Regional Outlook

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In Focus This Quarter

◆ ***Recent Trends Raise Concerns about the Future of Business Credit Quality***—**Commercial and industrial (C&I) lending is one of the largest and fastest-growing lending lines at insured institutions. Recent growth in C&I lending can be attributed to a strong U.S. economy, increased industrial merger activity, and a willingness of lenders to extend credit. While C&I credit quality remains relatively strong, signs of deterioration have recently begun appearing in C&I portfolios and in corporate bond defaults. These signs of weakness in commercial credit quality raise concerns because they are appearing during a period of economic strength. Business credit quality could deteriorate further in the event of an economic slowdown, higher interest rates, or a loosening of underwriting practices.** ***See page 3.***

By Arlinda Sothoron, Alan Deaton

◆ ***Local Industries in the Global Economy***—**The contribution of international trade to overall U.S. economic activity has been increasing for a number of years. Although the United States trades with many nations, most activity is concentrated in a few markets—Canada, Japan, and Mexico. Across a collection of industries, there is, however, considerable variation in both the level of exposure to export markets and the intensity of import competition. A number of industries are highly exposed to international markets, suggesting that economic conditions abroad are particularly important in any assessment of future revenue growth or profitability.** ***See page 11.***

By Paul C. Bishop

Regional Perspectives

◆ ***Overview of Banking and Economic Conditions***—**The strength of the Region's economy and health of its banks and thrifts are starting to exhibit some signs of weakening. Job growth in the Region has slowed and banks and thrifts have experienced modest deterioration in earnings, margins, and asset quality.** ***See page 18.***

◆ ***Agricultural Concerns Are Centered in Illinois***—**A large number of banks with exposure to the farm sector are located in Illinois. Some Illinois agricultural banks' balance sheets and earning statements reflect the financial strains experienced by crop farmers.** ***See page 20.***

◆ ***Commercial and Industrial Loans Are Growing Rapidly***—**Growth in commercial and industrial (C&I) loans accelerated in the year ending September 1999. Rapid C&I loan growth and the resulting increase in exposures raise concerns about how banks would fare should economic growth slow further.** ***See page 22.***

◆ ***Rising Interest Rates May Dampen Profitability of Residential Real Estate Lenders***—**Residential real estate lenders' profitability is being dampened by the past year's interest rate increases, which slowed refinancing activity, led to higher shares of adjustable-rate mortgages, and contributed to slower growth in permits for new single-family homes.** ***See page 25.***

The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation as an information source on banking and economic issues for insured financial institutions and financial institution regulators. It is produced for the following eight geographic regions:

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Recent Trends Raise Concerns about the Future of Business Credit Quality

- **C&I loan portfolios have been growing rapidly during this economic expansion.**
- **Indicators of weakening corporate credit quality have begun to appear, including higher C&I loan losses and rising corporate bond defaults.**
- **The future of business credit quality will depend on the economy and on underwriting practices.**

Commercial and industrial (C&I) lending is one of the largest and fastest-growing segments of lending at insured institutions. As of the third quarter of 1999, C&I loans comprised 24 percent of total loans and leases held by FDIC-insured institutions, up from 21 percent at the end of 1995. C&I loan portfolios have grown primarily because of strong loan demand driven by a long economic expansion during which the indebtedness on corporate balance sheets has expanded rapidly. Even as the economic expansion continues, C&I loan charge-offs have begun to trend upward, albeit from historically low levels. By some measures, banks and the financial markets appear to be assuming increased levels of risk that could lead to greater C&I loan losses when the economy eventually weakens.

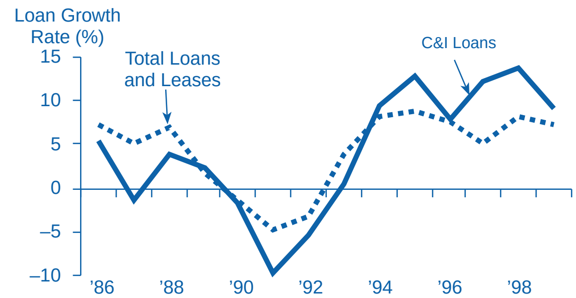
High rates of growth in commercial lending and weakening indicators of C&I credit quality raise concerns about the future of credit quality at insured institutions. This article examines the factors that have contributed to high C&I loan growth rates and discusses the drivers that will determine the direction of C&I credit quality in the future. While loan performance at insured institutions is relatively good at the present time, signs of deterioration and stress have begun to appear despite the continued strength of the domestic economy. The future of C&I credit quality will ultimately be determined by trends in underwriting and corporate debt levels, along with the performance of the U.S. economy.

C&I Loan Growth Has Accelerated

C&I loans held by FDIC-insured banks and thrifts grew by almost 9 percent during the 12 months ending in September 1999, down somewhat from a 13.4 percent rate of growth in 1998 (see Chart 1). By contrast, total

Chart 1

Commercial and Industrial (C&I) Loans Are Growing at a Faster Rate than Total Loans and Leases



Note: 1999 data are annualized based on 3Q99 data.
Source: FDIC Research Information System

loans and leases at insured institutions grew by only 7 percent in the 12 months ending in September 1999. C&I loans accounted for approximately 29 percent of all net new loans booked during the 12 months ending in September 1999, while unfunded C&I loan commitments grew by approximately 17 percent to $1.6 trillion. Syndicated lending played a major role in C&I loan growth during the 1990s. As intense competition and a narrowing of financial institutions' net interest margins have encouraged lenders to seek additional sources of revenue, larger institutions have become increasingly active as loan syndicators and as purchasers of syndicated credits. Syndicated loan volume reached its peak in 1997, when originations totaled some $1.1 trillion (see Chart 2, next page).[1] After falling off in 1998, originations of syndicated loans rose by 17 percent in 1999 to just over $1.0 trillion. Leveraged loans, in which the borrower's debt-to-equity ratio is significantly higher than the industry average, served as a catalyst for syndicated lending growth in 1999, accounting for 32 percent of total syndicated loan originations. Leveraged lending is very attractive to lending institutions because of the generous fee income associated with leveraged originations. Leveraged loan originations grew to $320 billion in 1999, partly because of the continued rapid pace of corporate mergers in 1999.[2]

[1] *LPC Gold Sheets,* Vol. XIV, No. 1. Loan Pricing Corporation. January 10, 2000.

[2] According to Houlihan Lokey's *Mergerstat,* total M&A activity set a new record of $1.4 trillion in merger deal value in 1999.

Most of the C&I loan growth among insured institutions since 1997 has been concentrated in loans to domestic borrowers. C&I loans held in foreign offices declined following the Asian economic crisis and the Russian government bond default in 1997 and 1998, respectively, while domestic C&I lending was growing at double-digit rates. During the 12 months ending in September 1999, C&I loans held in domestic offices grew 12.2 percent while C&I loans held in foreign offices declined by almost 6 percent.

Is This Rapid Loan Growth a Cause for Concern?

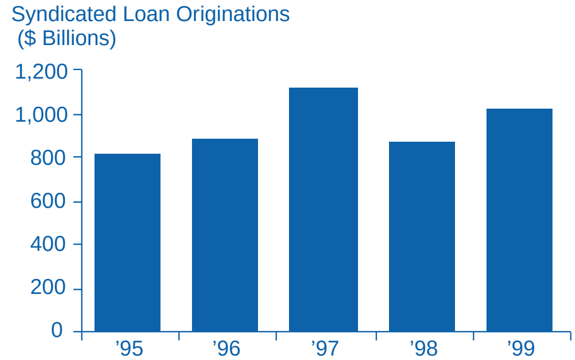
The effect of rapid loan growth on subsequent credit quality has been the subject of a number of articles. A recent study by the ***Federal Reserve Bank of Kansas City*** found that high rates of loan growth in the early 1980s and early 1990s appeared to be positively correlated with future higher loss rates.[3] The study also noted, however, that relatively high loan growth rates in the late 1980s did not result in sharply higher loss rates. Another study by the ***Federal Deposit Insurance Corporation*** found that banks that failed during the banking crisis of the 1980s were generally more likely to have grown their loan portfolios aggressively than banks that did not fail.[4] But it remains to be seen whether the high C&I loan growth rates of today will necessarily contribute to higher losses for insured institutions in the future. The future course of industry loan losses depends on many factors, including the condition of the economy, the interest rate environment, and underwriting standards used in originating C&I credits.

The Condition of the Economy Is an Important Driver of C&I Loan Growth

Recent economic conditions have been particularly conducive to rapid growth in domestic C&I lending. Business investment has expanded at double-digit annual rates as firms have invested in new technologies to raise productivity and keep costs down. These productivity gains have been instrumental in allowing the economy to grow at a relatively rapid pace with low inflation. Strong growth in real wages has helped boost the consumer confidence index to an all-time high of 144 in January 2000. Robust consumer demand for goods and services has kept business profits growing, further spurring business borrowing to finance inventories, new construction, and fixed assets such as computer networks. Amid all of these favorable trends, C&I loan charge-off rates have remained at record lows of less than 0.5 percent since 1994. Recently, however, despite a continuation of generally favorable conditions in the economy and the financial markets, signs of credit quality deterioration have begun to appear in C&I loan portfolios.

CHART 2

Syndicated Loan Originations Rebounded in 1999 after Falling from Record Levels



Source: Loan Pricing Corporation

Evidence from Financial Institutions Points to a Weakening in Business Credit Quality

Despite strong business conditions and generally good asset quality, signs of deterioration in C&I credit quality have begun to appear in bank portfolios. While problem C&I loan levels remain low by historical standards, net C&I loan charge-offs during the 12 months ending in September 1999 were 63 percent higher than during the previous 12-month period. The net C&I loan charge-off rate rose in the 12 months ending in September 1999 to 0.5 percent, up from 0.3 percent one year earlier. Similarly, noncurrent C&I loans as of September 1999 rose to $11.2 billion, or 1.2 percent of total C&I loans.[5] In dollar terms, this level of noncurrent loans is 30 percent higher than one year earlier.

[3] William R. Keeton. "Does Faster Loan Growth Lead to Higher Loan Losses?" *Economic Review.* Federal Reserve Bank of Kansas City. Second quarter 1999.

[4] Federal Deposit Insurance Corporation, Division of Research and Statistics. *History of the Eighties: Lessons for the Future. Vol. 1, An Examination of the Banking Crises of the 1980s and Early 1990s.* 1997. http://www.fdic.gov/bank/historical/history/contents.html.

[5] Noncurrent C&I loans include C&I loans past-due over 90 days and all C&I loans in nonaccrual status.

Despite these increases in C&I charge-offs and noncurrent C&I loans, the current industry ratios for these measures remain well below the 1.9 percent and 4.5 percent ratios reported during the recession in 1991 for net C&I charge-offs and noncurrent C&I loans, respectively.

Interagency Loan Review Reveals Increases in Problem Credits from Previously Low Levels

The results of the ***1999 Shared National Credit (SNC)*** review provide another indication of slipping credit quality at large commercial banks.[6] According to the ***Federal Reserve Board of Governors,*** adversely classified syndicated loans rose to $37.4 billion in the 1999 review, a level approximately 70 percent higher than that reported in 1998. This figure represents 2 percent of the $1.8 trillion in drawn and undrawn loan commitments reviewed in 1999. By contrast, adversely classified assets identified in the 1998 SNC review totaled only $22 billion, or 1.3 percent of loans reviewed in 1998.[7]

While the level of adversely classified syndicated loans remains low, 14 percent of the loans adversely classified during the 1999 review were loans made to new borrowers since the 1998 SNC review. In reference to this finding, ***Office of the Comptroller of the Currency (OCC)*** First Senior Deputy Comptroller and Chief Counsel Julie Williams has noted that "Banks are booking new loans that are weak at their inception."[8] The high rate of adversely classified new loans could be attributable to the continued effects of loan originations made toward the end of a period of loosened underwriting standards in 1997 and early 1998. Alternatively, it could indicate a higher-risk credit mix in current C&I loan portfolios.

Signs of corporate stress that may weaken credit quality at insured institutions are also reflected in recent ***Banc of America Securities*** analysis of publicly available bank loan amendments.[9] This study shows a significant increase in the number of loan amendments generated because of covenant relief requests, from 22 percent of all loan amendments during the last six months of 1998 to 45 percent during the first ten months of 1999.

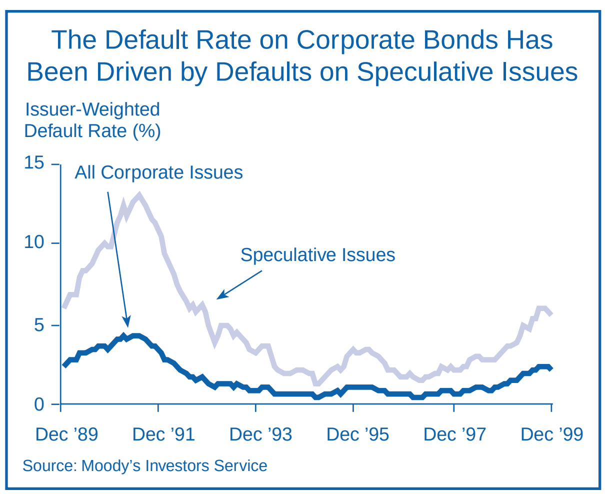
[6] The annual interagency process reviews commercial loans over $20 million that are shared by three or more participants.
[7] Federal Reserve Board Press Release. November 10, 1999.
[8] "OCC's Williams Warns of Credit Risk in the Banking System; Calls for Bankers to Scrutinize Loan Portfolios More Closely." OCC Press Release. October 5, 1999.
[9] "Leveraged Loans: The Plot Thickens." Banc of America Securities Syndicated Finance Research. November 15, 1999. This loan amendment analysis was completed using only publicly available information from Loan Pricing Corporation and Banc of America Securities LLC.

Corporate Bond Defaults Soared in 1999

Trends in corporate bond defaults also indicate increasing levels of stress in the corporate sector. During 1999, 147 issuers defaulted on $44.6 billion in long-term debt. Default rates as a percentage of volumes outstanding (or dollar default rates) have trended upward each year since 1996, reaching 2.2 percent for all corporate issues at year-end 1999. Much of the increase can be attributed to a rising dollar default rate for speculative-grade issues, which peaked in November 1999 at 8.2 percent. Measured as a percentage of all issuers, the default rate for speculative-grade issues rose to a post-1991 high of 6 percent in September 1999 (see Chart 3). According to ***Moody's,*** year-end 1999 default rates improved marginally but are expected to remain high through mid-2000.[10] In addition, domestic speculative-grade issuers reported twice as many issuer downgrades as upgrades during the fourth quarter of 1999, although the dollar volume of upgrades exceeded the dollar volume of downgrades by 55 percent.[11]

[10] "Corporate Bond Default Rates Highest Since 1991." Moody's Investors Service. October 13, 1999.
[11] "Moody's Default Rate Pendulum." Moody's October 1999 Commentary. Moody's Investors Service. October 18, 1999.

CHART 3



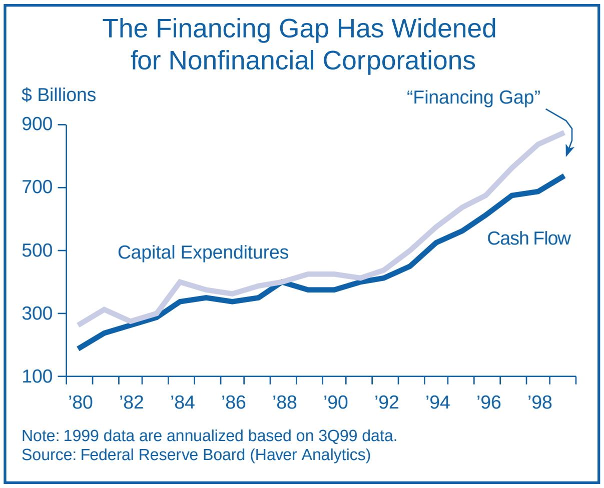
Why Are C&I Loan Losses Increasing Amid Strong Economic Growth?

Several factors have contributed to the current signs of deterioration of C&I credit quality in an environment of favorable business conditions. These factors include global competition and deflationary pressures, an increase in corporate debt levels, loosened underwriting standards, and a greater appetite for risk.

Global competition and deflationary pressures have squeezed revenues. An era of low inflation and intense global price competition has contributed to low or negative revenue growth in a number of domestic industry sectors, particularly commodities and manufacturing.[12] The result has been an increase in loan losses and corporate bond defaults in these sectors. ***Moody's*** noted that the industrial sector, weakened by low commodity prices, accounted for 64 percent of all defaults in 1999, with the oil and gas, steel, and shipping industries being especially hard-hit.[13] For example, ***Standard & Poor's (S&P)*** reports that third-quarter 1999 earnings for the iron and steel sector declined 80 percent from one year earlier after five consecutive quarters of negative year-over-year earnings growth. Initially, commodity price declines and the international economic turmoil in 1997 and 1998 resulted in slowed foreign C&I lending and increased net losses of C&I loans held in foreign offices. These losses accounted for the majority of net C&I loan losses in 1997 and 1998. However, this adverse trend reversed itself in 1999, when C&I loans held in domestic offices accounted for the majority of losses.

Corporations are increasingly reliant on debt markets. Increasing levels of debt on corporate balance sheets have helped to foster C&I loan growth. The growth in corporate debt is partially a result of actions taken by firms to improve operating efficiency, including increasing merger and acquisition (M&A) activity and rising spending on fixed investments. Capital expenditures on fixed investments by businesses have increased at a steady rate since the 1990–91 recession, as evidenced by Chart 4. Cash flow has also been increasing, but at a slower rate, resulting in a growing "financing gap" that reached an annualized level of

CHART 4



$142 billion in the third quarter of 1999. Where cash flow has not been available to finance investment, firms have turned primarily to debt financing as opposed to equity financing. Net new corporate equity issues by nonfarm nonfinancial corporations have been negative in each year since 1993, while net new corporate bond issuance has increased from $75 billion in 1993 to $219 billion in 1998.

Loosened underwriting standards in 1997 and early 1998 are contributing to current losses. Signs of stress in C&I loan portfolios can be partially attributed to loosened underwriting standards in 1997 and early 1998. During 1997 and early 1998, loan underwriting standards loosened, accompanied by reduced spreads and pricing. In May 1998, the ***Federal Reserve Board Senior Loan Officer Opinion Survey on Bank Lending Practices*** reported that domestic banks were "generally eager to make loans to businesses" and that during early 1998 "a large percentage cut their spreads on such loans." ***Moody's*** describes the second half of the 1990s as a "mini credit cycle." The cycle began in 1995, when the strong economy, accompanied by falling interest rates and low loan losses and default rates, encouraged investor demand for high-yield bonds and loans.[14]

A record number of first-time speculative-grade deals were also brought to market during 1997 and early 1998. The increase in the volume of issuance was itself enough to push the default rate lower, which in turn may have fueled investor demand for additional high-risk bonds. However, the Asian crisis during 1997 and the Russian debt default during the second half of 1998

[12] See also Richard A. Brown and Alan Deaton. "Falling Prices in Commodities and Manufacturing Pose Continuing Risks to Credit Quality." *Regional Outlook,* third quarter 1999. http://www.fdic.gov/bank/analytical/regional/ro19993q/na/t3q1999.pdf.

[13] "Historical Default Rates of Corporate Bond Issuers, 1920–1999." Moody's Investors Service, January 2000.

[14] "Default Rate Pendulum." October 18, 1999.

caused new issuance of speculative-grade bonds to slow significantly while defaults rose sharply, to a rate of 6 percent by issuer in September 1999. While speculative-grade bond issuance declined, banks stepped in to fill the void by raising originations of highly leveraged loans between second-quarter 1998 and fourth-quarter 1999.[15]

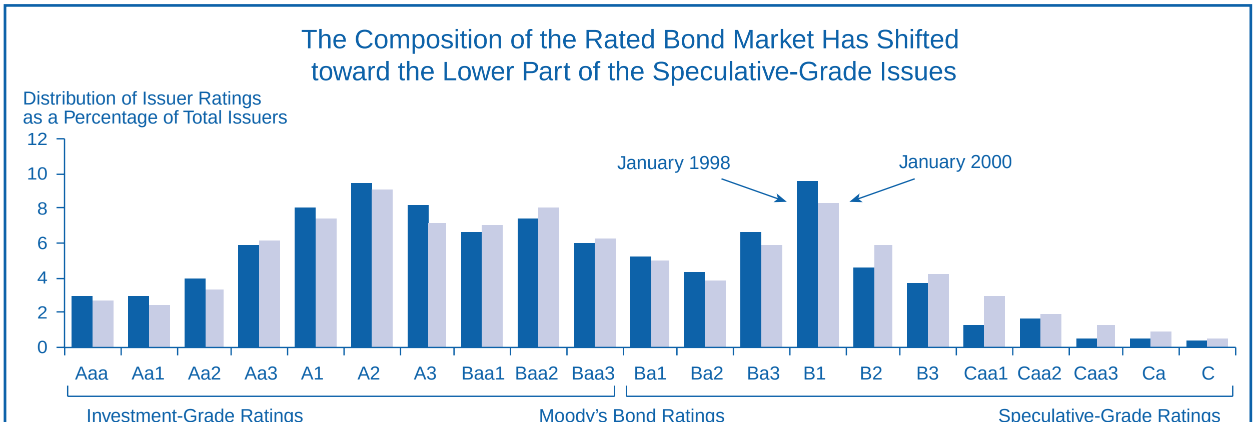
Financial markets have evidenced greater risk appetite. While the ratio of speculative-grade bond issues to total corporate bond issues has remained fairly stable at approximately 40 percent during the past decade, the composition of borrowings has shifted substantially. ***Moody's*** reports a shift in the distribution of bond issue ratings within the speculative-grade category toward the lower end of the ratings scale (see Chart 5).[16] Evidence of this shift is demonstrated by the fact that bonds rated B3 or lower currently comprise approximately 35 percent of all speculative-grade issues, a record high and up from 24 percent in 1995.[17] Furthermore, almost 50 percent of the issuers that defaulted during the year ending September 1999 were rated for three years or less.[18] This change in the composition of ratings has contributed to the current increase in speculative-grade defaults and could affect the future volatility and liquidity of the market. The current high volume of corporate bond defaults reflects the looser standards in 1997 and 1998 for corporate debt issued by low-rated first-time issuers, who accounted for 40 percent of rated bond defaults in 1999.[19] This relationship is analogous to the current increase in net C&I charge-offs partially attributable to weakened underwriting standards in 1997 and early 1998.

The Increase in Leveraged Lending Could Result in a Riskier Mix in C&I Loan Portfolios

Leveraged lending comprises an important part of the syndicated lending market and generates considerable fee income for financial institutions. Leveraged loans have grown from 12 percent of total syndicated loan originations in 1995 to 32 percent in 1999 (see Chart 6, next page). Leveraged syndicated loan originations grew 19 percent to $320 billion in 1999, as investors were seeking higher risk-adjusted returns and lenders were seeking higher fees. ***Paine Webber*** analysts estimate that leveraged lending accounts for over 80 percent of syndicated loan fees and profits earned by loan underwriters.[20] Highly leveraged lending increased to a new record of $190 billion in 1999.[21] This growth in loan originations reflects the current high corporate demand for loans, and by definition these loans are being made to borrowers with higher-than-normal levels of financial leverage and risk. In return for their higher risk profile, leveraged borrowers must compensate financial institutions through higher pricing and higher fees.

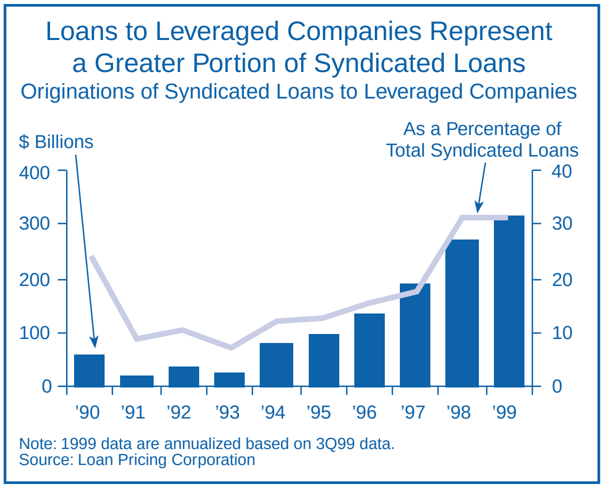
[15] *LPC Gold Sheets.* January 10, 2000.
[16] Moody's January 2000 Commentary. January 18, 2000.
[17] "Refunding Risk for Speculative Grade Borrowers." Moody's Special Comment. Moody's Investors Service. December 15, 1999.
[18] "Default Rate Pendulum." October 18, 1999.
[19] Moody's January 2000 Commentary. January 18, 2000.
[20] "The Biggest Secret of Wall Street." Paine Webber Equity Research. May 14, 1999.
[21] Loan Pricing Corporation defines highly leveraged loans as those for which pricing exceeds 250 basis points over LIBOR and generally involves sub-investment-grade credits.

CHART 5



Note: Unrated issues of corporate debt fall below the speculative-grade "C" rating.
Source: Moody's Investors Service

CHART 6



Leveraged lending volumes have recently been partially driven by M&A lending, which comprised over 30 percent of the total syndicated loan market in 1999. M&A activity approached $1.4 trillion in total volume during 1999, increasing the demand for capital and driving corporations to the loan market.[22] Approximately 22 percent of leveraged loans originated in 1998 were to the media and telecommunications industries, which have experienced significant levels of M&A activity.[23] Leveraged buyout activity contributed an additional 15 percent to leveraged lending volumes, surpassing 1998 levels in quantity.

Where Is Business Credit Quality Heading?

The future direction of business credit quality will be influenced by several factors, including the condition of the economy, growth in the indebtedness of corporate borrowers, exposure to vulnerable industry sectors, the interest rate environment, the development of emerging markets, and underwriting standards.

Economic growth will remain an important determinant of credit quality. Should economic growth slow and corporate profits decline, the demand for C&I loans is likely to fall, and problem asset levels are likely to rise. A recent S&P survey of global credit conditions noted that excessive credit, attributable to unsustainable corporate indebtedness and falling asset values, has weakened the financial systems of 20 nations. As for credit expansion in the United States, the survey noted that the ratio of private sector loans outstanding to gross domestic product rose from 101 percent in 1995 to 142 percent in 1999. S&P also noted evidence that banks' C&I loan portfolios may be relying too heavily on loan repayments based on projections that are realizable only if the current economic expansion continues. S&P estimates that 5 to 15 percent of bank loans could default should the United States experience a significant downturn in the stock market leading to a hard landing for the domestic economy.[24]

Continued growth in corporate indebtedness could contribute to increased losses and defaults. The growth rate of corporate debt has surpassed the growth rate of the economy in each year since 1994. A widening financing gap and increasing debt levels could pose problems if there are adverse changes in the interest rate environment or if corporate revenue growth slows. Rising rates will increase the costs of servicing debt, while a slowdown in revenue growth would reduce the cash flow available to service outstanding debt. Under such a scenario, business bankruptcies and failures are likely to rise, causing increased loan losses and bond defaults.

Lending to some industries involves high-risk exposures. Despite the strength of the U.S. economy, some domestic industries are continuing to experience stress. Exposures to weakened industry sectors, such as health care and oil and gas, could negatively affect C&I credit quality at insured institutions. One way to evaluate the relative riskiness of firms operating in a given industry is through ***KMV Corporation's®*** Expected Default Frequency™ (EDF™) analysis. KMV Corporation® has developed a proprietary method of measuring the degree of credit risk inherent in corporate borrowers by calculating an EDF™ score to estimate the probability that a firm will default on its obligations within one year.[25] Chart 7 diagrams syndicated loan exposures along with December 1999 EDF™ scores and the direction of change since December 1998. This chart illustrates one measure of the risk associated with the 10 industry sectors having the highest expected default

[22] Houlihan Lokey's *Mergerstat.* www.mergerstat.com.

[23] "The Biggest Secret of Wall Street." May 14, 1999.

[24] "Global Financial System Stress: The Weak, the Vulnerable, and Those Limping Toward Recovery." Standard & Poor's. December 17, 1999.

[25] KMV's® proprietary calculation for EDF™ is based on (1) the current market value of the firm, (2) the structure of the firm's current obligations, and (3) the vulnerability of the firm to large changes in market value. Multiplying industry originations by median industry EDF™ scores provides an estimate of expected default volumes. This figure provides a more meaningful measure of aggregate lending risk exposure than pure origination volumes alone and can be used to rank industry exposures.

volume based on the volume of 1999 syndicated loan originations. In 1999, loans originated to mortgage lenders (including subprime lenders), communications firms, oil and gas firms, health care firms, and retail trade organizations generated the five highest expected default volumes among 50 broad industry sector classifications.

The interest rate environment and refunding risk affect the demand for and availability of credit. Declining interest yield spreads from 1996 to 1998 benefited borrowers. As spreads declined, the rate of syndicated loan growth increased and refinancing activity was high. Increases in spreads since 1998, along with higher interest rates, have caused refinancing activity to slow significantly. However, rising rates have not significantly affected origination volumes, as new debt continues to come into the market. Rising interest rates and refunding risk particularly affect speculative-grade borrowers. Higher interest rates would raise businesses' cost of borrowing, potentially decreasing the demand for business credit and impairing borrowers' ability to repay their debts. Once a corporation's debt service ability is compromised, access to new capital markets can become limited. A sharp rise in interest rates would particularly impair the ability of highly leveraged firms to repay floating-rate debt obligations.

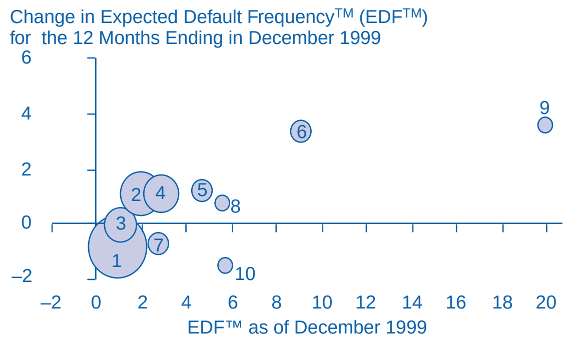
Refunding risk continues to be a concern for speculative-grade borrowers as they face potential problems refinancing the maturing portions of long-term debt. The current tightening of terms in the C&I market and increasing default rates heighten refunding risk to borrowers. Rising interest rates or limited access to secondary markets could also increase refunding risk. This situation could continue to be problematic, since a rising volume of speculative-grade borrowings, consisting largely of unsecured bank debt, matures in 2001 and 2002. Specifically, $64 billion in speculative-grade debt matures in 2001 and 2002, and approximately 63 percent of the debt is unsecured.[26]

Potential growth in new markets presents both opportunities and challenges. The Internet and European syndicated loan markets represent both future potential growth areas and possible sources of credit risk for C&I lenders. The Internet has introduced large new markets to the loan and bond markets and has

[26] "Refunding Risk for Speculative Grade Borrowers." December 15, 1999.

CHART 7

Lending to Some Industries May Involve Higher Risk Exposures



Industry Name and Origination Dollars in Billions:
1. Communication Services - $234.6
2. Motor Vehicles and Parts - $133.1
3. Chemicals and Drugs - $96.1
4. Retail Trade - $92.1
5. Wholesale Trade - $46.5
6. Health Care Services - $42.3
7. Oil & Gas Extraction - $41.8
8. Entertainment - $33.5
9. Mortgage Lenders and Mortage-Backed Securities - $20.2
10. Hotels & Lodging Services - $20.2

Note: Data and bubble size represent total syndicated loan originations for the year ending 1999.
Sources: Securities Data Corporation; KMV Credit Monitor®

increased market efficiency. The "Internet economy" grew 68 percent from the first quarter of 1998 to the first quarter of 1999, with annual revenue expected to exceed $500 billion in 1999.[27] Internet technology has improved the efficiency of the syndicated loan markets, with recent changes including the development of public price reporting, credit ratings, and Internet sites for online trading.[28] Increased levels of credit risk could result from the volatility of Internet stock prices and the competitive disadvantage faced by firms that do not have an Internet presence but must compete against firms that do.

While the majority of syndicated loan financing currently occurs in the United States, analysts predict that syndicated lending activity in Europe will accelerate significantly because of increased cross-border competition generated by the introduction of the euro and new financing needs. In addition, the European high-yield bond market is still developing but produced $6.8 billion of volume in the third quarter of 1999, or 61 per-

[27] "Internet Indicators." The Center for Research in Electronic Commerce at the University of Texas Graduate School of Business. October 27, 1999.

[28] "Syndicated Loan Market Soars as Efficiency Increases." *The Wall Street Journal.* December 6, 1999.

cent of the total market.[29] Domestic lenders have begun to compete for this market but face credit risks because the European markets also pose sovereign and foreign exchange risk.

Underwriting Remains the Key to Assessing C&I Credit Quality

The August 1999 ***OCC Survey of Credit Underwriting Practices*** reported some tightening of commercial loan underwriting standards. However, loan officers also reported increased embedded risks in commercial loan portfolios for the fifth consecutive year. Survey respondents attributed the increased risks to weakened underwriting standards in previous years. The November 1999 ***Federal Reserve Board Senior Loan Officer Opinion Survey on Bank Lending Practices*** found that 30 percent of domestic banks reported increasing risk premiums, credit line costs, and loan spreads during the preceding three months. Loan officers cited an uncertain or unfavorable economic outlook, an expected worsening of industry-specific problems, and a reduced tolerance for risk as reasons for tightening C&I lending standards.

Despite signs of tightening underwriting standards, the mix of credits appears to be riskier than in recent times. The OCC issued an advisory to banks in May 1999 warning of potential problems with leveraged lending. The OCC stated that highly leveraged corporations could be particularly vulnerable to economic weakness and may not be able to compete effectively in a rising interest rate environment. The OCC also addressed reliance on enterprise value loans, which are often used to support leveraged lending. Enterprise values are calculations based on projections of the future income of a firm. If such estimates are overly optimistic, or if the company fails to meet the assumptions underlying these estimates, the lender may be subject to considerable credit risk. The last interagency SNC review also noted instances of inadequate documentation and support for enterprise loans.[30]

Summary

C&I lending is one of the largest and fastest growing lending lines at insured institutions. Recent growth in C&I lending can be attributed to a number of factors, including a favorable economy, merger and acquisition activity, and other sources of high loan demand, strong asset quality, aggressive pricing, and attractive fee income. While indicators of C&I loan performance remain generally strong, signs of deterioration in commercial credit quality have begun to surface. These signs are cause for some concern because they are surfacing during a period of remarkable economic strength. Increasing corporate indebtedness, signs of corporate stress, and adverse trends in corporate bond defaults suggest that an economic downturn could result in a much more challenging environment for business credit quality.

By Arlinda Sothoron, Senior Financial Analyst
Alan Deaton, Economic Analyst

[29] *LPC Gold Sheets,* Vol. XII, No. 44. Loan Pricing Corporation. November 15, 1999.

[30] Remarks by OCC First Senior Deputy Comptroller and Chief Counsel Julie L. Williams before the Robert Morris Associates Conference on Lending and Credit Risk Management, October 5, 1999.

Local Industries in the Global Economy

- **The contribution of international trade to U.S. economic activity has risen rapidly during the past decade. The U.S. economy has been increasingly influenced by conditions abroad, such as the recent financial market turmoil in several emerging markets.**

- **Canada, Japan, and Mexico are the largest U.S. trading partners, accounting for approximately 40 percent of U.S. trade. Western Europe and Asia (excluding Japan) also account for a large share of U.S. trade.**

- **The importance of trade at the industry level varies widely. The industries most dependent on trade, including machinery and transportation equipment, also account for a large share of U.S. trade.**

The value of goods and services traded on international markets has more than doubled during the past decade. More goods and services than ever are being shipped abroad and imported from all parts of the globe. Consequently, U.S. economic activity is increasingly influenced by the flow of goods, services, and capital across national borders.

The increasing importance of international trade is reflected in different types and levels of exposure to international markets. First, total exports and imports compared with overall economic activity confirm the increasing contribution of trade to the economy as a whole. Second, the amount of U.S. trade with foreign markets, although widely varied, is concentrated in a small number of countries, namely Canada, Japan, and Mexico. Consequently, economic conditions in these countries are particularly important in assessing the influence of global economic conditions on U.S. trade. Third, the level of exposure to international trade across industry sectors varies considerably. Some industries are not influenced greatly by activity in international markets, while for other, more trade-dependent industries, conditions in the world economy are an important factor in determining the level of sales and profit. The exposure to international markets, either through reliance on trade with particular countries or via industries with a significant exposure to international markets, is an important consideration for lenders seeking to determine a firm's future profitability and financial condition.

International Trade Is of Growing Importance

Over the past 30 years, international trade has grown more quickly than the economy as a whole. Exports, which include both merchandise and services, have risen from less than 5 percent of U.S. gross domestic product (GDP) in 1970 to approximately 12 percent today. The merchandise component accounts for about 73 percent of exports and includes manufactured goods, agricultural products, and raw materials such as metals and oil. The services component of exports, accounting for about 28 percent of total exports, includes travel services, passenger fares, royalties, freight and port services, and a number of smaller sectors such as financial and educational services.

Imports also account for a growing share of U.S. consumption of goods and services, exceeding 15 percent of U.S. GDP in 1999, up from 6 percent in 1970. Merchandise is the largest component of imports, accounting for 83 percent, while services account for 17 percent (see Table 1, next page).

Although trade in services has grown quickly for many years, merchandise still accounts for the majority of all trade. The dominance of merchandise is attributable, in part, to the difficulty of trading many types of services. With few exceptions, services are generally produced and consumed within a local market because they cannot be transported easily and are subject to language and cultural barriers. Hospitals, dry cleaners, and movie theaters, for example, serve well-defined local markets and produce products that cannot be traded competitively on international markets. Although trade in services such as travel continues to grow, the remainder of this article focuses primarily on the dominant merchandise component.

U.S. Trade Activity Has Reflected Recent Global Economic Turmoil

Over time, conditions in the international economy have become an increasingly important influence on U.S. growth, since a rising share of all domestically produced goods and services is sold abroad. Similarly, an increasing volume of imported goods and services implies a higher level of competition for domestic producers that compete directly with imports.

Table 1

Merchandise Is the Largest Component of Trade			
	Dollar Value* (1998, $ millions)	Percent of Total	1999 Growth**
Exports	**$ 933,910**	**100.0%**	**1.8%**
Merchandise	682,138	73.0%	0.8%
Agriculture and Related Commodities	26,603	2.8%	-1.8%
Mineral Commodities	6,644	0.7%	-17.4%
Manufactured Goods	593,297	63.5%	-0.1%
Other Merchandise	55,593	6.0%	39.5%
Services	263,662	28.2%	4.3%
Travel	71,250	7.6%	3.0%
Passenger Fares	19,996	2.1%	2.7%
Royalties and License Fees	36,807	3.9%	4.1%
Freight and Port Services	25,520	2.7%	6.4%
Other Services	110,089	11.8%	5.0%
Adjustments***	(11,890)		
Imports	**$ 1,098,193**	**100.0%**	**10.3%**
Merchandise	907,647	82.6%	10.4%
Agriculture and Related Commodities	22,859	2.1%	-2.2%
Mineral Commodities	38,619	3.5%	5.6%
Manufactured Goods	803,384	73.2%	11.6%
Other Merchandise	42,786	3.9%	-0.6%
Services	181,015	16.5%	9.6%
Travel	56,105	5.1%	7.2%
Passenger Fares	19,797	1.8%	8.3%
Royalties and License Fees	11,293	1.0%	11.0%
Freight and Port Services	30,460	2.8%	11.4%
Other Services	63,360	5.8%	10.9%
Adjustments***	9,531		

* Sum of components may not equal total due to rounding.
** First three quarters of 1999 versus first three quarters of 1998.
*** Because of different methods of estimating the merchandise and services components of trade, an adjustment term is necessary. Consequently, percentages may not sum to 100.
Sources: Bureau of Economic Analysis; Bureau of Census

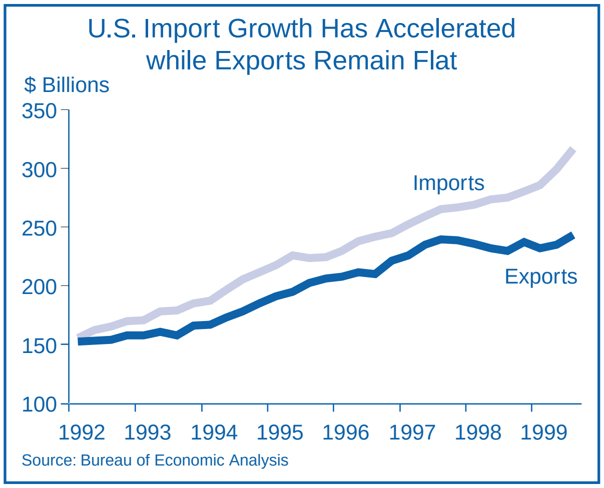
During the past two and a half years, for example, the international economy has been buffeted by a series of crises that resulted in steep exchange rate depreciations for a number of countries and a marked slowdown in economic growth in many emerging markets. Although the U.S. economy remained surprisingly strong during the worst of the emerging markets crises, the fallout was evident in the diverging performance of U.S. exports and imports over the period.

From mid-1997 through mid-1999, U.S. exports were generally flat, reflecting the sluggish pace of growth in several important U.S. export markets. Export prices fell by 4 percent over the period in response to weak demand for U.S. exports. In particular, exporters of agricultural products, basic manufactured goods, and commodities faced rapidly deteriorating conditions in several important overseas markets. For example, the value of merchandise exports to the Pacific Rim fell by 15 percent during the first six months of 1999 compared with the same period in 1997 because of the recent financial market turmoil in the region.

U.S. imports continued to grow during the period, however, reflecting both strong demand for imported goods and falling prices. In fact, average import prices fell by 5 percent between 1997 and 1999. At the same time, competition from imports limited the pricing power of domestic producers that compete with goods produced abroad. Although producers that compete with cheaper imports experienced adverse effects on profitability, consumers and firms that purchased goods from abroad generally benefited from falling import prices.[1]

The slowdown in U.S. export activity and the acceleration of import growth have resulted in an increasing trade imbalance (see Chart 1). The U.S. trade deficit, which reached a record $26.5 billion in November, has raised concerns among analysts about the vulnerability of the dollar. Faster growth abroad or a slowdown in U.S. growth could convince foreign investors to increase purchases of assets outside the United States, resulting in a sell-off of the dollar. Depending on the severity and speed of a sell-off, heightened financial market volatility and rising U.S. import prices could result. Although potentially many forces are at work in

CHART 1



Source: Bureau of Economic Analysis

such a scenario, rising inflation or a falling dollar may ultimately result in higher interest rates and slower U.S. growth. The extent to which U.S. trade would be affected by such a scenario is difficult to assess, since changes in the prices of either imports or exports would result in both positive and negative effects on firms' costs, revenue, and profitability.[2]

Most U.S. Trade Is Concentrated in a Few Foreign Markets

Because the United States trades with most nations, economic conditions abroad are one of the critical factors that determine the growth of U.S. trade. Foreign demand for U.S. goods and services depends on the strength of the markets to which exporters ship their goods. Consequently, economic weakness abroad often results in slower U.S. export growth. Economic conditions abroad also influence the level of import competition that U.S. firms experience. Foreign firms facing slack demand in their own domestic markets, much like manufacturers in Southeast Asia during the recent market turmoil, may

[1] Weak import prices are a factor cited by analysts to explain the benign performance of U.S. inflation during the past few years.

[2] During the early 1980s, the dollar rose by roughly 50 percent, as measured against a trade-weighted basket of currencies. The increase in the value of the dollar made U.S. exports much more costly on world markets and contributed to financial stress among export-dependent manufacturers and agriculture producers. Beginning in mid-1985 the dollar fell sharply, back to its pre-appreciation level. The resulting improvement in U.S. competitiveness contributed to robust growth in U.S. exports that lasted during the rest of the 1980s.

reduce prices of their U.S.-bound goods to compete more effectively with U.S. producers.[3]

Although the U.S. trades with many nations, a large share of U.S. trade is concentrated among a small number of countries. Canada, Mexico, and Japan account for more than 40 percent of merchandise exports and imports. Asia (excluding Japan) and Western Europe each account for just over 20 percent of U.S. exports and a broadly similar share of imports. Central and South America, despite proximity to the United States, account for less than 10 percent of exports and only 5 percent of imports (see Chart 2).

The United States has routinely run a trade deficit with its largest trading partners. The trade deficit with Canada was $22.8 billion through the first three quarters of 1999. The trade deficit with Mexico topped $18.8 billion during the same period. The trade deficits with Japan and China, by far the two largest at $53.4 billion and $49.4 billion, respectively, accounted for approximately 40 percent of the total U.S. merchandise trade deficit through the first three quarters of 1999.

The Importance of Trade Varies among Industries

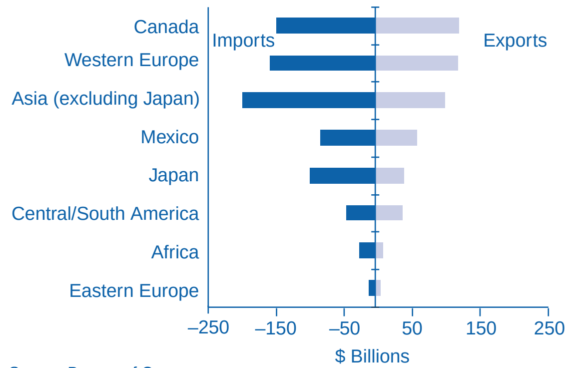
The level of export activity or the intensity of import competition also varies across industries. Besides the overall dollar volume of exports, industries differ in the proportion of total production that is exported. Although some industries, such as leather products, account for a relatively small share of total U.S. exports, exports from this industry make up a large share of all U.S. leather goods production. In cases such as this, conditions in export markets are important for producers even if total export sales from a particular industry are small.

Industries also differ in the share of total spending devoted to imports. Imports account for a relatively

[3] From the perspective of a foreign exporter, increased sales of goods abroad, even at reduced prices, may be a preferred strategy to offset lower sales within its own weaker domestic market. A foreign steel mill facing weak sales in its home market may choose to sell its output below cost on the world market if it can still cover its fixed costs of operation. There also may be an incentive to maintain or even expand market share and recoup current losses in the future when prices rebound.

CHART 2

Canada Is the Largest U.S. Trading Partner
(1Q99 through 3Q99, ranked by exports)



Source: Bureau of Census

small portion of all domestic spending on farm products such as grains and livestock, for example, while imports account for a relatively large share of all U.S. oil consumption. These differences expose U.S. industries to varying levels of competition from abroad. In industries characterized by high levels of import competition, import prices may largely shape the domestic pricing environment and, by extension, the revenue and profit growth of domestic firms.

For the purposes of this article, industries can be assigned to one of three broad categories depending on their exposure to international markets either through exports or through the intensity of import competition. Firms in *Less Exposed Industries* are not directly influenced by conditions in the global markets. Export markets are not a particularly important source of revenue, and imports are a negligible share of all domestic consumption of goods produced by these industries. In contrast, some industries are highly exposed through their reliance on export markets, through competition from imports, or in some cases, through both. For firms in these *Highly Exposed Industries,* conditions in international markets are clearly one of the important factors influencing current and prospective financial performance. Industries not part of either group, or *Moderately Exposed Industries,* face some competition from abroad and may earn a relatively small amount of revenue from export markets.

To gauge these differences more fully, a measure of exposure to international markets was calculated for a set of 26 industries (20 manufacturing industries, 4 mining industries, and 2 agriculture sectors). Table 2

Table 2

Industry Exposure to International Trade

Export Share of U.S. Production	Import Share of U.S. Consumption: Low	Import Share of U.S. Consumption: Medium	Import Share of U.S. Consumption: High
Low	Printing and publishing Food products	Lumber and wood products Petroleum and coal products Agricultural services, forestry, and fishing Furniture and fixtures	Oil and gas extraction
Medium	Coal mining Tobacco products Nonmetallic minerals, except fuels Fabricated metal products	Metal mining Paper and allied products Textile mill products Stone, clay, and glass products Rubber and plastic products Primary metal industries	Miscellaneous manufacturing industries Apparel products
High	Farm products	Chemicals and allied products Instruments and related products	Transportation equipment Industrial machinery and equipment Electronic equipment Leather and leather products

Highly Exposed Industries
Moderately Exposed Industries
Less Exposed Industries

summarizes the results of the assessment.[4] Each row shows industries that have high, medium, or low reliance on export markets, defined as the share of U.S. production in a particular industry that is exported. Each industry was ranked by this measure, with the 7 highest industries placed in the High category, the 7 lowest in the Low category, and the remaining 12 in the Medium category.[5] Table 2 shows, for example, that a relatively low proportion of production in the printing and publishing, lumber and wood products, and oil and gas extraction industries is exported. In contrast, a relatively high percentage of production in the farm products sector, chemicals, and transportation equipment industries is exported.

[4] Export share of production (rows in Table 2) was calculated as the ratio of inflation-adjusted exports at the industry level divided by inflation-adjusted production in that industry (Gross Output by Industry from the Bureau of Economic Analysis was used as a measure of industry production). The import share of consumption (columns in Table 2) was calculated as the share of inflation-adjusted industry imports divided by inflation-adjusted domestic production less exports plus imports. All calculations were based on 1997 data, the latest industry-level production data available.

[5] This allocation, while completely arbitrary, roughly corresponds to a distribution where 50 percent of the industries are assigned to the Medium category, with the remaining 50 percent evenly allocated between the High and Low categories. Breakpoints for the distribution of industries by export share of production were as follows: Low: less than 7 percent; High: greater than 13 percent.

The industries in each column are categorized by the share of U.S. consumption expenditures in a particular industry that are satisfied by imports. Again, the Low and High categories each include 7 industries, and the Medium category includes the remaining 12 industries.[6] On the basis of this analysis, for example, a relatively low share of U.S. consumption of food, fabricated metals, and farm products is imported. In contrast, a large share of U.S. consumption of oil, apparel, and electronic equipment is imported.[7]

As shown in the lower right cell of the table, four industries are highly exposed to both export markets and import competition. These industries—transportation equipment, industrial machinery, electronic equipment, and leather products—account for slightly less than half of total U.S. exports and a similar percentage of total U.S. imports. Not only are these industries more closely tied to international markets than most other industries examined, but they also account for a large share of U.S. international trade.

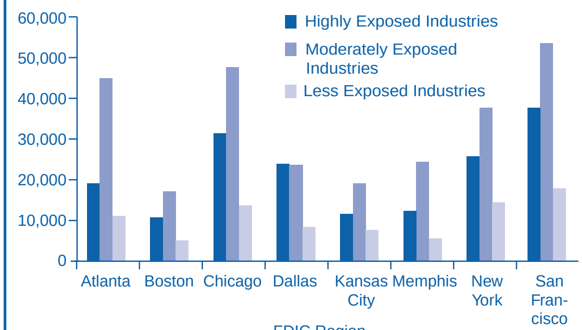
Using the terminology introduced above, Highly Exposed Industries are defined as those assigned to either of the High categories; industries in this group either are very reliant on export markets or face high levels of import competition. Less Exposed Industries are defined as those that have little exposure to either export markets or import competition; they are shown in the upper left cell in the Low classification. The remaining industries are defined as Moderately Exposed Industries.

Chart 3 illustrates the distribution of establishments in each of the three categories by Region.[8] Among the group of industries analyzed, most are in the Moderately Exposed Industries category. Of the FDIC Regions, Atlanta, Chicago, and San Francisco have the greatest number of establishments in this category. The Chicago and San Francisco Regions lead in the number of establishments in the Highly Exposed Industries group, followed by the New York and Dallas Regions.[9] Less Exposed Industries account for a relatively small number of establishments. As suggested above, however, most service-sector, construction, and government enterprises, while not part of this analysis, could be classified as Less Exposed.[10]

Although this analysis highlights the varying level of direct exposure to international markets, industries also may be exposed through a less direct secondary channel. Several industries, although not highly exposed themselves, are suppliers to Highly Exposed Industries. For example, the rubber and plastics industry produces goods that are used in the manufacture and assembly of transportation equipment, a Highly Exposed Industry.

CHART 3

Number of Establishments* Classified by International Trade Exposure by Region



*An establishment is a single physical location at which business is conducted.
Source: Bureau of Census, 1997 County Business Patterns Database

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[6] Breakpoints for the distribution of industries by import share of consumption were as follows: Low: less than 9 percent; High: greater than 25 percent.

[7] Although not directly included in the analysis, most domestically produced services also have minimal reliance on export markets and face little import competition. Retail trade, construction, local transportation services, and government, for example, all operate in relatively sheltered markets and are dependent on the health of the local economy. Particular firms may engage in high levels of international activity in tradable services such as travel, but manufacturing, mining, and agriculture account for the majority of imports and exports.

[8] An establishment is defined as a single physical location at which business is conducted or services or industrial operations are performed. It is not necessarily identical with a company or enterprise, which may consist of one or more establishments. Data are from *County Business Patterns* (Bureau of Census, 1997).

[9] An alternative way of analyzing the establishment data is to calculate the percentage of all establishments across the 25 industries that are in Highly Exposed Industries. On the basis of this calculation, the Dallas Region ranks highest at 42 percent because of the large number of establishments engaged in oil and gas extraction. For the remaining Regions, the percentages vary between 25 percent and 35 percent. Across all industries (including services and other sectors not part of this analysis), the percentage of Highly Exposed Industries in each Region ranges from 1.7 percent (Atlanta Region) to 3.4 percent (Boston Region) of total establishments.

[10] These data do not include a count of establishments in the farm products sector (Standard Industrial Code (SIC) 01 and SIC 02). Therefore, 25 industries are represented in the establishment data, and not 26 as in Table 2.

Consequently, conditions in export markets for transportation equipment are of particular interest for manufacturers of certain types of rubber and plastic products. These supplier industries are also vulnerable to import competition through this secondary exposure to international markets. A transportation equipment manufacturer, in response to heightened competition in international markets for its products, may switch from a domestic supplier of rubber products to a cheaper foreign supplier if a favorable price differential emerges. Therefore, assessing the exposure of industries to either exports or imports requires consideration of any secondary linkages between suppliers and purchasers of industry products.

Summary

The contribution of international trade to overall U.S. economic activity has been increasing for a number of years. The growing significance of trade has been highlighted by the recent series of economic and financial crises across the globe. One result of recent global economic turmoil has been a slowdown in U.S. export growth resulting from both slumping international demand for U.S. goods and services and weak prices. Import growth has continued unabated, largely because of strong U.S. growth, leading to a rapidly widening trade deficit. The effects of import and export growth on particular industries vary because of differing levels of reliance on export markets and the extent of import competition. This analysis suggests that several industries are highly exposed to changing global economic conditions. Lenders should be aware that for firms in these industries, changes in global economic conditions, including demand for U.S. exports and prices of both imports and exports, largely determine pricing, revenue growth, and profitability.

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Senior Financial Economist

Regional Perspectives

- **While unemployment remains low, the strength of the Region's economy and health of its banks and thrifts are starting to exhibit signs of weakening. For example, job growth in the Region slowed during 1999, and the Region's banks and thrifts reported modest deterioration in earnings, margins, and asset quality.**

- **Pressures on grain farmers' finances appear to be generating not only larger amounts of carryover farm debt but also a modest rise in problem consumer loans among Illinois' agricultural banks. Forecasts of continued low corn and soybean prices suggest that the pressure on farmers and agricultural lenders will continue.**

- **Strong loan growth is centered in traditionally higher-risk commercial and industrial (C&I) loans. Although asset quality among C&I lenders was favorable in the third quarter, rapid C&I loan growth and the resulting rise in exposures raise questions about how banks would fare should the economy slow.**

- **Profitability levels for banks specializing in residential lending appear vulnerable given recent increases in interest rates and weakening mortgage markets.**

Region's Banking and Economic Conditions

Institutions Are Generally Healthy

The Region's banks and thrifts report healthy conditions; however, signs of weakness are beginning to develop. Based on median values for all institutions in the third quarter,

- the return on assets (ROA) for all institutions was 1.03 percent in the third quarter;
- the net interest margin (NIM) was 3.93 percent;
- past-due and nonaccrual loans were 1.78 percent of total loans; and
- the Tier One capital ratio was 9.34 percent.

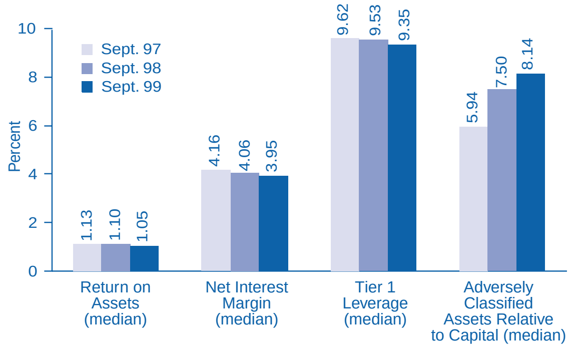
Although the levels of these and other aggregate measures of institutions' condition suggest that performance remains healthy, they nevertheless have shown some slight weakening recently. The Region's 1,835 established community institutions,[1] for example, continued to show modest deterioration during the third quarter of 1999. In addition, the percentage of community institutions with composite CAMELS (capital adequacy, asset quality, management, earnings, liquidity, and sensitivity) ratings of 3, 4, or 5 edged up in late 1999. Based on median values for September 30, 1999, conditions at all community institutions showed the following (see Chart 1):

- ROA was 5 basis points lower than in September 1998 and 8 basis points lower than in September 1997;
- NIM fell 21 basis points over the same two-year period;
- Tier One leverage ratio was 27 basis points lower than in September 1997; and
- adversely classified assets relative to capital increased 220 basis points from a low level two years earlier.

Most types of lenders are beginning to exhibit modest signs of strain. Deterioration in agricultural banks' performance reflects the effects of low crop prices and the significance of the farm sector in some lenders' markets. A variety of factors underlie developments among other types of institutions. C&I lenders are experiencing strong loan growth, which may result in increased levels of credit risk. Institutions heavily exposed to residential real estate face potential earnings pressure from recent

[1] Established community institutions are defined as banks and thrifts with assets of $1 billion or less, excluding those established in the past three years.

CHART 1



Sources: Bank and Thrift Call Reports and FDIC's Research Information System Data Warehouse

interest rate increases and mortgage market developments. Challenges facing agricultural, C&I, and residential real estate lenders are discussed later in this article.

Economy Is Healthy but May Be Slowing

Economic conditions also remain healthy but show signs of softening. While the Region's unemployment rate hovered below 4 percent in 1999, the job growth rate slowed to 1.1 percent in the third quarter. This pace was more than half a percentage point slower than in 1998 and 1997, partly because about 30,000 manufacturing jobs were cut during 1999.

Conditions in the Region's major sectors and communities likely will become more uneven should the pace of recent cutbacks in manufacturing employment continue and the consensus forecast[2] for slower growth come true. Developments in labor markets, the consumer sector, and residential housing markets illustrate how mild pressures may be building and affecting areas within the Region differently.

Labor markets are experiencing slower job growth, partly because low unemployment is limiting employers' ability to hire additional workers. On a year-over-year basis, the Region's job growth rate in the first three quarters of 1999 ranged between 1.3 and 1.1 percent. In contrast, during 1998 the rate ranged between 1.7 and 2.0 percent.

Slower employment growth has affected states within the Region differently. For example, third-quarter manufacturing employment was nearly 1 percent lower than a year earlier in **Illinois** and **Wisconsin,** little changed in **Ohio,** and almost 1 percent higher in **Indiana.** A 1.3 percent gain in **Michigan** likely was temporary, reflecting a rebound from a year-ago job count that was suppressed by a strike against ***General Motors.*** The weakness in hiring by manufacturers—an important swing sector in this Region—warrants monitoring as a possible indicator of slower economic growth overall.

The strength of household spending for goods and services (along with gains in stock market indices) continues to surprise many forecasters. Even so, certain developments suggest that the strength of the consumer sector in recent years might weaken. Last year's tremendous boost to households' purchasing power from mortgage refinancing, for example, stalled when mortgage rates stopped falling. Further, the pace of job growth has slowed, and rising interest rates over the past year have increased the cost of financing a home and other major purchases. Any resulting weakening in demand for durable goods, such as motor vehicles and appliances, likely will be felt promptly by some of this Region's manufacturers and their employees.

Residential housing indicators also are generally showing less vigor. Demand for new and existing homes may continue to soften because many households have already purchased a home or traded up, interest rates have risen, and job growth has slowed. Should the housing market slow in 2000, demand for appliances, home furnishings, and other related items that typically follow the purchase of a home (and that may be produced in this Region) will likely weaken. Such a development could further slow the pace of job growth and household spending.

Growth in the issuance of single-family permits slowed by varying degrees among the Region's states toward year-end 1999 (see Table 1, next page), even though activity in all states was affected by slower job growth and higher mortgage rates. Despite the slowdown, Illinois, Ohio, and Wisconsin continued posting double-digit gains. Sales of existing homes also varied among states. Growth in home resales slowed noticeably in Illinois but moderately in Indiana and Ohio. Wisconsin and Michigan recorded modest gains, but they were insufficient to offset the prior year's retrenchment.

[2] See, for example, Ford, Constance Mitchell, "Economists Are Euphoric About the Prospect for 2000—Nearly All Surveyed Believe Expansion Will Become Longest on Record," *The Wall Street Journal,* January 3, 2000, page A2.

TABLE 1

Residential Housing Developments Are Mixed (percent change from a year earlier)	Single-Family Permits		Sales of Existing Homes	
	3Q98	3Q99	3Q98	3Q99
Region	**12.2**	**8.8**	**3.8**	**4.3**
Illinois	10.5	10.4	18.3	4.2
Indiana	12.8	8.1	12.6	10.7
Michigan	9.8	4.4	–13.6	0.9
Ohio	14.2	12.2	5.2	4.3
Wisconsin	15.6	10.1	–5.3	2.5

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

Agricultural Concerns Are Centered in Illinois

The effects of low corn and soybean prices continue to concern the Region's agricultural lenders. These crops account for about 70 percent of farmers' total cash receipts in Illinois, 58 percent in Indiana, 40 percent in Ohio, and lesser shares elsewhere in the Region.

The negative consequences of low commodity prices on net farm income are being tempered by federal assistance payments. However, several years of declining prices appear to have eroded farmers' financial health. The financial positions of approximately 22 percent of Illinois grain farms are classified as stressed or severe and a slightly lower percentage as vulnerable, according to a recent study of 1,076 farms by experts at the ***University of Illinois*** (see Chart 2).[3] The southern part of the state is most affected because of recent poor growing conditions and low yields. Average projected 1999 net farm income in the east-southeast district is estimated to be $17,000, compared with the statewide average of $25,000.[4] The southwest and southeast districts are projected to report negative average income.[5]

Although call report data do not reveal any significant deterioration in insured institutions' earnings or asset quality, Illinois agricultural banks' balance sheets are beginning to reflect the problems affecting grain farmers.[6] For example, the median ROA for this group fell to 1.03 percent as of September 30, 1999, from 1.16 percent a year earlier and 1.20 percent two years earlier. Moreover, the growing number of Subchapter S institutions in the Region produces an upward bias in ROA because of the tax benefits. To address this bias, one can

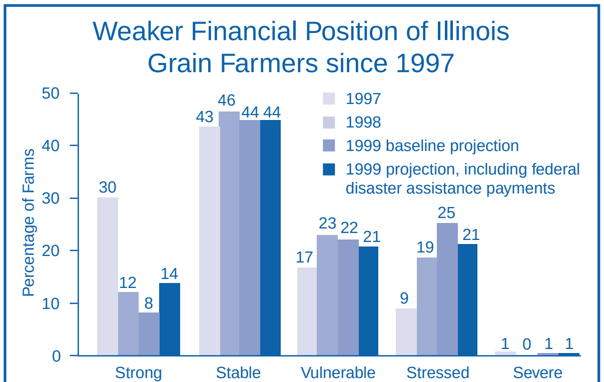
[3] Lattz, Dale, Paul Ellinger, and Gary Schnitkey, *Estimated 1999 Farm Income and Financial Position of Illinois Grain Farms,* Department of Agriculture and Consumer Economics and The Center for Farm and Rural Business Finance, University of Illinois at Urbana-Champaign, October 1999.

[4] Ibid.

[5] Ibid.

[6] Illinois had 232 established banks and thrifts for which agricultural production loans plus farm real estate loans totaled 25 percent or more of loan portfolios on September 30, 1999. Three newly established Illinois banks with significant shares of agricultural loans are excluded from this discussion.

CHART 2



Source: Lattz, Dale, Paul Ellinger, and Gary Schnitkey, *Estimated 1999 Farm Income and Financial Position of Illinois Grain Farms,* Department of Agriculture and Consumer Economics and The Center for Farm and Rural Business Finance, University of Illinois at Urbana-Champaign, October 1999.

look at pretax ROA, which has been slipping and was 28 basis points lower on September 30, 1999, than it was two years earlier (see addendum to Table 2). Meanwhile, Illinois agricultural banks' Tier One leverage ratio has declined slightly, past-due and nonaccrual ratios are rising, and the allowance for loan and lease losses relative to noncurrent loans (the reserve coverage ratio) is shrinking (see Table 2).

The reduction in reserve coverage occurred as the median value of all past-due and nonaccrual loans among Illinois agricultural banks rose modestly, reaching 2.01 percent of total loans on September 30, 1999, from 1.81 percent in the prior two Septembers. Eleven percent of Illinois agricultural institutions reported past-due and nonaccrual ratios exceeding 5 percent at quarter-end, up from 8.6 percent of these institutions on September 30, 1998. This increase highlights the need to evaluate the relative level of the allowance for loan losses carefully in light of conditions affecting grain farmers and the expectation that corn and soybean prices will remain relatively low in 2000.[7]

The median value of past-due and nonaccrual agricultural loans on September 30, 1999, remained low—well below 1 percent. The increasing extension of carryover debt[8] may help to explain why agricultural loan performance in Illinois has worsened only slightly despite sustained softness in crop prices. Should lenders become less willing to extend carryover debt or should Congress not appropriate additional emergency assistance funds, banks' past-due and nonaccrual agricultural loans could rise abruptly.

Recent developments among Illinois agricultural banks illustrate that all segments of the loan portfolio warrant attention when economic conditions in the surrounding community weaken, regardless of whether agriculture or heavy manufacturing, for example, is the area's dominant industry. Spillover effects from the softness in corn and soybean farmers' incomes appear to be affecting local lenders in other loan categories. For example, the median level of past-due and nonaccrual consumer loans at Illinois agricultural banks increased by 10 basis points over the past year to 2.42 percent on September 30, 1999. In contrast, the state's consumer institutions[9]

[7] U.S. Department of Agriculture, *World Agricultural Supply and Demand,* December 10, 1999.

[8] Nationally, 37 percent of agricultural banks posted a "moderate" increase in carryover debt and 5 percent showed a "sharp" increase, according to the FDIC's *Report on Underwriting Practices* for April through September 1999. The current share of institutions reporting a moderate or sharp increase in the level of carryover debt compares with 32 percent in the prior six-month period and is more than three times higher than in the six months ending March 1998.

[9] Consumer institutions are defined as banks and thrifts with one- to four-family mortgage loans plus loans to individuals greater than 50 percent of total assets, excluding banks less than three years old.

Table 2

Overview of Illinois' Agricultural Banks

	Sept. 97	Sept. 98	Sept. 99
Number of Institutions	245	244	232
Tier One Leverage	10.34	10.61	10.40
Asset Quality			
Percentage of Loans Past-Due and Nonaccrual	1.81	1.81	2.01
Allowance for Loan and Lease Losses to Noncurrent Loans	1.83	1.64	1.29
Percentage of Institutions with Past-Due and Nonaccrual Loans >5 percent	7.35	8.61	11.21
Earnings			
Return on Assets (ROA)	1.20	1.16	1.03
Net Interest Margin	4.00	3.50	3.84
Addendum: Subchapter S Institutions			
Number of Institutions	19	32	37
Pretax ROA	1.63	1.53	1.35

Note: Median values shown where appropriate.
Source: Bank and Thrift Call Reports

reported significant improvement in past-due and nonaccrual consumer loans to a much lower 1.84 percent over the same period. In addition, the 2.14 percent past-due and nonaccrual rate for residential one- to four-family mortgages at Illinois agricultural banks exceeds those at agricultural banks in Indiana, Wisconsin, and Michigan, where the past-due and nonaccrual rates for residential mortgages were 1.55 percent or less on September 30, 1999.

Recent evidence that earnings and loan quality are being pressured and the outlook for another year of low corn and soybean prices suggest that agricultural banks and farmers in Illinois and other affected areas may face another challenging year in 2000.

Commercial and Industrial Loans Are Growing Rapidly

A robust economy has created expansion opportunities for entrepreneurs and existing businesses, which has helped fuel C&I loan demand in the Chicago Region. Banks considered C&I lenders[10] experienced strong C&I loan growth as of year-end September 30, 1999. There were 601 banks in this category, and the median C&I loan growth for this group was approximately 18 percent during the year ending September 30, 1999, up from 14 percent a year earlier (see Chart 3). Furthermore, almost one-half of C&I lenders recently experienced C&I loan growth rates of 20 percent or more, a much larger share than for other loan types, with the exception of commercial real estate (see Table 3). As mentioned in this issue's ***In Focus*** article, factors such as a widening corporate financing gap and merger and acquisition activity are driving C&I loan growth nationwide. In addition, small commercial loans (defined as C&I loans with an original balance of $1 million or less) have shown strong growth in the Chicago Region.

Small commercial loans are a major part of the Region's C&I lenders' loan portfolios. These loans comprised at least 30 percent of the C&I loan portfolios at 96 percent (558) of the C&I banks as of June 30, 1999.[11] Small commercial loans at the Region's C&I lenders grew to $35 billion by June 30, 1999, up from $31 billion a year earlier. Much of this growth occurred in institutions with assets greater than $250 million. The increasing use of computerized credit-scoring models and mass-marketing efforts by larger institutions have facilitated growth of these smaller commercial loans and intensified competition (see "Will Credit Scoring Transform the Market for Small Business Lending?"; ***Regional Outlook,*** Second Quarter 1997). While credit scoring can help standardize operations and reduce loan

[10] Commercial and industrial lenders are defined as established banks with commercial and industrial loans greater than or equal to 10 percent of total assets.

[11] Data on the size of C&I loans are collected once a year in the June call report.

Chart 3

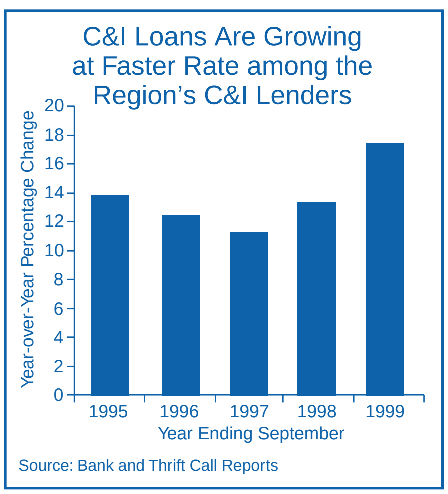


Table 3

Many of the Region's Institutions Report Rapid Commercial Loan Growth

Type of Loan	Percentage of Institutions with Over 20% Loan Growth*
Agricultural	12
Commercial and Industrial	47
Commercial Real Estate	47
Consumer	28
Residential Real Estate	20

* Only institutions with at least 10% of assets in each loan category, excluding institutions established after September 30, 1995.
Source: Bank and Thrift Call Reports, September 30, 1999

overhead, the application of these techniques to small-business credits is relatively new and has not been tested during an economic downturn.

A Rising Share of C&I Loans Could Indicate Greater Credit Risk

Growth in C&I loans has increased the share of these assets held by the Region's C&I lenders. At the end of third quarter 1999, the median C&I loan level was 22 percent of total loans, up from 18 percent at September 30, 1997. The shift in asset composition toward higher-yielding C&I loans could be a response to declining NIMs experienced by these banks over the past couple of years. As a result, profitability levels—as measured by ROA—may have been buoyed by the higher yields received from a growing C&I loan portfolio. ROA, which fell slightly during the first nine months of 1999 to 1.27 percent from 1.33 percent a year earlier, remained above the level reported two years earlier, when C&I loans represented a smaller portion of the overall loan portfolio. The increasing exposure to C&I lending, traditionally a higher-risk form of lending, could be a growing concern in the case of potential downturns in the economy.

The median C&I total past-due ratio of the Region's C&I lenders improved as of September 30, 1999, to 1.67 percent from 1.96 percent in the year-earlier period. However, the rapid growth in C&I loans over the past couple of years may make it more difficult to identify asset quality problems at these institutions. A declining past-due ratio is typical during times of rapid loan growth. Newly originated loans are unlikely to fail to perform initially; consequently, the large volume of new loans tends to have lower reported past-due levels, which gives the appearance of improved asset quality. Given the relative newness of these credits, it is uncertain how these loans will perform during an economic contraction.

Risk in C&I Portfolios May Vary with the Area's Economic Diversity

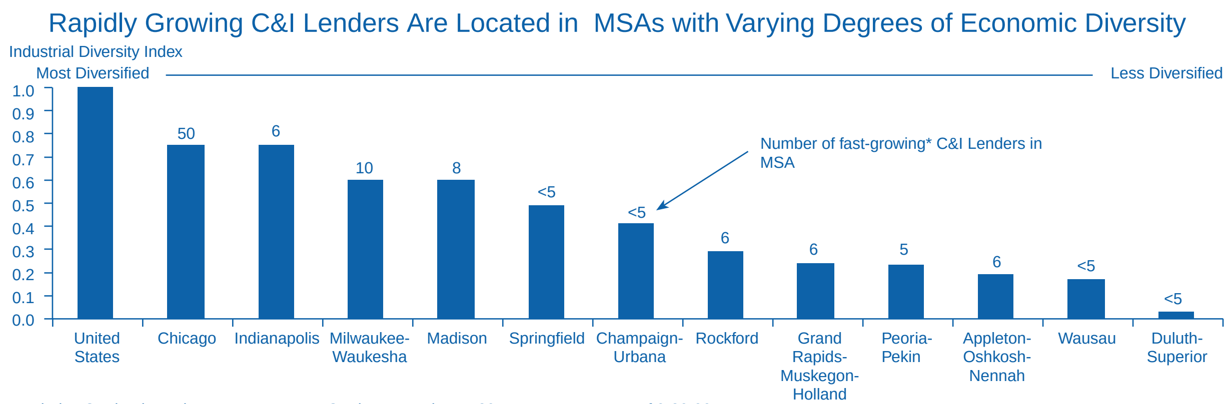
In the event of an economic slowdown, the performance of an institution's C&I loan portfolio will depend largely on the industry concentrations represented in that portfolio and the economic conditions in the lending area. Nearly one-half of C&I lenders (288 banks) are rapidly increasing exposure to C&I loans (i.e., they experienced growth of 20 percent or more in the C&I portfolio from third quarter 1998 to third quarter 1999). A majority (60 percent) of these "fast-growing" C&I lenders are located in the Region's metropolitan statistical areas (MSAs), including **Chicago,** Illinois (50 banks); **Milwaukee-Waukesha,** Wisconsin (10 banks); and **Madison,** Wisconsin (8 banks). Furthermore, most of the C&I lenders experiencing rapid C&I loan growth are community banks[12] that are likely lending to a diversified group of small businesses rather than lending predominantly to one or two industries. If a bank is located in a large, economically diverse MSA and reflects the diversity of its community, it is not likely that a downturn in one industry would significantly affect the bank's C&I credit quality.

The Chicago and **Indianapolis** MSAs are the most economically diverse MSAs in this Region, according to the ***Regional Financial Associates (RFA) Index of Industrial Diversity***[13] (see Chart 4, next page). The **Cincinnati, Cleveland,** and **Columbus** MSAs also are relatively diverse, with index values of 0.73, 0.70, and 0.72, respectively. Index values for the Region's MSAs are calculated relative to the U.S. economy, which is the most diverse and is assigned a value of 1.00. For a geographic area, the lower the index value, the greater its vulnerability to a downturn in its dominant industry. A significant number of fast-growing C&I lenders are located in the Milwaukee and Madison MSAs, which show only moderate economic diversity. However, other MSAs show very little economic diversity. For example, despite the fact that it is one of the most populous MSAs in the Region, the index value for the **Grand Rapids-Muskegon-Holland** MSA is quite low because of its exposure to the manufacturing industry, especially ***Steelcase*** and ***General Motors.*** A downturn in the manufacturing industry alone, or one of its major employers, could significantly dampen the economic health of small businesses in the MSA and, consequently, could adversely affect community banks' C&I portfolios.

[12] Banks with assets of $1 billion or less, exclusive of those established in the past three years.

[13] This index incorporates every three-digit Standard Industrial Code classified industry.

Chart 4



* Includes C&I lenders where year-over-year C&I loan growth was 20 percent or more as of 9-30-99.
Note: The index includes all three-digit Standard Industrial Code classified industries.
Source: Regional Financial Associates, June 1999

A total of 116 fast-growing C&I lenders are located outside the Region's MSAs. These banks tend to be smaller, with an average asset size of $149 million. They typically do not have the same advantages, in terms of economic diversity, as institutions within MSAs. Assuming that these banks' C&I portfolios reflect the industry exposures of the local area, asset quality would be much more vulnerable to a downturn in a single industry. For example, approximately 18 percent of the fast-growing C&I lenders located outside an MSA are also heavily exposed to agricultural lending; thus, the stress in agricultural communities might spill over into these institutions' C&I portfolios.

Summary

Recent loan growth among the Region's C&I lenders has been strong. C&I loans represent an increasing share of C&I lenders' loan portfolios, which might indicate greater credit-risk exposure. Although past-due and loan loss levels currently remain low, rapid growth in the C&I loan segment could make it more difficult to identify asset quality problems. In the event of an economic downturn, performance of an institution's C&I portfolio could depend greatly on the economic diversity of the lending area. While the past favorable economic and interest rate environments may have encouraged some institutions to expand C&I lending portfolios, the increasing exposure of this loan type should be carefully monitored.

Rising Interest Rates May Affect Residential Real Estate Lenders' Profitability

Interest rates rose noticeably in 1999, raising questions about how residential real estate (RRE) banks[14] might be affected. The last time interest rates rose appreciably, in 1994, profitability at RRE banks weakened quickly and substantially (see Chart 5). There are, of course, distinctions between the interest rate climates of 1994 and 1999. In 1994, the Federal Reserve raised short-term rates six times for a total of 250 basis points. In 1999, the yield curve steepened while short-term rates increased more modestly than in 1994. To date, tighter monetary policy has weakened mortgage markets and real estate conditions, reduced fee income, and resulted in securities portfolio depreciation. Profitability, not credit quality, is this group's primary concern, given its relatively conservative credit risk profile.

Softening Mortgage Markets May Affect the Region's RRE Lenders

Mortgage activity, particularly refinancing activity, slowed significantly when interest rates stopped falling

[14] Residential real estate banks are defined as banks and thrifts with 50 percent of assets in the sum of one- to four-family loans and mortgage-backed securities.

in 1999 (see Chart 6). Because year-end 1999 refinancings already represent a very low percentage of total originations, any further interest rate increases likely will not affect refinancing activity significantly. However, loans to finance the purchase of residential real estate might decline if RRE conditions continue to slow (for further discussion see "Economy Is Healthy but May Be Slowing," page 19).

As refinancings have subsided, some analysts have predicted that consumers will take out more second-lien home equity loans because they can no longer increase cash flow by refinancing first liens at a lower rate. Community RRE banks have indeed experienced a steadily rising share of home equity loans; however, such loans currently represent only 2.88 percent of total loans.

Looking forward, the ***Mortgage Bankers Association***'s chief economist recently stated that the mortgage industry is headed for a steep cyclical downturn in 2000. Already, the industry has seen layoffs and restructuring at some of the nation's largest lenders. Mortgage lenders hoping to maintain volume may be forced to compete strongly on price, which may lead to further erosion of these banks' margins.

The Interest Rate Increases in 1999 May Strain Profitability

Recent interest rate increases and a consensus opinion for slower economic growth[15] may continue to pressure RRE banks' margins, as occurred in 1994. The interest rate increases in 1994 likely hurt these institutions' profitability—in part, because they were liability sensitive in the aggregate. This assumption is consistent with the fact that many community institutions have shorter average maturities on the liability side of the balance sheet than on the asset side.

No generalizations can be made about current aggregate interest rate risk levels because institutions' balance sheet structures and interest rate risk management differ. Because long- and short-term rates increased in 1999, the effects on margins may be muted, and increased loan yields may compensate. Timing differences may temporarily strain margins, as loans often have longer maturities and will take longer to reprice at higher rates. As a result of experiences in 1994, many institutions may now be more actively managing interest rate risk positions to help ensure that profitability levels are not as vulnerable to rising interest rates as they have been in the past.

However, asset yields will likely be pressured because of increased borrower preference for lower-yielding adjustable-rate mortgages (ARMs). ARMs represent an increasing percentage of loan originations and, according to the MBA, are expected to continue to do so.[16] The adjustable-rate share of conventional purchase loans rose substantially from 11 percent in January 1999 to 30 percent as of November 1999.

[15] Ford, op. cit.

[16] Mortgage Bankers Association, *Mortgage Finance Forecast,* December 8, 1999.

CHART 5

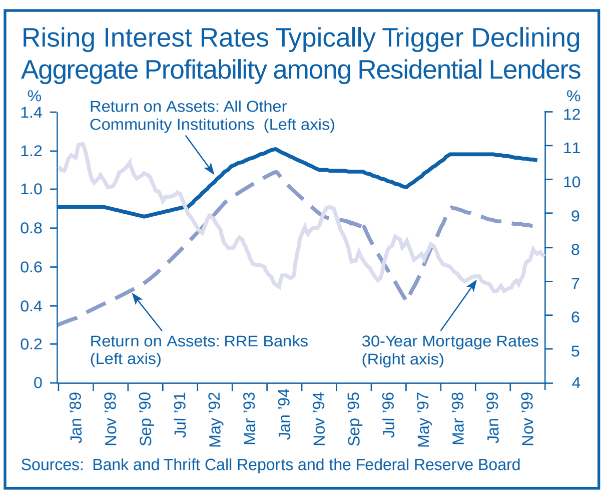
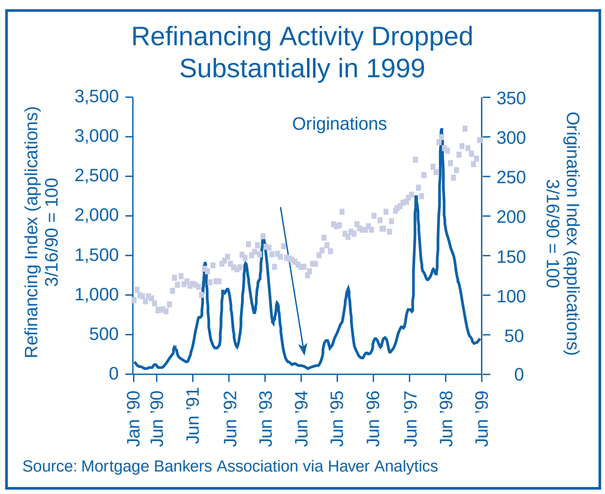


CHART 6



Rising Competition and Interest Rates Have Hurt RRE Bank Profitability

Weakening mortgage markets and higher interest rates already may have affected the Region's RRE banks, most of which are small institutions that are experiencing declining profitability. Currently, 316 community[17] institutions in the Region are considered RRE banks; they hold aggregate assets of $47.8 billion. Reported asset quality and capital levels and trends appear favorable; however, profitability has dropped during the past two years from a median ROA of 0.87 percent to 0.70 percent as of September 30, 1999. This trend has occurred largely because of NIM compression.

During this past decade, RRE banks' net interest margins peaked in 1993 and trended downward over the next six years. Much of the margin compression has occurred during a period of declining interest rates and strong mortgage markets, underscoring the fact that structural and competitive factors have played a significant role. In addition, the Region's RRE banks have relied to a greater degree than institutions elsewhere on borrowings, which often have higher costs than core funding. However, some RRE banks may experience less change in funding costs from recent interest rate hikes because of increased use of longer term borrowings, which can take longer to reprice.

RRE banks with the lowest levels of earnings have experienced the greatest declines in profitability on a percentage basis. RRE banks with profits in the 25th percentile have seen ROA slip from 0.47 percent to 0.32 percent over the past two years. Increasing variability in RRE banks' profits may be indicative of the stress this group is already experiencing because of increased competition and a slowdown in mortgage markets. Should margins tighten further as a result of recent interest rate hikes, this group of institutions may see profitability decline further. Such an event could lead some institutions to engage in traditionally riskier forms of lending in an effort to increase profitability.

Securities Portfolios Have Depreciated Notably

RRE banks' securities portfolios also have been significantly affected by modest interest rate increases in 1999. The negative convexity inherent in many mortgage-backed securities has likely led to more significant depreciation in RRE bank portfolios. For example, when interest rates rise, the market value of these securities declines, much like any fixed-income investment. The reduction in market value is often more severe in the case of these instruments, because the expected maturity may increase as homeowners are less likely to prepay mortgages after interest rates rise. As a result, these securities may yield less than market rates and have an expected maturity longer than initially anticipated.

The effects of recent interest rate increases are apparent at the 123 banks[18] in the community RRE group. As of December 31, 1998, *appreciation* in these banks' securities portfolios totaled 4.1 percent of aggregate Tier One capital. As of September 30, 1999, these same banks' securities portfolio *depreciation* totaled 3.6 percent of aggregate Tier One capital. Declines in market values have been slightly higher for RRE banks compared with the remainder of the Region's banks.

Some RRE banks have considerable depreciation, which may have earnings or liquidity ramifications. Sixteen of these institutions had depreciation in excess of 10 percent of Tier One capital as of September 30, 1999. Should interest rates and depreciation levels continue to rise, a reluctance to sell securities will likely follow. The earnings of institutions that retain securities at depreciated market values will be constrained because they are holding lower-yielding investments. Banks and thrifts selling depreciated securities in order to reinvest at the current market rate or to meet unexpected liquidity needs will have to realize losses in the period when they are sold.

Some Residential Real Estate Lenders Will Benefit from Mortgage Servicing Rights

As of September 30, 1999, slightly fewer than one-half of the banks[19] in the RRE group held mortgage servicing rights. The median level held was 18 percent of assets. Recent interest rate increases should increase the average life of this servicing income and partially offset potential lost income resulting from reductions in originations and refinancings at these institutions. However,

[17] Community institutions are defined as institutions with less than $1 billion in assets.

[18] Thrift institutions do not report securities appreciation and depreciation.

[19] Thrift institutions do not report the notional value of mortgage servicing rights.

only a small percentage of banks in this group have significant servicing portfolios that may allow them to benefit from rising interest rates.

Implications for RRE Banks

Profitability has trended downward, and recent interest rate increases will make sustaining profitability levels more difficult for many members of this group. RRE banks with low long-term borrowings, small servicing portfolios, and significant mortgage-backed securities portfolios will likely see the greatest NIM squeeze should rates continue to rise. Also, credit quality issues could arise if these institutions loosen underwriting standards or engage in riskier forms of lending to maintain volume or profits.

Diane Ellis, Senior Financial Analyst
and the Chicago Region Staff

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