Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION — FOURTH QUARTER 2000

FDIC MEMPHIS REGION

Regional Perspectives

◆ *Earnings Pressures Lead to Heightened Levels of Credit Risk*—**With increasing competition compressing net interest margins, many of the Region's banks are accepting greater levels of credit risk to improve asset yields, potentially heightening their vulnerability to any deterioration in economic conditions. Risk management is becoming increasingly important, particularly as capital levels are declining.** *See page 3.*

◆ *Perspectives from the FDIC Regional Director*—**The senior regulator for the FDIC in the Memphis Region, Division of Supervision Regional Director Cottrell Webster, hopes that bank management will review strategies and policies and take any needed steps to strengthen risk management procedures.** *See page 11.*

By the Memphis Region Staff

In Focus This Quarter

◆ *Emerging Risks in an Aging Economic Expansion*—**This article focuses on the potential risks of current economic conditions to insured depository institutions. Although the current conditions may appear to be ideal, some imbalances are emerging: rising energy prices, tight labor markets, a less robust stock market, a large trade deficit and strong U.S. dollar, rising household debt burdens, increased corporate leverage and rising potential default risk, and, in some metropolitan areas, overheated housing and commercial real estate markets. At the same time, aggregate risk within the banking industry appears to have risen, as evidenced by softening profitability, growing reliance on noncore funding, heightened levels of interest rate risk, and increasing concentrations in traditionally higher-risk loan categories. A confluence of these trends could heighten the vulnerability of some insured institutions.** *See page 13.*

By the Division of Insurance Staff

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REVISION:

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

Regional Perspectives

- **With increasing competition compressing net interest margins, many banks are accepting greater credit risk to improve asset yields. Rising loan levels contributed to higher net interest margins in the first half of 2000 but may be difficult to sustain.**

- **High and growing credit exposure may increase the vulnerability of the Region's banks to any deterioration in economic conditions. It also increases the importance of risk management, particularly as capital levels are declining.**

Late Cycle Behavior: Earnings Pressures Lead to Increased Credit Risk

The duration and continuing strength of the economic expansion have provided a positive environment for banks and other financial institutions. This positive environment, however, has led to the emergence of considerable competition from a growing number of newly established banks and the entrance of nonbanks into traditional banking lines of business. Resulting pricing pressures for both loans and funding have affected banks' net interest margins (NIMs) adversely. Many banks have responded to declining margins by steadily increasing loan-to-asset (LTA) ratios, accommodated by strong loan demand. The first half of this article discusses the emphasis many banks have placed on loan growth to combat margin pressures.

The second half of this article focuses on the potential negative consequences associated with higher credit exposure should economic conditions deteriorate. Experiences during the banking crises of the 1980s and early 1990s suggest that increases in LTA ratios heighten banks' vulnerability to changing economic conditions. During the previous expansion, the Region's economy and banks' credit exposure grew slowly and were less affected by the subsequent recession in 1990–1991 than those of other areas of the nation. During the current expansion, however, the Region's economy and bank credit exposure have grown rapidly. Recent growth has been fueled by migration into higher-risk loan types, such as construction and development (C&D) lending. Some banks currently report higher capital and allowance levels in line with risk selections. Many other banks, however, are emphasizing short-term profitability while relying on continuing economic strength to minimize potential long-term credit concerns. The title "Late Cycle Behavior" is less a reflection of the maturity of the current economic expansion than a description of the changing risk tolerances at many financial institutions, which is consistent with behaviors exhibited in the later stages of previous economic cycles.

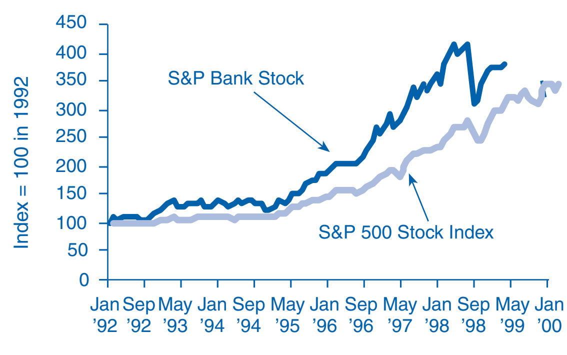
Earnings Pressures Are Driving Bank Risk Selections

Although the current banking environment remains favorable, some concerns have emerged, as evidenced by the performance of bank stocks in public markets. Bank stocks outperformed broader stock indices throughout much of the 1990s but have underperformed broader market trends since late 1998 (see Chart 1). Bank share prices have been held down by a decline in merger and acquisition activity, worries about possible credit quality deterioration, and concerns over earnings performance given rising interest rates and questions regarding revenue growth potential.[1]

Although the stock of many smaller banks and bank holding companies is not publicly traded, management at these institutions also faces pressure from stockholders

CHART 1

Bank Stocks Underperformed Broader Markets in the Late 1990s



Source: Standard & Poor's

[1] Standard & Poor's. July 1999 to July 2000. *Monthly Investment Review Industry Survey.*

to improve earnings performance. Return on assets (ROA) and NIMs contracted at most community banks[2] in the Memphis Region in the late 1990s (see Chart 2). In fact, during 1998 and 1999, NIMs were below the average reported over the past 15 years. This decline followed a period of exceptionally strong earnings early in the expansion and is consistent with banks' performance nationwide.

However, during the first half of 2000, NIMs and ROAs were no longer declining. Banks in the Region and nation reported improved or stable earnings during this period (see Table 1). Increased credit exposure appears to be a primary contributor to the improvement in NIMs, as community banks reported higher LTA levels and a shift in loan portfolio composition.

Loan-to-Asset Levels Have Risen Sharply

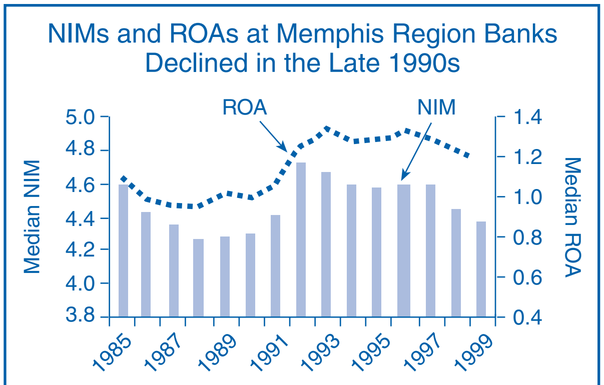
In the absence of other changes, NIMs typically increase as assets are shifted from securities to loans, which usually offer higher yields. Although LTA levels have climbed steadily since the early 1990s (with a brief pause in 1998 because of capital markets-driven credit concerns), recent increases have been particularly large. Memphis Region community bank aggregate LTA

Table 1

Community Bank NIMs Improved in the First Half of 2000			
		Six Months Ending	
		June 30, 1999	June 30, 2000
Nation	Median ROA	1.15	1.21
	Median NIM	4.32	4.45
Region	Median ROA	1.22	1.22
	Median NIM	4.32	4.40

Note: Includes banks with less than $1 billion in total assets that have been in operation for three years or longer.
ROA = return on assets; NIM = net interest margin
Source: Bank Call Reports

Chart 2



Note: Includes banks with less than $1 billion in total assets in operation for three years or more.
NIM = net interest margin; ROA = return on assets
Source: Bank Call Reports

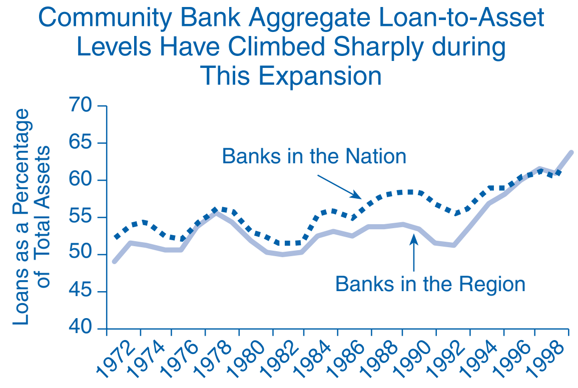
ratios rose from 60.9 percent at the beginning of 1999 to 65.3 percent by midyear 2000. The sharp increase over the past 18 months, mirrored by community banks nationally, equaled the cumulative growth in LTA levels over the preceding six years. As shown in Chart 3, LTA ratios are at historically high levels.

The correlation between rising LTA ratios and recent improvement in NIMs at many banks is shown in Table 2. This analysis segregates community banks in the Memphis Region[3] into five equal groups (quintiles) on the basis of each institution's reported change in NIMs from June 30, 1999, to June 30, 2000. The top quintile represents the 20 percent of banks reporting the largest increase in NIMs during the period. The changes in LTA ratios between year-end 1998 and year-end 1999 were then calculated for each group.[4] Bank groups that reported progressively stronger improvement in NIMs (moving up the table) also reported progressively larger increases in LTA ratios during 1999. The banks reporting the greatest improvement in NIMs, for example, reported an increase in LTA ratios of almost 400 basis points. The bottom quintile of banks reported a decline in NIMs despite an increase in LTA ratios. For this group, the increased earnings potential resulting from slightly higher LTA ratios was more than offset by competitive pressures and other factors discussed in the box on page 6.

[2] We define community banks as commercial banks (not savings and loan institutions) with less than $1 billion in total assets that have been in operation three years or longer, unless otherwise noted.
[3] The data shown in Table 2 are for banks headquartered in the Memphis Region. Expanded analysis of approximately 7,400 banks nationally reveals a similar positive relationship between improvement in NIMs and increases in LTA ratios.

[4] The built-in lag between changes in LTA ratios and NIMs is necessary, as balance sheet composition changes do not occur instantaneously; rather, they take place throughout the reporting period. Changes in LTAs in the first reporting period, the first half of 1999, for example, would have only a limited effect on NIMs during the period but would be fully incorporated into NIM performance in the following period.

CHART 3



Note: Includes banks with less than $1 billion in total assets in operation for three years or longer and with at least 10 percent of total assets in loans.
Source: Bank Call Reports

TABLE 2

MEMPHIS REGION NIM IMPROVEMENT APPEARS LINKED TO RISING LOAN-TO-ASSET RATIOS

BANKS GROUPED BY CHANGE IN NIMS	RANGE OF NIM CHANGE (BPS)	MEDIAN CHANGE IN LTA RATIO (BPS)
TOP QUINTILE	MORE THAN 37	398
SECOND QUINTILE	18 TO 37	295
THIRD QUINTILE	2 TO 18	251
FOURTH QUINTILE	–18 TO 2	137
BOTTOM QUINTILE	LESS THAN –18	45

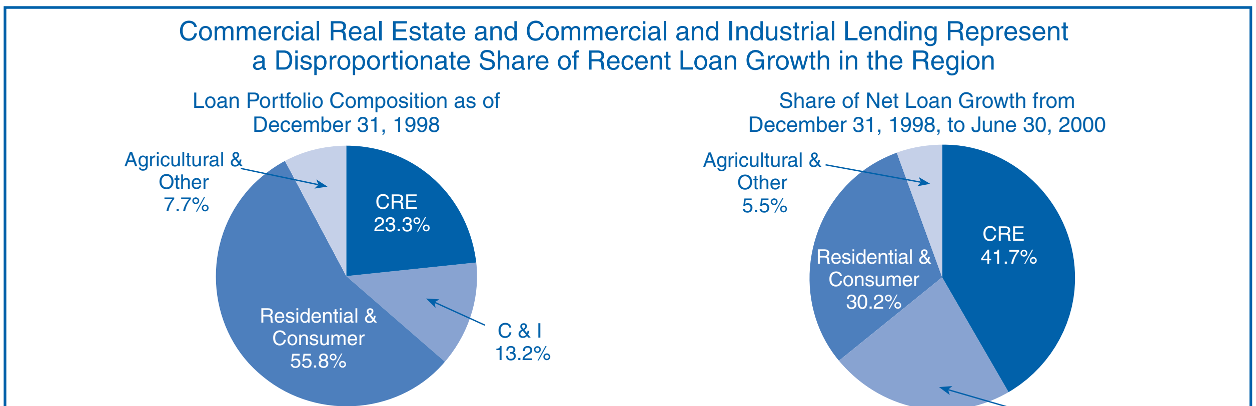
NOTES: THIS ANALYSIS INCLUDED 805 MEMPHIS REGION BANKS THAT REPORTED LESS THAN $1 BILLION IN TOTAL ASSETS, HAD BEEN IN OPERATION FOR THREE YEARS OR LONGER, AND REPORTED AT LEAST 10 PERCENT OF TOTAL ASSETS IN LOANS.
SOURCE: BANK CALL REPORTS

Commercial Real Estate Loan Growth Has Driven Overall Portfolio Growth in Recent Periods

Credit risk among Memphis Region banks increased not only as a result of higher LTA ratios but also because recent growth has been concentrated in higher-yielding, and traditionally higher-risk, loan types. Commercial real estate (CRE) loans and commercial and industrial (C&I) loans represent a disproportionate share of overall loan growth since the beginning of 1999 (see Chart 4). C&D loans, a component of CRE lending and potentially the most complex and highest-risk type of lending performed by most community banks, constituted the fastest-growing segment of loan portfolios at community banks during the period.

CRE loans typically generate considerable loan fees and are often characterized by higher contractual interest rates than many other forms of lending. Therefore, some banks may be targeting these loan types in an effort to improve overall loan yields. Strong demand for CRE loans offered banks this opportunity to shift loan portfolio composition.

CHART 4



Note: Includes banks with total assets of less than $1 billion that have been in operation for three years or longer.
CRE = commercial real estate; C&I = commercial and industrial
Source: Bank Call Reports

Other Factors May Have Affected NIMs

Factors other than increasing competition and rising loan exposure undoubtedly influenced NIMs during the first half of 2000.

Rising Interest Rates: From June 30, 1999, to June 30, 2000, the Federal Reserve Board increased short-term interest rates 175 basis points. NIMs may have been affected adversely by rising interest rates as most banks, at least on the surface, remain liability sensitive (i.e., bank liabilities can be repriced more quickly than assets). As discussed below, however, the inelastic repricing nature of core deposits likely offsets some of the otherwise negative effects of rising interest rates on bank earnings.

Yield Curve Changes: Changes in the shape of the yield curve have considerable influence on NIMs, as banks tend to "fund short and lend long." Most bank funding is priced from the short end of the yield curve, while many loans and securities are priced further out on the yield curve. A comparison of short-term interest rates (three-month U.S. Treasury bill) and longer-term rates (10-year U.S. Treasury note) reveals a narrow spread between these rates from late 1997 to early 1999. This spread increased somewhat from midyear 1999 through first quarter 2000 and likely contributed to the improvement in NIMs discussed in this article. In March 2000, the yield curve flattened again.

Inelastic Nature of Core Deposit Rates: Although bank core deposits such as savings accounts, negotiable order of withdrawal accounts, and money market deposits are potentially subject to daily repricing, banks historically have been able to lag changing rates paid on such deposits behind changes in market interest rates. As a result, banks were often able to improve NIMs in the short run during periods of rising rates even though the longer-term effects of rising rates are often negative for liability-sensitive banks. The inelastic nature of core deposits may have waned in recent years, however, as consumers have become increasingly savvy money managers and competition among financial institutions for funding has intensified.

Asset Maturity Extension: After averaging just over 14 percent of total assets during the first five years of this expansion (1992–1996), long-term assets (those maturing or repricing in more than five years) at community banks in the Region rose to 18.4 percent of assets by year-end 1999. Assets with longer maturities or repricing frequencies typically provide incrementally higher rates of return in exchange for the opportunity costs of longer holding or repricing periods. However, with interest rates increasing from June 1999 to June 2000, the extension of asset maturities in the late 1990s likely had an adverse affect on NIMs. Perhaps in response to rising interest rates, banks began to move away from long-term assets; the ratio of long-term assets to total assets as of June 30, 2000, declined slightly from year-ago levels.

Recent Improvement in NIMs May Be Difficult to Sustain without a Steepening of the Yield Curve

Additional pricing pressures on loans could constrain banks' ability to improve NIMs by increasing loan exposure. Greater competition could lead to reductions in interest rates charged on loans (relative to other interest rates) and lower loan fees, particularly if loan demand softens. Moderating economic conditions in the Region seem unlikely to sustain recent levels of loan growth indefinitely.

The cost of funding loan growth also could continue to escalate. In the early and mid-1990s, loan growth was funded largely through a combination of core deposit growth and the liquidation of securities portfolios. As core deposit growth at many banks remained anemic and securities portfolios approached minimum levels[5] in the late 1990s, institutions began to rely on higher-cost noncore funding sources to support loan growth. Going forward, NIMs likely will be pressured further as the cost of funding new loans continues to rise.

Increased Credit Exposure Equates to Higher Levels of Risk during Economic Downturns

The positive economic environment in recent years has not only allowed financial institutions to grow loan portfolios but also contributed to exceptionally strong

[5] Community banks typically require minimum levels of securities for pledging against public funds and as a source of liquidity.

credit quality. Reported past-due loan ratios and loan loss rates remain favorable by historical standards. Annual aggregate loan losses at the Region's banks, for example, ranged from 0.38 percent to 0.43 percent of total loans from 1994 to 1999. These traditional measures of asset quality, however, are of limited predictive value for loan portfolio performance because by definition they are lagging indicators of credit quality deterioration.[6] Repayment difficulties for most loans are unlikely to surface until economic conditions erode. The severity of credit quality deterioration at such a time likely would be influenced heavily by current bank risk selections.

Banks most adversely affected in regional or sectoral downturns during the previous economic cycle exhibited some common characteristics important in evaluating the risk of rising credit exposure at institutions today. A 1997 study of banking crises in the 1980s and early 1990s described two such characteristics:[7]

- During periods of economic expansion preceding regional or sectoral downturns, many banks pursued a strategy of aggressive loan growth in response to strong credit demand, leading to rising LTA ratios at these institutions.

- Banks that failed during the economic downturns were found to have higher LTA ratios and CRE loan exposure than banks that survived. In fact, the probability of failure for the group of institutions reporting the highest LTA ratios (the top quintile) was more than double the probability of failure for all banks.

Before the current expansion, community banks in the Region consistently reported LTA levels at or below national levels; this gap gradually widened to more than 400 basis points by year-end 1989 (see Chart 3). From December 31, 1991, through December 31, 1999, however, loan growth at established community banks in the Memphis Region averaged 9.7 percent annually, compared with 7.9 percent annual growth at community banks nationwide. With strong loan growth, aggregate LTA levels among established community banks in the Memphis Region are now slightly above national levels.

> Excerpt from *History of the Eighties—Lessons for the Future, Volume I: An Examination of the Banking Crises of the 1980s and Early 1990s,* p. 27.
>
> Although the interplay of broad economic, legislative, and regulatory forces helped make the environment for banking increasingly demanding, the more immediate cause of bank failures was a series of regional and sectoral recessions. Because most U.S. banks served relatively narrow geographic markets, these regional and sectoral recessions had a severe impact on local banks. It should be noted, however, that not all regional recessions of the magnitude experienced during the 1980–94 period resulted in a major increase in the number of bank failures. Rather, bank failures were generally associated with regional recessions that had been preceded by rapid regional expansions—that is, they were associated with "boom-and-bust" patterns of economic activity.

The strong growth in the economy and the banking industry in the Memphis Region throughout much of the past decade is reminiscent of growth experienced by several states in the early 1980s that later fell victim to regional or sectoral downturns. The repercussions of economic strength and aggressive loan growth may be best illustrated by comparing banks headquartered in metropolitan areas in the Memphis Region with those in a "boom" area, New England,[8] where both economic and banking conditions differed greatly in the previous economic cycle.

During the mid-1980s, New England states had rapidly expanding economies that helped fuel considerable commercial and residential real estate activity. Banks in the area responded with growing loan portfolios and significant involvement in financing ballooning CRE markets (see Chart 5, next page).

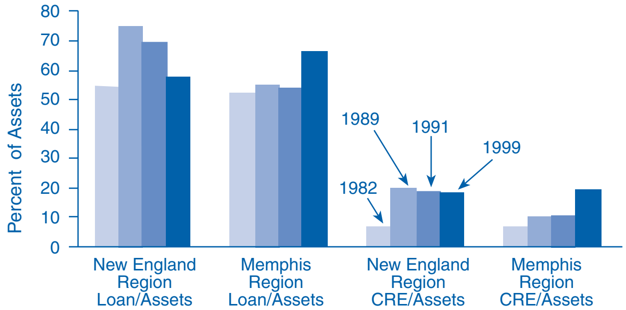
[6] Examination ratings trends, which include an evaluation of underwriting standards and credit administration practices in the assessment of potential future credit quality performance, suggest rising levels of credit risk in recent periods.

[7] Federal Deposit Insurance Corporation. 1997. *History of the Eighties—Lessons for the Future, Volume I: An Examination of the Banking Crises of the 1980s and Early 1990s.*

[8] New England states considered in this analysis are Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, and Vermont. Only metropolitan community banks are included in this analysis. Any comparison of all banks operating in both Regions would lack validity, as a majority of banks in New England are headquartered in metropolitan areas, unlike in the Memphis Region. Also, savings banks, prevalent in New England but absent from the Memphis Region, are excluded from this analysis.

CHART 5

Comparison of Inherent Credit Risk in the 1980s and 1990s: Memphis Region Community Banks in Metropolitan Statistical Areas Report Higher Risk This Cycle



	New England Region Loan/Assets	Memphis Region Loan/Assets	New England Region CRE/Assets	Memphis Region CRE/Assets
1982	54.4	52.5	7.2	7.2
1989	74.6	55.0	19.9	10.4
1991	69.4	54.1	19.2	10.8
1999	57.0	66.3	18.5	19.6

Note: Includes commercial banks with total assets less than $1 billion, in operation for three years or more, with 10 percent of total assets in loans, and headquartered in metropolitan statistical areas.
CRE = commercial real estate
Source: Bank Call Reports

By contrast, the Memphis Region recovered slowly from the 1980–1982 recessions. Depressed commodity prices for both energy and agriculture dampened the Region's recovery. **Louisiana,** heavily influenced by the oil and gas industry, did not emerge from its economic downturn until 1987. LTA levels and CRE loan exposure at metropolitan-headquartered community banks in the Memphis Region rose only modestly from 1982 through 1989.

Because the Memphis Region did not share fully in the expansion from 1982 to 1990, it was less affected by the national recession that followed. During the 1990–1991 recession, economic growth[9] in the Region slowed appreciably but remained positive, unlike many areas, such as the northeast and west coast, where economies contracted. With slow economic growth and moderate loan exposure levels entering the recession, Memphis Region banks generally weathered the downturn better than banks in some other parts of the country. Only 16 banks in the Memphis Region failed from 1990 to 1993, equivalent to 1.3 percent of commercial banks in operation in the Region at year-end 1989. This failure rate compares favorably with the 3.2 percent national failure rate during this period. New England suffered an extraordinarily high 16.3 percent failure rate, underscoring the potential risk associated with rapid economic growth and high loan exposure levels.

Extending the comparison into the current expansion shows a reversal from the previous economic cycle. Memphis Region states recovered quickly in the 1990s. Average annual personal income growth of 5.8 percent from 1991 to 1997 exceeded the national average of 5.4 percent. Gross state products in the Region also grew faster than national production. The Region shifted from its commodity and nondurable manufacturing bases, with economic growth led by strong growth in the service and retail sectors. The construction sector also has been strong, with active real estate markets reported Regionwide. Commercial and residential real estate construction activity expanded rapidly in the late 1990s and only recently began to slow in response to higher interest rates.[10] Credit exposure in the Memphis Region also has grown considerably in the current expansion (see Chart 5). Conversely, credit exposure in New England subsided somewhat, influenced by the Region's more gradual recovery and perhaps also by a more cautious strategy toward credit risk selection among the Region's banks.

More recently, the Memphis Region's economy has begun to slow. Employment growth has trailed the nation's since 1996, after leading during the first four years of the expansion. Likewise, personal income growth has trailed the national rate in recent years, with all five states in the Region reporting personal income growth below the national rate in 1999 for the first time during this expansion. The moderating of the Region's economy seems somewhat inconsistent with the continued strong loan growth at the Region's insured financial institutions.

[9] As measured by personal income growth adjusted by the gross domestic product deflator.

[10] Recent construction activity and related lending issues are discussed in *Regional Perspectives,* third quarter 2000.

The comparison between New England in the 1980s and the Memphis Region in the 1990s is not intended to suggest that New England's banking crisis is on the verge of recurring in the Memphis Region. New England in the 1980s was very different from the Memphis Region today: New England's economic growth was stronger prior to the downturn, CRE markets were more active, and banks' credit exposure levels were higher. Furthermore, credit underwriting is generally perceived to be considerably stronger today. The comparison does, however, demonstrate the relatively low exposure levels of the Memphis Region during the previous economic cycle compared with those of a "boom" Region, and it highlights growing credit exposure during the current cycle.

Banks with High Credit Exposure Report Lower Capital Levels

Banks willing to operate with high loan exposure also report other characteristics that demonstrate a high risk tolerance. These characteristics, described below, could expose the banks to greater performance variability in the event of economic deterioration.

Metropolitan Areas May Be More at Risk

The Memphis Region's economic growth in the current expansion is bifurcated; strong growth in urban areas contrasts with slow growth (or no growth) in many rural areas. Both job growth and personal income growth have been consistently higher in metropolitan areas than in rural areas in the 1990s. Many rural areas continue to report double-digit unemployment rates because of declining nondurable manufacturing, such as in the textile and apparel sector. With relatively low-skilled labor forces, many rural areas have difficulty attracting service or durable goods manufacturing firms to compensate for these job losses. Weaknesses in the agricultural sector since 1997 also contributed to depressed conditions in many rural areas. Metropolitan areas, by contrast, have benefited from strong service, retail, and durable goods manufacturing employment gains.

Bank loan growth also has been strongest in metropolitan areas. As shown in Table 3, credit exposure at community banks headquartered in metropolitan areas, particularly CRE loan exposure, rose sharply in recent years. These banks reported annual aggregate CRE loan growth of 21.0 percent in 1998 and 23.6 percent in 1999, following average annual growth of 15.9 percent over 1993 to 1997. Year-over-year CRE loan growth as of June 30, 2000, slowed modestly to 21.1 percent but remained well above the average for the preceding five years.

The first quarter 2001 ***Memphis Regional Perspectives*** article will describe specific metropolitan markets that may be most vulnerable to any deterioration in economic conditions. The article will focus on markets where competitive pressures have been or are becoming particularly strong. The emphasis will be on how banks operating in these markets have responded to these competitive pressures.

Table 3

Loan Exposure Has Grown Rapidly at Memphis Region Community Banks Headquartered in Metropolitan Areas

MSAs Nationwide	LTA	CRE/Assets	C&D/Assets
June 30, 2000	65.9	20.1	3.2
MSAs Regionwide			
June 30, 2000	68.9	20.1	4.8
June 30, 1999	64.8	18.9	4.1
June 30, 1998	63.7	15.8	3.7

Note: Includes banks headquartered in metropolitan areas with less than $1 billion in total assets in operation for three years or longer and with at least 10 percent of total assets in loans.
MSA = metropolitan statistical area; LTA = loan to asset; CRE = commercial real estate; C&D = construction and development
Source: Bank Call Reports

Table 4

Memphis Region Banks with High Loan-to-Asset Ratios Report Additional Risk Factors and Lower Capital						
		Risk Factors		Protection Factors		
Banks Grouped by LTA Ratios	Range of LTA Ratios	Loan Growth[1]	CRE/ Total Loans[2]	Risk-Based Capital Ratio	Tier 1 Capital Ratio	Allowance/ Total Loans
Top Quintile	**Greater than 74.1**	**15.8**	**26.2**	**12.3**	**8.5**	**1.22**
Second Quintile	67.3 to 74.1	10.9	22.5	13.3	8.7	1.23
Third Quintile	**60.8 to 67.3**	**9.0**	**20.7**	**15.8**	**9.8**	**1.25**
Fourth Quintile	52.4 to 60.8	7.0	18.7	18.7	10.8	1.30
Bottom Quintile	Less than 52.4	3.0	16.0	23.7	11.7	1.56

Notes: Includes banks with total assets of less than $1 billion in operation for three years or more and with 10 percent of total assets in loans.

[1]Merger-adjusted loan growth from year-end 1998 to year-end 1999.

[2]CRE is shown relative to total loans in this table rather than total assets because banks with high loan-to-asset ratios could be expected to report high levels of CRE to assets without necessarily reflecting increased emphasis on this loan type.

LTA = loan to asset; CRE = commercial real estate

Source: Bank Call Reports

Other potential risks associated with banks reporting high LTA ratios are shown in Table 4. This analysis segregates community banks in the Region into five equal groups based on reported LTA ratios as of June 30, 2000, with the top quintile representing banks with the highest LTA ratios. This analysis is distinct from the analysis performed earlier in this article that grouped the Region's banks on the basis of *changes in NIMs* and then focused on *changes in LTA ratios.* The current analysis groups banks on the basis of *level of LTA ratios* and then focuses on other risk factors and capital levels.

In addition to reporting the highest LTA ratios, the top quintile of banks reported considerably faster loan growth in 1999 and significantly greater exposure to CRE loans as of midyear 2000 than typical community banks in the Region (represented by the third quintile of banks, which are clustered around the median ratio reported by all banks in the sample). Although not shown in the table, banks with the highest LTA levels also are relying more heavily on alternative sources to fund loan portfolios. As noncore funding sources may represent a more volatile and more costly source of funding, liquidity risk could be higher at these institutions.

Despite the higher credit exposure of banks in the top quintile, this group reported lower capital and allowance for loan and lease losses levels at midyear 2000. Tier 1 capital ratios for this group, as with most community banks, declined in recent years. The median Tier 1 capital ratio for banks with the highest LTA ratios declined 12 basis points from June 30, 1999, to June 30, 2000.

Risk Analysis and Management Are Vital Today

There is nothing inherently inappropriate in a strategy of accepting additional credit exposure; banks are in the business of accepting and managing credit risk. In fact, such a strategy may be even more necessary in today's banking environment in order to preserve earnings. But with credit exposure rising and capital levels declining, strong risk management becomes increasingly critical.

While economic conditions remain favorable, bank management may want to evaluate acceptable risk tolerance levels in reviewing overall credit exposure and take steps to correct any specific underwriting laxity. The Comptroller of the Currency, in a recent letter to board members and chief executive officers of all national banks, asked bankers to prepare for the eventuality of rising delinquencies and collection problems by "shoring up collateral values and guarantor support, and, where possible, correcting overly generous repayment terms."[11] The senior regulator for the FDIC in the Memphis Region, Division of Supervision Regional Director Cottrell L. Webster, also hopes to see banks take this opportunity to review their strategies and policies and take any needed steps to strengthen their risk management procedures as discussed in the box that follows.

Memphis Region Staff

Perspectives from the FDIC Regional Director

Every chief executive officer can relate to earnings pressure described in the article entitled "Late Cycle Behavior: Earnings Pressures Lead to Increased Credit Risk." This article could not be more timely. Many banks have squeezed the last ounce of efficiency from operations and must look to increasing asset yields to maintain revenue growth.

As you have read, FDIC analysts (and some bankers) contend that the economic expansion begun in the 1990s is the first in which the Midsouth has fully participated. If this is so, our banks may also fully participate in the subsequent contraction. The FDIC is not in the business of predicting business cycles and has no interest in seeing the nation's economic expansion end. However, both the FDIC and the banking industry would be careless if we did not anticipate and plan for a contracting economy.

But how does a chief executive officer do that? Where does competition for credit end and disregard for prudent lending standards begin? The question does not have an easy answer. Subtle growth in the loan portfolio adds slow, increasing pressure on capital, liquidity, and portfolio risk from marginal credits that might have been rejected in less aggressive times.

Rapid loan growth has been verified in our current examination cycle. Loan-to-asset ratios in excess of 75 percent, once rare, are increasingly common. Commercial real estate and commercial and industrial loans have fueled the growth, but all lending categories are expanding. The shift from securities investments to loans has increased banks' risk exposure. Asset deterioration, though hardly a regional pattern, is appearing in isolated segments of the Memphis Region.

Our examiners sympathize with the balance chief executive officers must maintain between an elusive net interest margin and financial prudence. My concern, quite frankly, is that chief executive officers and the boards of directors will become numb to the incremental risk they have assumed in recent periods.

The best way to counteract complacency with risk is to establish risk parameters beyond which the bank will not operate. Managers who exceed those parameters, by either design or default, should be held accountable.

In 1998, four of the bank regulatory agencies compiled a list of "best practices" regarding residential real estate lending in the greater Atlanta area. The techniques were not new or particularly sophisticated, but they could be applied to virtually any type of community lending. They are not intended to replace sound underwriting, but they serve to diversify credit risk if conscientiously implemented. Here is a partial list of those best practices that FDIC examiners may suggest during your next examination:

- Establish portfolio limits by lending category (e.g., commercial real estate, residential, consumer, and agricultural). Depending on the degree of risk, specialized lending within these broad categories may benefit from volume limitations.
- Incorporate location criteria into your real estate lending portfolio to encourage diversity and limit overexposure in a particular market.
- Be mindful of indirect loans and commitments to borrowers who are reliant on the successful completion of commercial projects when evaluating individual lines of credit and total portfolio exposure.

(continued on page 12)

[11] Letter to Board Members and Chief Executive Officers of National Banks, September 2000, which discusses the results of the Office of the Comptroller of the Currency's *2000 Survey of Credit Underwriting Practices.*

- Reevaluate appraisals as appropriate and required by regulation. Market information should be part of an ongoing appraisal review program.

- Keep apprised of economic conditions that affect your institution's market area.

Just as important are events that will trigger a review of lending policies. Most banks operate with policies adopted during strong economic conditions, which may not protect the bank from undue risk in a less favorable economy. Prudence suggests that key measures of strength for main business lines be identified, along with thresholds that, if passed, lead to a review of policy. For example, higher minimum equity in a speculative home, or minimum capitalization for the builder, might be appropriate when unsold inventory levels begin to rise. Simple or sophisticated, our examiners will be looking for written boundaries and sufficient board oversight for specialized lending.

The FDIC has specific regulations that provide greater detail regarding real estate lending and portfolio management. Refer to Parts 323 and 365 of the FDIC Rules and Regulations. National and state member banks should consult 12 CFR 34 for the Comptroller of the Currency guidelines and Regulation H Appendix C of the Federal Reserve Board Regulations. State law also establishes lending limitations. For additional guidance, contact your primary regulator.

Federal Reserve Chairman Alan Greenspan recently remarked to a meeting of the American Bankers Association, "Today's products and rapidly changing structures of finance mean that supervisors are backing off from detail-oriented supervision, which no longer can be implemented effectively." I contend that the FDIC is concentrating on those aspects of banking that pose the greatest risk to the deposit insurance fund. Community banks of all sizes within the Memphis Region are experiencing rapid loan growth and engaging in specialized activity, such as subprime lending. To the extent that sufficient oversight and operating policies are in place, financially sound banks are free to offer the products their customers demand. The depth and degree of the FDIC's supervisory role is entirely dependent on how well banks balance financial reward with economic risk.

Cottrell L. Webster, Regional Director
Memphis, Tennessee

Emerging Risks in an Aging Economic Expansion

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

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

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

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

Imbalances Are Appearing amid a Healthy Macroeconomic Environment

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

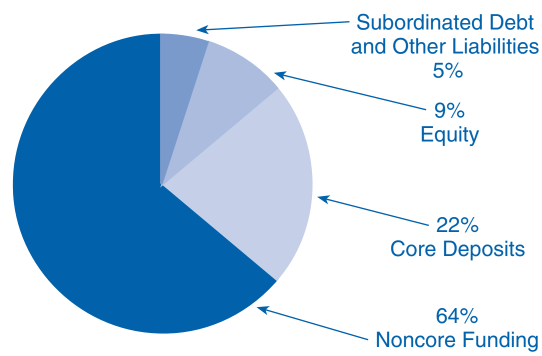
Overall industry profitability is beginning to soften, led primarily by rising commercial loan losses at large institutions and declining net interest margins in institutions of all sizes. Credit card loss rates, which had been steadily falling since late 1997, have stalled in recent quarters, suggesting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

Funding Patterns Heighten Liquidity Concerns

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

CHART 1

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



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

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

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

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

Increasing Levels of Interest Rate Risk Challenge Some Institutions

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

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

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

CHART 2

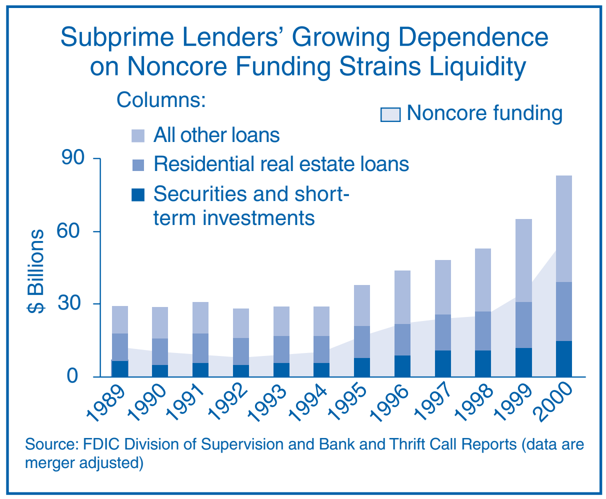
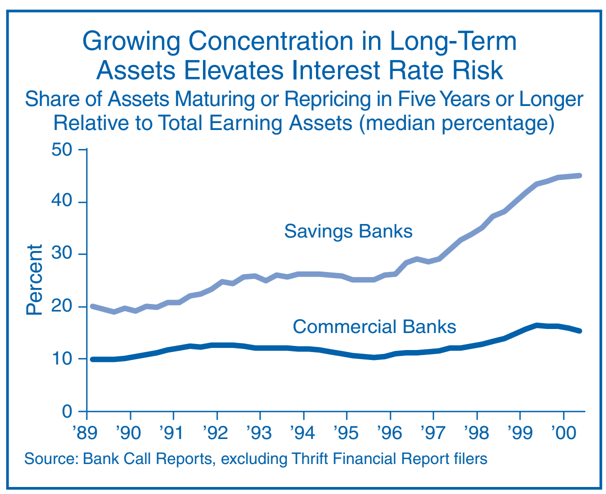


CHART 3



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

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

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

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

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

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

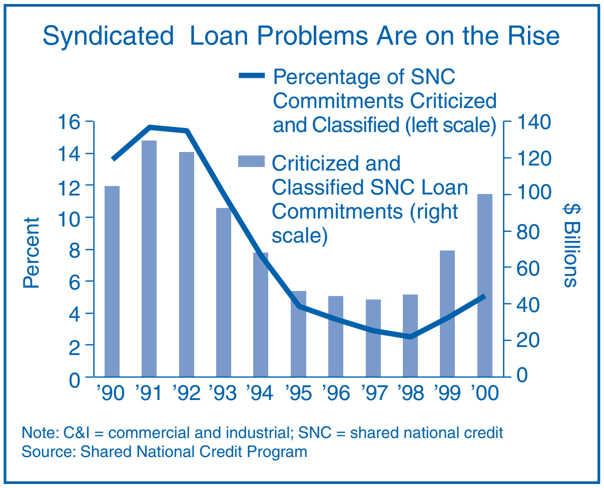
The Rising Level of Problem Business Loans Is Centered in Large Banks

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

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

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

CHART 4



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

Industry Sector Weaknesses

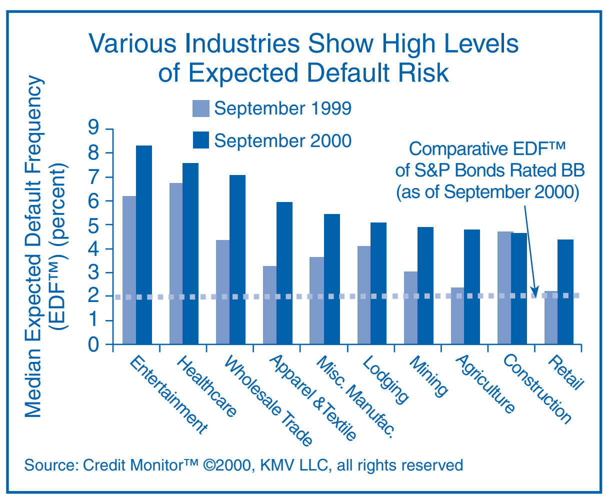
The financial stresses facing healthcare and entertainment companies (cinema operators in particular) have been well publicized. While the healthcare and entertainment sectors have contributed significantly to the decline in commercial credit quality, problems within these two sectors do not account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

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

Rising Corporate Debt Burdens

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

CHART 5



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

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

Seasoning of 1997–1998 Vintage Loans

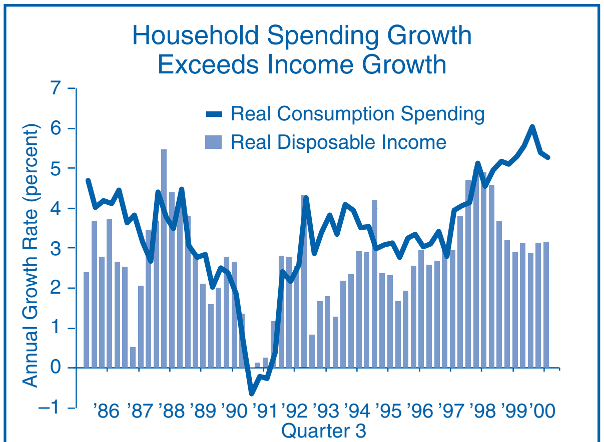
Results of recent supervisory surveys suggest that banks are tightening terms and conditions on loans to small-, middle-, and large-market obligors. However, this tightening follows a relaxation of standards in prior years that has contributed to a heightened level of risk in banks' loan portfolios.[4]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

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

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

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

CHART 6



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

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

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

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

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

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

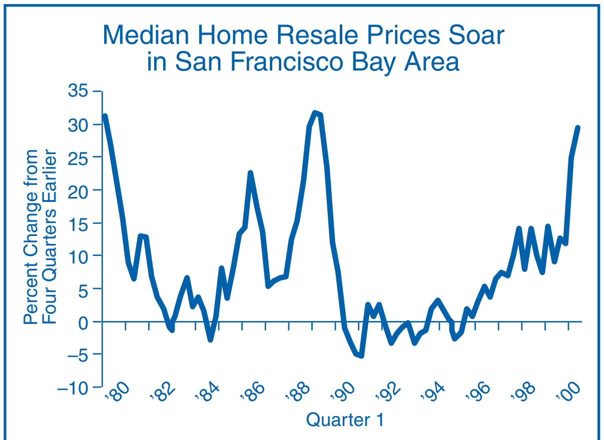
enhanced by gains in wealth rather than in income. Even so, similar surges in home resale prices in the past often were not sustainable. The subsequent years of stagnant or falling collateral values caused financial stress among some homeowners and their lenders. Further concern about residential real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

Construction and Development Loan Growth Is Accelerating

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

Such growth is contributing to higher concentrations of C&D loans relative to Tier 1 capital. At current levels, concentrations do not begin to approach those of the late 1980s. However, several metropolitan areas have a

CHART 7



Source: National Association of Realtors via Haver Analytics, Inc.

large percentage of insured institutions reporting high and rising concentrations. Table 1 (next page) shows MSAs with at least 15 nonspecialized community banks[7] and at least one-third of those institutions reporting concentrations in C&D loans equal to at least 100 percent of Tier 1 capital. The Atlanta MSA stands out. Sixty-five percent of Atlanta's 85 nonspecialized community institutions reported C&D loans exceeding 100 percent of Tier 1 capital on June 30, 2000, and 35 percent reported a concentration exceeding 200 percent. The aggregate C&D concentration for all 85 institutions in the MSA was 156 percent, the highest among MSAs with at least 15 institutions of similar size and nature. Several other markets also include significant shares of institutions with high concentration levels.

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

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

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

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

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

Table 1

High C&D Loan Exposure Appears in Various MSAs		
MSAs with 15 or More Nonspecialized Community Institutions*	Share (%) of Institutions* with C&D Concentrations > or = 100% of Tier 1 Capital	Aggregate C&D Loans Relative to Aggregate Tier 1 Capital (as %) in This MSA*
Atlanta, GA	**65**	**156**
Phoenix–Mesa, AZ	**56**	**131**
Memphis, TN–AR–MS	52	154
Portland–Vancouver, OR–WA	**47**	**146**
Oakland, CA	47	163
Nashville, TN	44	103
Riverside–San Bernardino, CA	42	110
San Diego, CA	41	90
Grand Rapids–Muskegon–Holland, MI	40	81
Seattle–Bellevue–Everett, WA	**39**	**98**
Salt Lake City–Ogden, UT	**38**	**56**
Fort Worth–Arlington, TX	**38**	**110**
Dallas, TX	**36**	**95**
Las Vegas, NV–AZ	**35**	**119**
Lexington, KY	34	80
Denver, CO	**33**	**113**

*Sample includes institutions with total assets under $1 billion that are not specialty institutions such as credit card or trust banks.
Note: Boldface indicates major MSAs identified at risk for excess commercial real estate construction in Regional Outlook, third quarter 2000.
C&D = construction and development, MSA = metropolitan statistical area
Source: Bank and Thrift Call Reports for June 30, 2000

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

Farm Sector Challenges Continue

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

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

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

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

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

Summary

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

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

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