At year-end 1998, San Jose's manufacturing sector accounted for almost 27 percent of total nonfarm payroll employment, almost twice the 15 percent figure for the nation. A broader measure of high-tech employment used by RFA includes high-tech service and communications jobs, as well as manufacturing jobs. This broader measure indicates that over 25 percent of all jobs in the San Jose MSA are high-tech-related.[9] This dependence on high-tech also is evident in San Jose's export statistics. According to ***ITA,*** the San Jose MSA was the nation's second leading export center in 1997, and high-tech related exports accounted for $27.6 billion of its $29.1 billion in exports. Finally, exports to Asia, which had risen at a 9.5 percent rate in 1996, declined by 7.8 percent in 1997, even though the crisis did not hit until midyear.

The slower economy in 1998 has not yet adversely affected San Jose's community banks, which produced strong ROAs and reported low past-due loan ratios, also shown in Table 1. However, high-tech employment expansion during 1996 and 1997 created booms in San Jose's residential and commercial real estate markets. The area's active real estate market, which has only recently begun to slow, has provided San Jose's community banks numerous opportunities in construction and CRE lending. San Jose's community banks have increased their construction lending concentrations significantly since year-end 1993, from 5.0 percent to a high 11.8 percent of total assets as of year-end 1998, much higher than the rest of the Region or the nation, as shown in Table 1. The ratio of commercial real estate loans (including construction loans) to total assets is also much higher in San Jose's community banks than in the rest of the Region or the nation. Furthermore, five of the seven community banks in San Jose have commercial and industrial loans totaling more than the Regional average of 15 percent of their assets. Although asset quality and earnings remain strong in San Jose's community banks, high exposure to construction, commercial real estate, and commercial and industrial loans may increase risk in the future should the high-tech slowdown continue.

[9] RFA uses a broader measure of high-technology that includes biotech, medical and photographic instruments, and software services in this ratio.

Phoenix's Economy Continues to Grow Rapidly despite High-Tech Manufacturing Slowdown

Although the Phoenix-Mesa MSA continues to outperform the Region and the nation in the growth of nonfarm payroll employment, its manufacturing sector is beginning to slow, principally in the area of high-technology. Most of Arizona's manufacturing jobs are located in the Phoenix MSA (78 percent), where high-technology firms such as ***Motorola, Intel, Honeywell,*** and ***Allied Signal*** rank among the top ten employers. Despite the fact that Phoenix is relatively less reliant on manufacturing (11.3 percent of total employment) than the nation (14.5 percent of employment), the MSA remains exposed to a slowdown in the manufacturing industry because of its high concentration of exports to struggling Asian markets.

The current weakness in Phoenix's high-technology sector may be a direct result of the Asian crisis. According to the ***ITA Exporter Location*** data for 1997, the Phoenix MSA is especially exposed to slowdowns in the global economy, as it ranks tenth in the nation among MSAs for dollar value of exports. In addition, the ITA stated that over 40 percent of Arizona's exports are destined for Asia and that 77 percent of the state's exports are high-tech goods. Therefore, deterioration of global economic conditions, especially in Asia, may be a main

driver in the decline in job growth in durable goods manufacturing in 1998, as well as a factor leading to slower growth in the future.

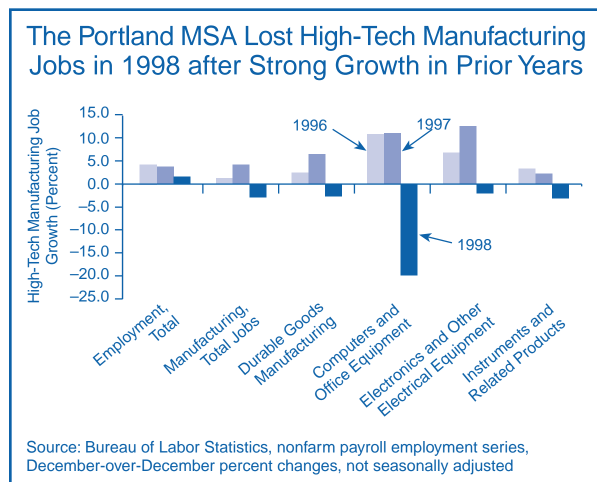
Following the downward trend across the Region, year-over-year employment growth in durable goods manufacturing in the Phoenix MSA has plummeted from a sizzling 9.2 percent recorded for the 12 months ending December 1997 to a much slower 2.2 percent growth rate for the comparable 1998 period. Phoenix's manufacturing employment slowdown could worsen as a result of layoffs recently announced by top employers in the MSA. ***RFA*** states that Intel and Motorola together reported over 4,000 layoffs in 1998. These layoffs could have broad-based effects on the aggregate Phoenix economy in 1999 and 2000.

Nonetheless, banking conditions in the MSA remain robust. Two trends in the MSA's insured institutions are worth noting. First, there has been significant growth in both the aggregate amount of assets held at community banks as well as in the number of community banks in the area. Since 1995, 11 new community banks have been chartered in Phoenix, bringing the total to 22. During this period, total assets at insured institutions in Phoenix have nearly doubled, from $1.5 billion at year-end 1995 to $3.1 billion at year-end 1998. This increase may lead to more competition among lenders. The second trend is the strong asset quality reported at insured institutions. The past-due loan ratio for banks in Phoenix is 0.69 percent as of year-end 1998, materially less than the ratio for the Region as a whole.

Weakening Exports to Asia Hit Portland's Economy Hard

Portland has been significantly hurt by the Asian crisis. Much of Portland's economic strength prior to 1998 was attributable to its growing manufacturing sector, particularly high-technology. Intel, ***Tektronics, Boeing,*** and similar firms transformed Portland into one of the hottest high-tech centers in the nation. These firms brought in jobs directly and indirectly through rapid construction of new plants, service firms, and housing production. Labeled the "Silicon Forest," Portland's durable goods manufacturing jobs account for nearly half of all manufacturing jobs in the state. However, after significantly outpacing the nation in terms of job growth, population growth, and economic prosperity, Portland's economy is showing signs of slowing (see Chart 7).

CHART 7



At the core of this problem is the decline in exports to Asian markets, as products produced in the United States have become relatively more expensive than goods produced in Asia. Growth and oversupply in the sub-$1,000 PC market have put additional pressure on already thinning profit margins. Chart 4 shows that durable goods manufacturing in Portland lost jobs at a rate of 2.7 percent in 1998. As Chart 7 shows, jobs in computers and office equipment have been hit hardest. Computer manufacturing jobs fell 19.8 percent in the past year owing to substantial layoffs. Most manufacturing plant expansions have either been postponed or cancelled. ***Komatsu,*** which once promised to be the largest semiconductor producer in Silicon Forest, recently announced the closure of its third facility in the area, a facility where it had earlier planned a further $50 million investment. Intel, which has its largest operation in Portland and is Portland's largest employer, announced a corporationwide layoff of 3,000 last spring. This deterioration in high-tech job growth has caused dependent secondary markets such as construction and commercial real estate to slow as well. Year-over-year job growth in the construction sector was only 2 percent as of December 1998.

Table 1 shows that although Portland's community banks continue to report strong performance and capital levels well in excess of minimum requirements, they have become significantly more exposed to commercial real estate. In the past five years, these institutions have increased their total loan concentrations in commercial real estate (including construction loans) from 17 percent to 26 percent of their assets. At the same time, there

has been an uptick in past-due and noncurrent loan status for multifamily and construction and land development loans.[10] Nonetheless, the allowance for loan and lease losses, at 1.19 percent of total loans, has remained well below the average 1.66 percent for similar-sized institutions in the Region. In fact, 8 of the 12 community banks in the Portland MSA have less than the Regional and national averages in loan loss reserves to total loans.

Utah's Metropolitan Areas Show Deterioration in High-Technology Sectors

In 1998, combined employment figures for the Salt Lake City and Provo MSAs showed continued weakness in durable goods manufacturing, likely because of a reduction in high-technology exports to Asia (see Chart 4). High-tech had contributed significantly to the economic expansion of the MSAs over the past decade. High-technology firms such as ***Novell, Gateway,*** and Intel helped fuel this growth by opening and expanding facilities. The current high-tech slowdown warrants monitoring, because during the past high-growth period for these MSAs, community banks significantly increased their exposure to traditionally higher-risk loan categories such as construction and commercial real estate loans.

According to ***ITA,*** as of the first quarter of 1998, Utah's exports to Asia declined 14 percent from the same quarter in 1997. This figure is in sharp contrast to the rapid export growth that both Salt Lake City and Provo experienced during the 1993 to 1997 period. The deterioration in export markets is reflected in the employment statistics of these MSAs as well.

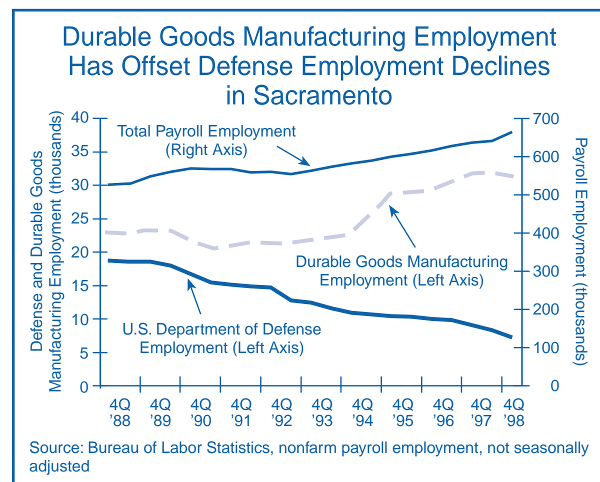
The slowdown in manufacturing may pose an emerging risk for community banks operating in these MSAs, since they have some of the highest construction and CRE loan concentrations in the Region. Community banks in these MSAs have significantly increased their exposure to construction loans since year-end 1993. As Table 1 shows, community banks in Provo and Salt Lake City now have combined construction loans to total assets of over 15 percent, well above averages for both the Region and the nation. Their CRE loan exposure is also quite high. While these institutions continue to report strong earnings and asset quality, the local economy's recent slowing may increase the risks associated with a heavy concentration in construction lending.

Technology Slowdown Hits Sacramento while Defense Employment Continues to Decline

Much like some of the Region's other high-technology centers, the Sacramento MSA saw its manufacturing employment growth rate slow considerably during 1998. As shown in Chart 4, durable goods manufacturing jobs fell 2.5 percent in 1998, after rising nearly 10 percent in 1997. Prior to 1998, the Sacramento area had benefited from relocating Silicon Valley firms, which had moved to escape the higher costs of Silicon Valley. This influx of technology companies has spurred residential and commercial real estate development in certain areas of the MSA. While the expansion of high-tech companies has brought jobs to an MSA traditionally dependent on government employment and suffering from defense cutbacks, it has made the MSA more susceptible to the global trends hurting some firms that manufacture PCs and semiconductors.

The growth in manufacturing employment prior to 1998 helped keep Sacramento's employment growth rate above that of the nation since year-end 1995. The MSA benefited from its proximity to Silicon Valley during the 1990s, when such prominent companies as Intel, ***Packard Bell/NEC, Hewlett-Packard, Oracle,*** and ***Apple Computers*** opened or expanded operations. As Chart 8 shows, the strong growth in manufacturing has helped offset declines in defense employment, in particular the closings of Mather Air Force Base and the

CHART 8



Source: Bureau of Labor Statistics, nonfarm payroll employment, not seasonally adjusted

[10] These categories are two of the three loan categories that comprise commercial real estate loans.

Sacramento Army Depot, as well as the privatization and downsizing of McClellan Air Force Base.

While the Sacramento MSA remains an attractive destination for high-technology companies in the long term, manufacturing employment contracted during 1998, primarily because of technology layoffs. According to ***RFA,*** Packard Bell/NEC cut employment at its south Sacramento PC manufacturing plant owing to the intense cost competition in the sub-$1,000 PC market. Intel and Hewlett-Packard, which together contribute about 10,000 jobs to the MSA, postponed further plant expansion in 1998 because of oversupply in the processor and PC markets, according to RFA and the ***Sacramento Business Journal.*** The slowdown is potentially troublesome since, according to RFA, up to 3,000 workers at McClellan will lose their jobs by 2001, as several airplane maintenance contracts shift from McClellan to Hill Air Force Base in Utah.

Despite the recent slowdown, the expansion of technology companies has led to strong residential and commercial real estate development, especially in warehouse and research and development (R&D) properties, in south Placer County, the Highway 50 corridor, and south Sacramento. The ten community banks headquartered in Sacramento have benefited from the hot property market, as construction loans now equal 12.6 percent of total assets, significantly above the national and regional averages (see Table 1). Their ratio of commercial real estate loans to total assets is also well above regional and national averages. Further, economic growth, as well as past banking consolidations, have spurred several new community bank charters. The slowdown in manufacturing and defense, coupled with the increased competition from newly chartered banks, could increase risk for community banks operating in the area, which continue to hold higher levels of nonperforming assets than peers in the Region and nation.

Conclusion

The San Francisco Region continues to exhibit robust growth, albeit at a slower pace than in 1997; the slowdown can be attributed to a contraction in manufacturing employment, particularly high-tech manufacturing. The slowdown in this sector is important because the growth in high-tech manufacturing employment prior to 1998 was one of the key reasons that the San Francisco Region has outperformed the national economy since 1994. The Asian financial crisis was the primary culprit in slowing the Region's high-tech manufacturing employment growth, since the Region is heavily dependent upon high-tech exports to Asia. However, thus far, there is little evidence that the 1998 slowdown in high-technology has hurt the performance of most of the Region's financial institutions.

Several MSAs in the Region are more vulnerable to the slowdown in technology than others because high-tech companies tend to cluster in MSAs with well-educated workforces, strong transportation systems, and vibrant R&D centers. These MSAs include San Jose, Phoenix, Portland, Salt Lake City/Provo, and Sacramento. Partly as a result of the clustering of high-tech companies and rapid high-tech employment growth prior to 1998, each of these markets has experienced strong residential and commercial real estate development. Moreover, community banks in these MSAs, for the most part, have higher construction and commercial real estate loan concentrations than their peers in the Region and the nation. Community banks with high levels of construction and commercial real estate loan concentrations should consider the potential risk of continued weakness in the high-tech sector and its effect on their local economy.

San Francisco Region Staff

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