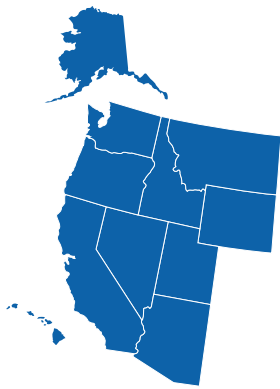

◆ Regional Outlook ◆

FEDERAL DEPOSIT INSURANCE CORPORATION

SECOND QUARTER 2000

Regional Perspectives

FDIC SAN FRANCISCO REGION



◆ *Region's Economic and Banking Conditions*—The San Francisco Region's economy continues to outperform the nation's because of strong growth in the construction, trade, and services sectors, particularly in Arizona, California, Idaho, Nevada, and Utah. Continuing contraction in the manufacturing sector slowed employment growth in Oregon and Washington. Despite strong reported earnings, profitability levels of mortgage and large commercial lenders may be increasingly vulnerable to rising interest rates. Commercial lenders in many of the Region's states reported rapid growth and increased concentrations in construction, commercial real estate, and commercial and industrial loans during 1999. *See page 3.*

By the San Francisco Region Staff

In Focus This Quarter

DIVISION OF INSURANCE

CATHERINE I.
PHILLIPS-OLSEN,
REGIONAL MANAGER

PAUL R. AGOSTI,
REGIONAL ECONOMIST

MILLEN L. SIMPSON,
FINANCIAL ANALYST

SHAYNA M. OLESIUKE,
ECONOMIC ANALYST

◆ *Banking Risk in the New Economy*—This article summarizes current economic conditions, with a primary focus on potential risks to insured depository institutions. It explores the implications of long-term trends that have led to the *New Economy*. Recent high rates of economic growth with low inflation have been made possible by increases in productivity arising from new technologies, higher investment spending by businesses, and large-scale industrial restructuring. Underlying these trends has been a financial environment that has largely accommodated the growing borrowing needs of consumers and businesses. Market-based financing, provided in large part through securitizations and mutual funds, has made capital readily available to start-up "new economy" firms as well as mature companies that seek to merge or restructure. Despite the clear benefits of market-based financing in supporting economic activity, there are also concerns. A recurrence of financial market turmoil, such as that experienced in fall 1998, has the potential to quickly change the currently positive economic outlook to one that is far more challenging. Detail is provided on commercial credit quality, market sources of revenue, and other risks to watch in banking. *See page 11.*

By the Analysis Branch Staff

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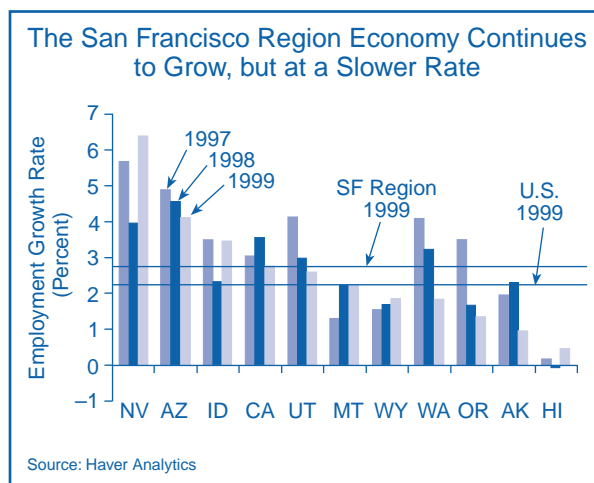
- The Region's economy continues to outperform the nation's because of robust growth in the trade, services, and construction sectors, offsetting weakness in the agricultural, manufacturing, and mining sectors.
- Despite robust reported earnings, profits of the Region's mortgage and large commercial lenders may be increasingly vulnerable should interest rates continue to rise.
- Commercial lenders in many of the Region's states reported rapid growth and increased concentrations in construction, commercial real estate, and commercial and industrial loans during 1999.
- Some of the Region's commercial lenders maintained relatively low allowances for loan and lease losses compared with national peers.

Economic and Banking Conditions

The San Francisco Region's Economy Continues to Grow

The San Francisco Region's economy remains strong compared with the nation's, as measured by nonfarm payroll employment growth. The Region's employment expanded through year-end 1999, driven primarily by strength in the services, trade, and construction sectors. However, while the Region's employment growth rate surpassed the nation's, manufacturing sector employment contracted, which contributed to the slower employment growth seen in **Oregon** and **Washington** (see Chart 1). Also, persistent weakness in the agricultural and mining sectors continued to negatively affect some of the Region's more rural areas. Per capita personal income growth and housing price appreciation were robust for most of the Region during 1999.

CHART 1



States Performing Ahead of the National Curve

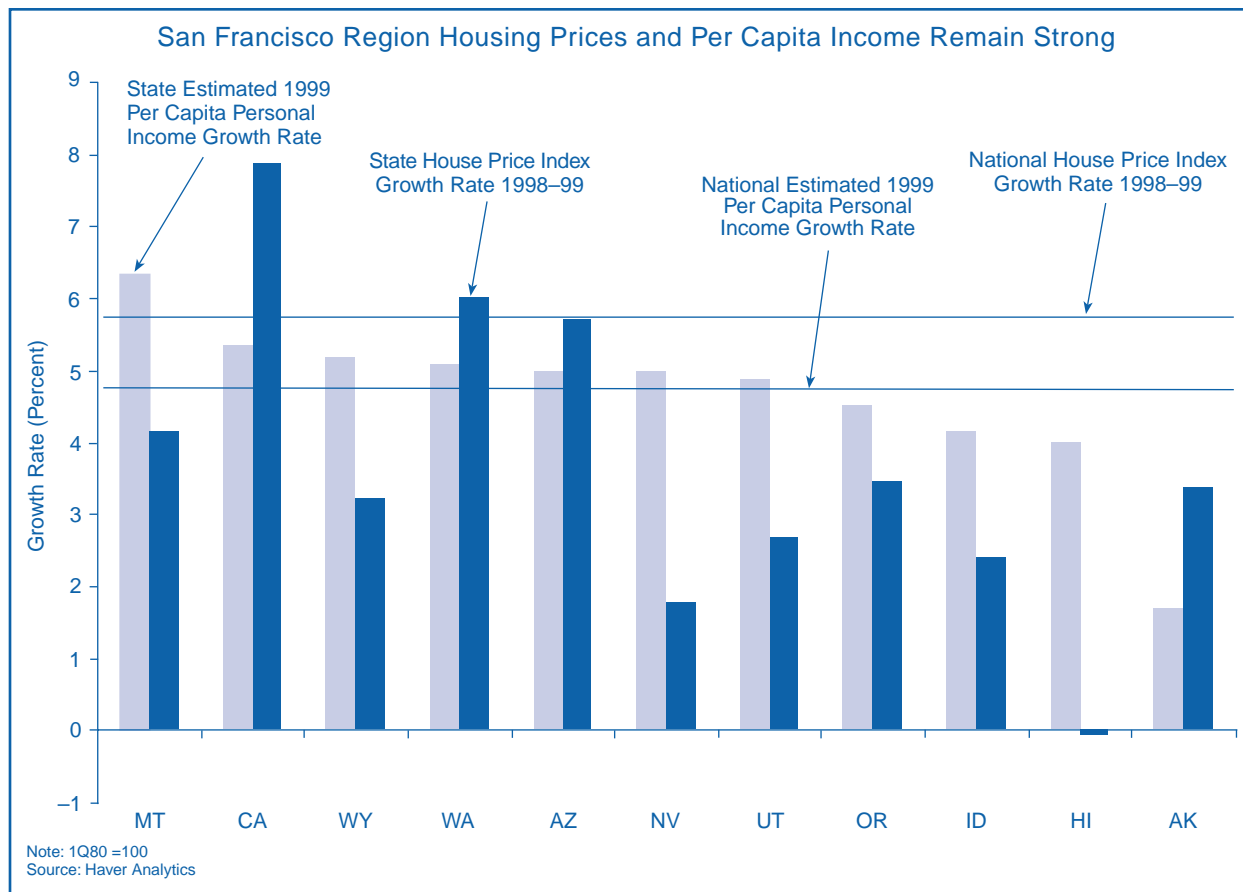
Nevada led the Region and the nation during 1999 in total nonfarm employment growth. Expansion in the services, trade, and construction sectors was attributed to continued strength in the gaming and tourism industries. Services sector employment, which represents over 40 percent of total employment, expanded more than 8 percent.

Arizona's economy remained robust. Manufacturing employment contracted in 1999, undoubtedly from lingering weaknesses in overseas economies, primarily in Asian countries. However, a December 1999 report prepared by *Regional Financial Associates (RFA)* states that the rising value of electrical equipment exports bodes well for chip manufacturing. Aerospace continues to account for a significant percentage of manufacturing employment: roughly 13 percent.

Idaho's economy performed well during 1999, driven by growth in the construction and services industries. Per capita personal income and house prices appreciated (see Chart 2, next page), and nonfarm employment grew 3.4 percent, exceeding the 1998 rate of 2.3 percent. Export levels are rebounding in the electrical equipment sector but declining in the agricultural sector.

California's economy performed well, with employment expanding in all major industries except mining and manufacturing. Many large cities are experiencing tight labor markets. For example, the **San Francisco**, **Orange County**, and **San Diego** metropolitan statistical

CHART 2



areas (MSA) reported unemployment rates below 2.5 percent during December 1999, much lower than the state and national rates. However, the unemployment rate in **Los Angeles-Long Beach** MSA exceeds the national and state averages, primarily because of weakness in the manufacturing industry. In particular, the city's aerospace and apparel sectors continue to lose jobs.

Utah remained an above-average performer. Although total nonfarm employment growth slowed in 1999, the state's construction sector posted solid employment gains.

States Tracking the Nation but Showing Weakness

Montana's nonfarm employment grew 2.2 percent in 1999, unchanged from a year ago. Growth in the state's services and trade sectors was a key economic driver during 1999; however, the state's mining and agricultur-

al industries continued to be adversely affected by low commodity prices.

Wyoming's economy benefited from job growth in the trade and government sectors, which make up roughly half of nonfarm employment. However, the state lagged the nation in nonfarm employment growth. The mining industry continues to be adversely affected by softness in the oil and gas industries. While oil prices have firmed, drilling activity remains depressed.

Washington's economy has slowed, experiencing weakness in the manufacturing industry. The state ended 1999 with nonfarm employment growth of 1.8 percent, less than half what it was at year-end 1998. Washington's manufacturing employment contracted over 4 percent during the year, the greatest regional decline for that sector. Job losses at Boeing, one of the state's largest employers, and lingering weakness in overseas economies have hurt export-manufacturing employment growth. A robust construction industry and increased growth in the transportation and public utili-

ties industries have absorbed some of the excess labor, resulting in a slight decline in the state's unemployment rate.

States Lagging the Nation

Oregon's economy continued to slow in 1999, ending the year with nonfarm employment growth of 1.3 percent. Construction and services employment growth expanded during 1999, but the manufacturing industry lost jobs, largely as a result of lingering weakness in Asian economies.

Alaska experienced nominal nonfarm employment growth in 1999. Furthermore, continued consolidation in the oil and gas industry, notably the BP-ARCO merger currently under federal government review, could adversely affect the Alaskan economy because of the potential for job losses. The state's mining industry lost jobs during 1999.

Hawaii's economy appears to be recovering. Total nonfarm employment grew slightly in 1999. Strong westbound arrivals supported the tourism industry, while an increase in eastbound arrivals also was noted. An upswing in visitor arrivals has contributed to additional hiring in the services and trade sectors, helping to lower the state's unemployment rate.

Banking Conditions Remain Sound, but Profitability Levels May Be Susceptible to Increasing Interest Rate Sensitivity

The majority of the Region's insured financial institutions reported sound conditions as of year-end 1999, the third consecutive year of increasing profits. Aggregate return on average assets (ROA) for year-end 1999 improved to 1.37 percent from 1.30 percent a year ago, on a merger-adjusted basis. Strong growth in fee income and declining provision expenses offset declining net interest margins (NIMs). A lower level of provision expenses is attributed to continued improvements in reported asset quality. The Region's year-end 1.69 percent past-due loan ratio was the lowest year-end level in the decade.

However, rising interest rates during the latter half of 1999 could pose problems for industry profitability levels going forward. For example, banking analysts have

become more concerned about how rising interest rates could affect insured institutions' profitability levels, while regulatory agency examiners have noted increasing levels of interest rate risk among the nation's insured financial institutions. Banking analysts are concerned that rising interest rates could continue to compress NIMs while constraining noninterest income sources, such as mutual fund sales, mortgage banking revenue, venture capital gains, and securities underwriting fees. These concerns were in part responsible for the decline in market valuations experienced by the Region's publicly traded institutions during 1999. Examiners also have identified increasing interest rate sensitivity in the Region's insured financial institutions. In fact, during 1999, downgrades of the market sensitivity or "S" component of the CAMELS rating¹ exceeded upgrades. This was in contrast to 1998, when "S" component upgrades exceeded downgrades.

Increasing interest rate sensitivity is most pronounced among the Region's mortgage lenders,² which account for only 7 percent of the Region's institutions but hold a disproportionately high 40 percent of total assets. The Office of Thrift Supervision (OTS), the federal regulator for the majority of the Region's mortgage lenders,³ has stated that median interest rate sensitivity is at its highest level since 1993. Further, as of December 31, 1999, the OTS reported five consecutive quarters of increasing median interest rate sensitivity nationwide. Not surprisingly, the Region's mortgage lenders also posted five consecutive quarters of declining NIMs, on a merger-adjusted basis. Only reductions in overhead and provision expenses have kept reported ROA from declining significantly.

Rising interest rate sensitivity is not confined to the Region's mortgage lenders. Larger commercial lenders⁴

¹ The "S" component of the CAMELS [Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity] rating methodology measures the sensitivity of an institution's earnings and economic value of equity to changes in interest rates, equity prices, commodity prices, and foreign exchange rates. Management's ability to assess, measure, monitor, and control these risks is also considered in the "S" component rating.

² Mortgage lenders hold single-family mortgage loans and mortgage-backed securities greater than 50 percent of total assets.

³ The OTS is the primary regulator for federally chartered savings banks. Because of the requirements of the qualified thrift lender test, many of these institutions hold relatively high concentrations in single-family mortgage loans and securities.

⁴ Commercial lenders hold construction, multifamily, nonfarm, commercial real estate, and commercial and industrial loans greater than 25 percent of total assets.

(total assets greater than \$1 billion) have also shown vulnerability to rising interest rates. These lenders have increasingly funded long-term assets with interest-sensitive liabilities. In addition, available-for-sale securities losses have grown steadily over the past year. These trends have resulted in stagnant NIMs, despite robust loan growth. Compressed NIMs have not hurt these lenders' profitability, however, because of growth in noninterest income. Some increases in fee income—from such sources as mutual fund sales, venture capital gains, and underwriting revenues—could be characterized as “market sensitive” and may decline if interest rate increases slow capital markets activity.

In the short term, rising interest rates have benefited the Region's smaller commercial lenders (total assets of less than \$1 billion). As of December 31, 1999, these lenders reported NIM increases for three consecutive quarters, on a merger-adjusted basis. Smaller commercial lenders primarily originate variable-rate loans, whose interest rates rise with increases in the federal funds rate. While this is beneficial in the short run, large increases in interest rates pose a longer-term risk to these lenders: asset quality deterioration. Since rising interest rates can increase debt service requirements for variable-rate loan debtors, cash flow for these debtors can become strained. While reported asset quality across the Region remained strong, the “A” (asset quality) component⁵ of the CAMELS rating was downgraded more frequently in 1999 than in 1998. Upgrades Region-wide continued to exceed downgrades by a slim margin; however, excluding southern California, downgrades in asset quality did exceed upgrades during 1999 in the Region. Should interest rates continue to rise, resulting in less robust economic growth, the Region's commercial lenders could face heightened risk of asset quality deterioration.

Some of the Region's Commercial Lenders Report Increased Concentrations in Traditionally Higher Risk Loan Types

The Region's 574 commercial lenders,⁶ which account for 68 percent of the Region's insured institutions and

⁵ The “A” component in the CAMELS rating methodology measures the credit risk associated with an institution's asset portfolio. This component also measures management's ability to assess, measure, monitor, and control asset quality.

⁶ See footnote 4.

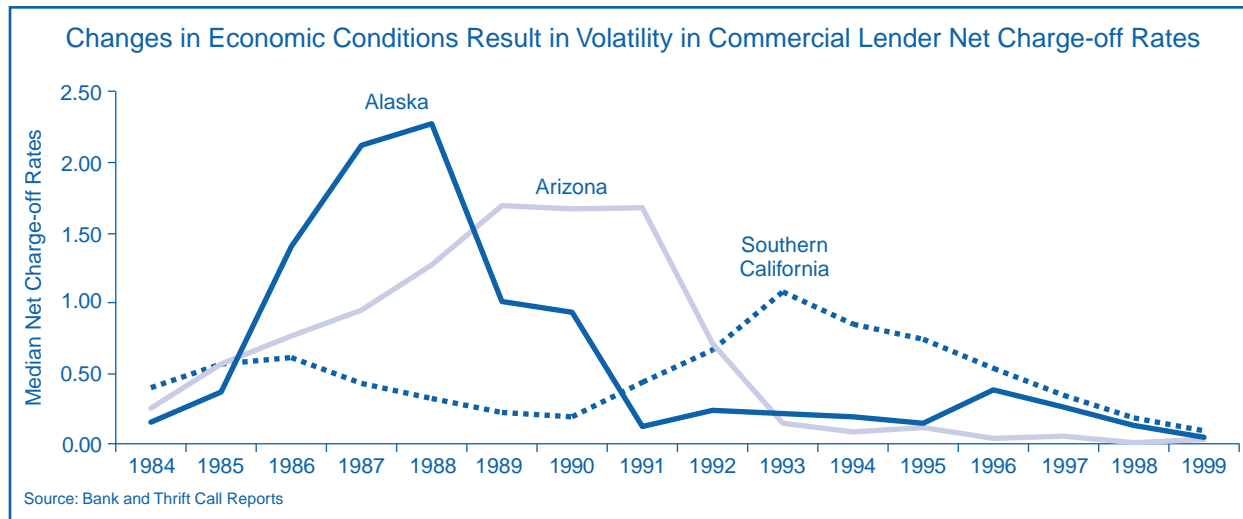
hold 44 percent of the Region's assets, could face the greatest challenge in maintaining asset quality in the event of an economic slowdown. Commercial lenders in most of the Region's states have increased concentrations in traditionally higher-risk loan types—construction, commercial real estate (CRE), and commercial and industrial (C&I) loans—through rapid loan growth during the current economic expansion. The increase in traditionally riskier assets can be problematic in the event of an economic slowdown, because commercial lenders' net charge-off rates, one measure of overall asset quality, can change significantly when economic conditions weaken. Chart 3 shows commercial lenders' median net charge-off rates in three areas of the Region that experienced economic downturns during the past 15 years: Alaska, Arizona, and Southern California. The chart shows that changes in local economic conditions can result in volatility in commercial lenders' net charge-off rates.

Favorable economic conditions throughout the 1990s have fostered rapid loan growth rates among the Region's commercial lenders. Table 1 shows that 59 percent of the Region's commercial lenders exceeded the nation's median loan growth rate during 1999.⁷ However, only 13 commercial lenders achieved this rapid growth through an acquisition; the vast majority of the Region's commercial lenders have generated rapid loan growth internally. In fact, the median loan growth rate for the Region has exceeded the nation's during each of the past four years. Further, the Region's construction, CRE, and C&I median loan growth rates exceeded the nation's during 1998 and 1999.

Commercial lenders in some states have outpaced the nation's loan growth rate for an even longer period because of robust economic conditions. For example, commercial lenders in Arizona, Nevada, Utah, and Washington, states that have led the Region in economic growth throughout much of the decade, have exceeded the nation's median loan growth rates since 1992. Oregon, until its recent economic slowdown, surpassed the nation's median loan growth rate from 1992 through 1998. In addition, commercial lenders in these states have generally experienced a more rapid median loan growth rate than the nation's in construction, CRE, and C&I loans since 1992. Moreover, in several states, rapid loan growth was widespread. Over 70 percent of the

⁷ When determining median growth rates for commercial lenders, de novo institutions were excluded.

CHART 3



commercial lenders in Arizona, Nevada, and Washington topped the nation's 1999 median loan growth rate. The strong economic growth in these states during the 1990s is reflected in the rapid loan growth figures.

In addition to rapid loan growth, examiner surveys indicate that the Region's insured financial institutions may

be engaging in potentially higher-risk underwriting practices than institutions in other parts of the country. Likely due to the robust real estate markets in the majority of the Region's metropolitan areas, the FDIC San Francisco Region Underwriting Survey has consistently shown that the Region's state nonmember banks are more likely than nonmember banks nationwide to

TABLE 1

HIGH PERCENTAGES OF COMMERCIAL LENDERS IN SOME STATES REPORT RAPID LOAN GROWTH, HIGH CONCENTRATIONS IN RISKIER ASSETS, AND RELATIVELY LOW ALLL LEVELS									
STATE	LOAN GROWTH		CONSTRUCTION, CRE, AND C&I LOAN CONCENTRATIONS		ALLOWANCE FOR LOAN AND LEASE LOSSES (ALLL)		% OF COMMERCIAL LENDERS WITH ALL THREE CHARACTERISTICS**	TIER 1 LEVERAGE CAPITAL RATIO*	
	MEDIAN* (%)	% ABOVE NATIONAL MEDIAN	MEDIAN (AS A % OF TOTAL ASSETS)	% ABOVE NATIONAL MEDIAN	MEDIAN (AS A % OF TOTAL LOANS)	% BELOW NATIONAL MEDIAN		MEDIAN (AS A % OF AVERAGE ASSETS)	% BELOW NATIONAL MEDIAN
	ARIZONA	28.56	84	52.39	87	1.19		58	45
WASHINGTON	19.47	70	41.60	75	1.13	58	39	9.93	23
OREGON	13.24	48	45.06	68	1.18	56	22	8.68	39
NEVADA	37.24	92	49.35	78	1.26	33	22	8.58	50
SOUTHERN CA	18.69	63	49.56	86	1.34	39	22	8.47	49
NORTHERN CA	14.70	54	45.75	79	1.42	35	21	8.29	50
UTAH	15.79	54	45.46	77	1.64	13	10	11.06	19
REGION	17.73	59	45.78	75	1.33	40	23	8.68	42
NATION	14.51	50	35.95	50	1.23	50	16	8.38	50

* MEDIAN LOAN GROWTH RATES AND CAPITAL RATIOS EXCLUDE DE NOVO INSTITUTIONS.
 ** % OF COMMERCIAL LENDERS WITH ALL THREE CHARACTERISTICS REFERS TO THE PERCENTAGE OF INSTITUTIONS THAT REPORT LOAN GROWTH RATES AND PORTFOLIO CONCENTRATIONS ABOVE THE NATIONAL MEDIAN AND ALLL LEVELS BELOW THE NATIONAL MEDIAN.
 SOURCES: YEAR-END 1999 BANK AND THRIFT CALL REPORTS

originate speculative construction loans⁸ and mini-permanent CRE loans.⁹ Also, San Francisco nonmember banks are more likely to originate loans to businesses without demonstrated ability to repay, likely due to strong growth in technology, Internet, and other start-up companies. *While this cannot be interpreted as a sign that all or even most of the San Francisco Region commercial lenders engage in potentially more risky underwriting practices, these practices were found to occur more frequently in state nonmember banks in this Region than in the nation.*

The percentage of San Francisco Region commercial lenders experiencing rapid loan growth has shifted loan portfolios toward higher concentrations in construction, CRE, and C&I loans than those held by commercial lenders nationwide (see Table 1). Table 1 also shows that several states' median concentrations in combined construction, CRE, and C&I loans are much higher than the Region's median levels. In addition, commercial lenders in Nevada, Oregon, Utah, and Washington have developed these concentrations only recently. Chart 4 shows that median exposure in each state remained relatively constant and close to the national median from 1984 through 1992, then steadily increased. Exposures in Arizona and California (not shown in Chart 4) have generally remained higher than those in the nation throughout the past 15 years, despite the 1990 through

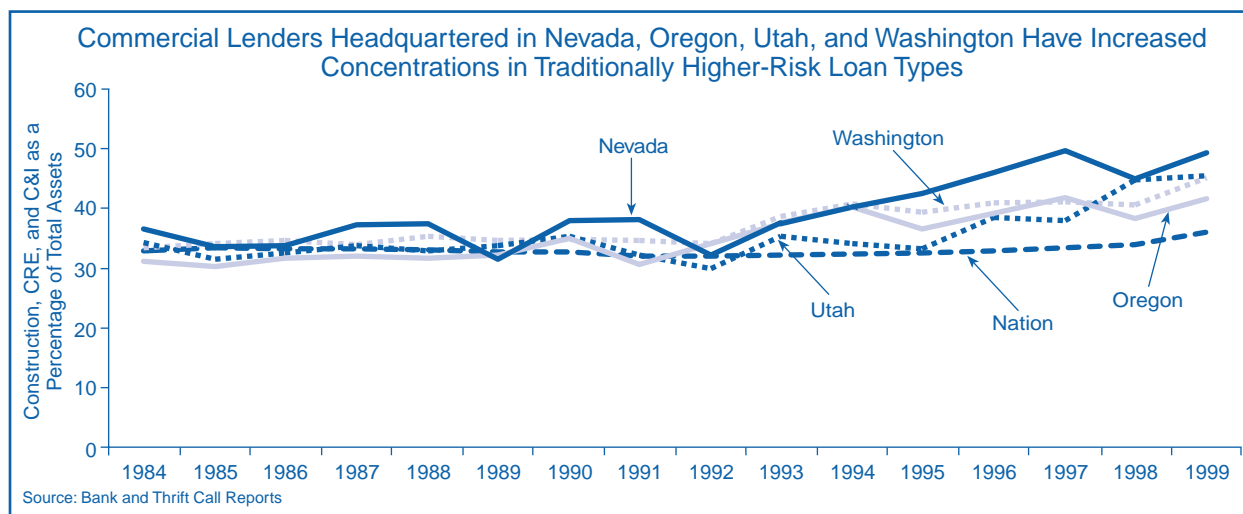
1993 California recession and the 1988 through 1992 Arizona slowdown.

The Region's Commercial Lenders' ALLL Levels Exceed the Nation's...

An assessment of the allowance for loan and lease loss (ALLL) levels is difficult and can be influenced by many variables. Loan growth levels, portfolio mix, problem loan levels and net charge-off volatility, underwriting, and credit administration practices are some of the factors that make this task a challenging one. In addition, management practices can heighten or reduce risk for any given portfolio relative to other institutions. Examiners, accountants, and bank managers are better able, at the individual institution level, to determine the appropriate ALLL level because of their access to institution-specific, nonpublic information. Therefore, the following analysis of aggregate ALLL levels reported by the Region's commercial lenders is based on reported data and does not consider all factors that could affect statements about the adequacy of the allowance.

An analysis of ALLL levels for the Region highlights certain positive trends. First, San Francisco Region commercial lenders report higher median ALLL levels

CHART 4



⁸ Speculative construction loans are for commercial buildings or homes under construction that are not preleased or presold.

⁹ A mini-permanent CRE loan is one with payments based on a longer amortization schedule than the maturity of the loan. This type of loan generally has a large "bullet" or balloon payment due at maturity because of the extended amortization schedule.

than commercial lenders nationwide. Second, ALLL levels have fallen more slowly than reductions in net charge-off rates in recent years (see Chart 5). Third, despite the downward trend in ALLL levels, the ALLL coverage of nonperforming loans is at its highest point in 15 years. Finally, commercial lenders in most states—including Alaska, Arizona, Northern and Southern California, Idaho, Montana, and Wyoming—report median ALLL levels above those that preceded each state’s last economic downturn or banking crisis.

...But Reported ALLL Levels in Certain States Lag the Nation; High Concentrations and Rapid Loan Growth Rates Are Also Reported

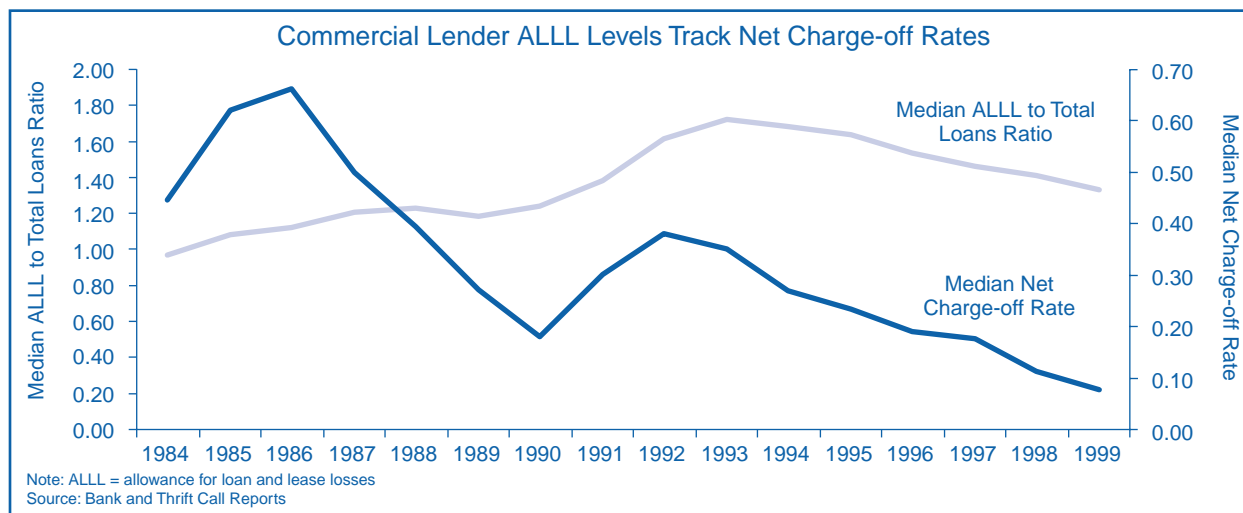
Commercial lenders in some states, however, maintain ALLL levels at or below the national level despite rapid loan growth and high portfolio concentrations in potentially higher risk loan types. Table 1 shows that the median ALLL level for commercial lenders in Arizona, Washington, Oregon, and Nevada are similar to or lower than the nation’s; yet median concentrations in riskier loan types reported by commercial lenders in these states are relatively high compared with the nation. Additionally, Arizona, Washington, and Nevada commercial lenders continue to experience loan growth rates well in excess of the nation’s. Conversely, California and Utah commercial lenders report median growth

rate and portfolio concentration levels above the nation, but exceed the nation’s median ALLL levels.

Table 1 also shows that Arizona and Washington are home to a disproportionate number of commercial lenders that report above-median loan growth rates and concentrations in riskier construction, CRE, and C&I loans, while maintaining below-median ALLL levels. Nevada, Oregon, and California also have a fairly high percentage of institutions that exhibit a combination of these characteristics.

Geographic diversification at the level of the bank holding company may mitigate some of the risk from high concentrations and rapid growth noted in Arizona and Nevada commercial lenders. Over half of the commercial lenders in these two states, including almost two-thirds of the de novo institutions, are subsidiaries of multibank holding companies headquartered elsewhere. Many of the commercial lenders in Arizona and Nevada have been chartered or acquired by bank holding companies headquartered in slower growing mid-western states, and the banking subsidiaries in Arizona and Nevada may represent only a small portion of the holding companies’ assets. Thus, even if institutions in these states have relatively low ALLL levels relative to high growth and portfolio concentrations, the bank holding companies could provide them with financial support and management expertise. On the other hand,

CHART 5



Regional Perspectives

institutions that have entered these markets through acquisitions or de novo chartering may not be familiar with the Arizona or Nevada economies.

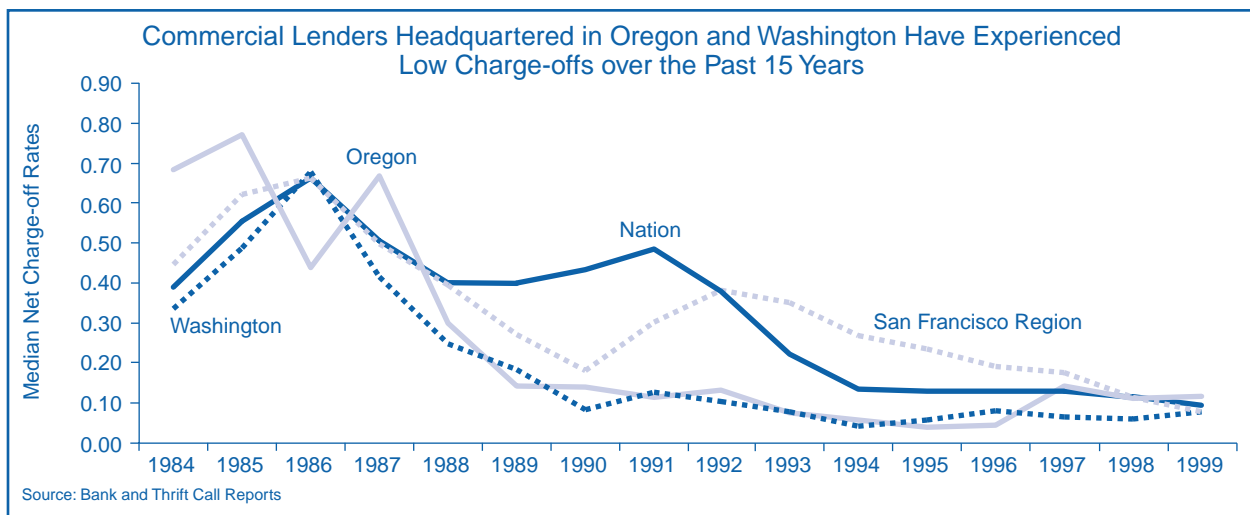
Although ALLL levels maintained by commercial lenders headquartered in the Pacific Northwest states appear relatively low, this may be the result of low historical net charge-off experience and relatively strong capital levels. As Chart 6 shows, median net charge-off rates for commercial lenders in Oregon and Washington have generally remained below those of the Region and the nation since 1987. Further, Table 1 shows that the majority of commercial lenders in the Pacific Northwest maintain stronger Tier 1 Leverage Capital ratios than that of the nation. Net charge-off rates have likely been low relative to those in the rest of the Region because these states have not experienced an economic slowdown such as that in Alaska (oil, 1986 through 1987); Idaho, Montana, and Wyoming (agriculture, 1986 through 1987); Arizona (real estate, 1988 through 1992); or California (real estate and defense/aerospace spending cutbacks, 1990 through 1993).¹⁰ Neither Oregon nor Washington has experienced an annual contrac-

tion in employment growth or gross state product since 1984.

While economic growth in the Pacific Northwest has been generally strong for the past 15 years, signs of slowing have emerged recently. As a result of the Asian economic slowdown, Oregon posted annual employment growth well below its 15-year average during 1998 and 1999. Washington's economic growth rate for 1999 lagged its 15-year average, primarily because of the aerospace employment layoffs at Boeing. Commercial lenders in the Pacific Northwest should remain cognizant of slowing in these two states' economies, because rapid loan growth and increased concentrations in riskier loan types have developed during a period of sustained economic growth. Further, the majority of Oregon and Washington commercial lenders, unlike those in Arizona and Nevada, are not subsidiaries of multistate bank holding companies and therefore cannot draw on the geographic diversification and support those entities may offer.

San Francisco Region Staff

CHART 6



¹⁰ Oregon's recession during 1990-91 was not as severe or as lengthy as the nation's.

Banking Risk in the New Economy

The Division of Insurance periodically assesses conditions in the economy and the banking industry to identify and evaluate trends that could adversely affect the performance of insured depository institutions. At this time, the banking industry as a whole continues to enjoy record profits and solid financial ratios.¹ Much of the industry's strength derives from the remarkable performance of the U.S. economy, which has been expanding for the past nine years. This article explores factors that have shaped this unusually robust economic environment and discusses how changes in the economy may create new types of risks for insured depository institutions.

During 1999, the FDIC reported the first annual loss for the Bank Insurance Fund since 1991. This loss primarily resulted from an uptick in unanticipated and high-cost bank failures. Some of these failures were associated with high-risk activities such as subprime lending, and some were related to operational weaknesses and fraud. The emergence of these problems in the midst of a strong economic environment raises concerns about how the condition of the banking industry might change if economic conditions deteriorate.

The Longest U.S. Expansion

In February 2000, the U.S. economy entered its 108th month of expansion, making this the longest period of uninterrupted growth in U.S. history.² This record-setting performance has also been marked by a recent acceleration in the rate of real gross domestic product (GDP) growth, which has exceeded 4 percent in each year since 1997. Meanwhile, price inflation has remained relatively subdued. The core inflation rate, which excludes the volatile food and energy components, was just 2.1 percent in 1999, the lowest core rate since 1965.

Recent economic conditions have been highly conducive to strong loan growth, low credit losses, and record earnings for the banking industry. The important

question going forward is how long these favorable conditions might last. Is this remarkable economic performance the result of some long-term upward shift in the pace of economic activity, or is it the temporary result of a few transitory factors? More important, are there new and unfamiliar dangers that, at some point, could significantly impair banking industry performance? To evaluate these questions, we must assess the factors that have contributed to recent economic performance and think ahead to possible developments that could end this expansion.

What Is the New Economy?

The term used most often to describe the recent period of economic performance has been somewhat controversial: the *New Economy*. Much of the controversy has arisen because people interpret the term in different ways. Wall Street analysts use the term to refer to the high-technology sectors of the economy, such as computers and software, biotechnology, and especially the Internet. Some of these New Economy firms have been able to raise large amounts of capital and command market valuations in the tens of billions of dollars well in advance of earning a profit or even booking significant cash revenues.



Economists tend to employ the term New Economy in a slightly different way. To them, it refers to evidence that some of the traditional economic relationships have changed. For example, intangible assets now appear to play a much larger role in the valuation of investments than they have in the past.³ Firms in some industries now may exhibit increasing returns to scale (rather than diminishing returns), reflecting the fact that the value of their product rises as it becomes a de facto industry standard.⁴ Individual decision making, too, may be changing. Some believe that investors have reduced the risk premium they demand to hold equity positions

¹ For a recent summary of financial performance and condition of the banking and thrift industries, see the FDIC *Quarterly Banking Profile*, fourth quarter 1999, <http://www2.fdic.gov/qbp/>.

² The chronology of U.S. business cycles is available from the National Bureau of Economic Research, <http://www.nber.org/cycles.html>.

³ Nakamura, Leonard. Federal Reserve Bank of Philadelphia. July/August 1999. Intangibles: What Put the New in the New Economy? *Business Review*. <http://www.phil.frb.org/files/br/brja99ln.pdf>.

⁴ Brown, William S. March 2000. Market Failure in the New Economy. *Journal of Economic Issues*, 219-27.

because of their perception that holding equity is not, after all, substantially riskier than holding debt.⁵ Such a shift in investor attitudes could help explain why the price-to-earnings ratio for the S&P 500 index has recently approached all-time highs.⁶

Perhaps the most important underlying change in the economy is the relationship between high rates of economic growth and changes in inflation. Economists have long maintained that rapid growth in economic activity has a tendency to lead to excess demand for goods (thereby raising consumer and producer prices) and excess demand for labor (thereby raising wage rates). But during the late 1990s, as growth accelerated and inflation remained low, economists began to reevaluate their notions of these trade-offs. Some argued that the low rate of inflation during this expansion was the fortunate result of temporary factors, such as a strong dollar and low energy prices, both of which could diminish or reverse direction over time.⁷ Only a few analysts were so bold as to suggest that the fundamental workings of the economy had changed in such a way as to allow a sustained period of high economic growth with low inflation.

An early Wall Street description of the New Economy appeared in an article released by **Goldman Sachs** in January 1997.⁸ It describes a number of fundamental changes in the economy—driven by global competition and advancing technology—that may permit business cycle expansions to last longer than they have in the past. At the same time, it warned that longer economic expansions might have a tendency to contribute to greater financial excess and the possibility of more severe recessions and more sluggish recoveries.

If this hypothesis is correct, and an emerging New Economy would contribute to longer expansions and more severe recessions, there may be implications for how banks manage risks. Since the Great Depression, U.S. business cycle recessions have not necessarily been catalysts for large numbers of bank and thrift failures.

⁵ January 24, 2000. Has the Market Gone Mad? *Fortune*.

⁶ September 1999. Earnings: Why They Matter. *Money*.

⁷ Brown, Lynn Elaine. Federal Reserve Bank of New England. May/June 1999. U.S. Economic Performance: Good Fortune, Bubble, or New Era? *New England Economic Review*. <http://www.bos.frb.org/economic/pdf/neer399a.pdf>, and Brinner, Roger E. Federal Reserve Bank of New England. January/February 1999. Is Inflation Dead? *New England Economic Review*. <http://www.bos.frb.org/economic/pdf/neer199c.pdf>.

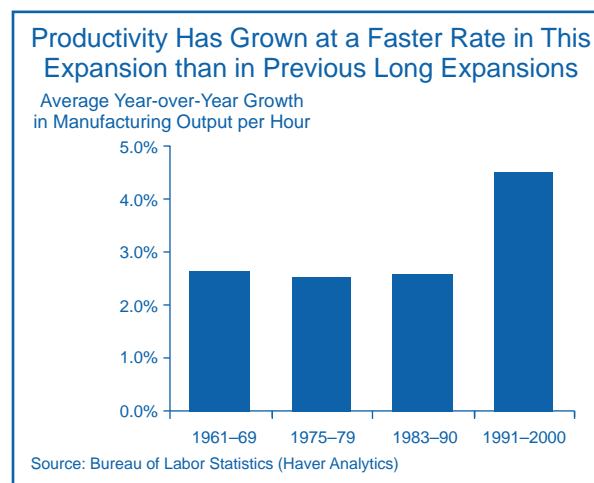
⁸ Dudley, William C., and Edward F. McKelvey. January 1997. The Brave New Business Cycle: No Recession in Sight. *U.S. Economic Research*, Goldman Sachs.

During the period from 1983 to 1989, when the U.S. economy was in the midst of a long expansion, some 1,855 insured banks and thrifts failed. This wave of failures has been attributed to a variety of factors, including severe regional economic downturns, real-estate-related problems, stress in the agricultural sector, an influx of newly chartered banks and banks that converted charters, and high nominal interest rates.⁹ However, the potential for significantly more severe national recessions would represent largely uncharted territory that could cause losses and loss correlations to depart from historical norms, posing a new set of risk management challenges for the industry going forward.

The Productivity Revolution

As the essential element that links faster economic growth and low inflation, productivity growth is the cornerstone of the New Economy. Productivity refers generally to the amount of output that can be obtained from a fixed amount of input. Labor productivity is usually measured in terms of output per hour. Chart 1 shows that output per hour in manufacturing has risen at an average annual rate of 4.5 percent during the current expansion, compared with rates of just over 2.5 percent in the three previous long economic expansions. Moreover, productivity growth accelerated in 1999 to a rate of 6.3 percent. Why is productivity growing so fast now compared with previous expansions? Even economists who believe that economic relationships have funda-

CHART 1



⁹ FDIC Division of Research and Statistics. 1997. *History of the Eighties: Lessons for the Future, Vol. 1, An Examination of the Banking Crises of the 1980s and Early 1990s*, 16-17. <http://www.fdic.gov/bank/historical/history/contents.html>.

mentally changed are hard-pressed to explain why all of the factors came together in the late 1990s and not before.¹⁰ Still, explanations for the increase in productivity tend to focus on three main factors.

Increased Competition. Expanding global trade during the 1980s and 1990s has subjected U.S. firms to new competition from around the world. Annual U.S. exports of goods and services grew by over 230 percent (after inflation) between 1982 and 1999, while imports grew by 315 percent. The construction of new production facilities around the world in industries such as autos and chemicals has led to excess manufacturing capacity that has kept prices low. In other industries, including air travel, trucking, telecommunications, and banking, competition has been intensified through domestic deregulation. Facing intense competitive pressures and a low rate of general price inflation, firms cannot rely on annual price increases to help expand top-line revenue. Instead, there is pressure to continually cut costs in order to increase earnings. For many firms, this means adopting new technologies and new ways of organizing operations.

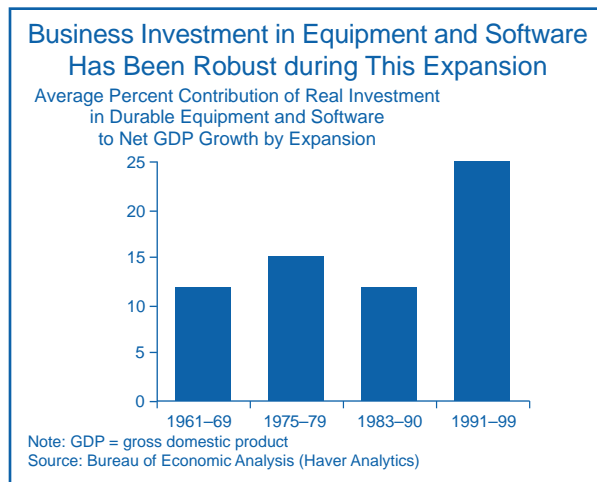
Expanded Investment. U.S. firms of all sizes have invested in new technologies at a rapid pace during this expansion. Chart 2 shows that business investment in equipment and software represents almost one-quarter of total net GDP growth during this expansion, com-

pared with around 15 percent or less during previous long expansions. While this investment has been motivated by the need to cut costs, it has also been fueled by the availability of new computer technologies that have fallen in cost over time and by the ready availability of financial capital on favorable terms.

Industrial Restructuring. The third aspect of the productivity revolution is large-scale restructuring in the U.S. corporate sector. Chart 3 shows that both the annual number and dollar volume of mergers in the late 1990s far exceeded the pace of the so-called merger mania of the late 1980s. Two classes of firms are leading the new wave of mergers. First, companies in mature industries such as oil, autos, and banking are faced with excess productive capacity and intense price competition. For these firms, mergers are useful in expanding market share and removing redundant operations. Second, the largest dollar volume of mergers is in some of the most volatile emerging industries, including telecom, media, and the Internet. It is in these sectors of the economy, in particular, where the business models are evolving rapidly and where technological standards are still being determined. Firms in these industries that can grow rapidly through mergers have the chance to achieve long-term market dominance in what appear to be some of the fastest growing industries of the new century.

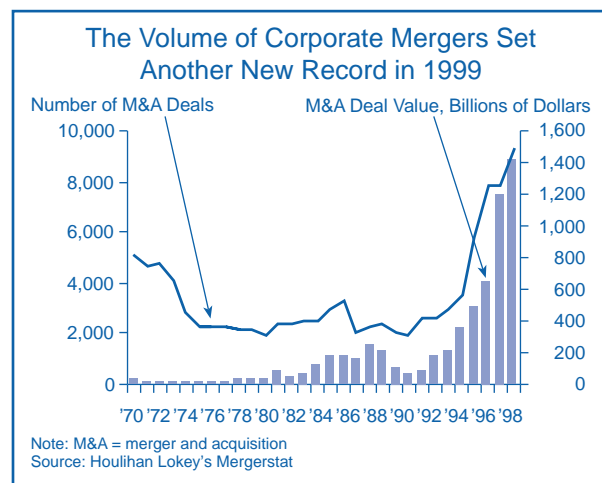
The implications of the productivity revolution for the banking industry have been decidedly positive. Higher productivity has allowed a long expansion and faster economic growth with low inflation, all of which are conducive to robust financial performance by deposit institutions. Higher rates of business investment

CHART 2



¹⁰ One possible explanation is that there is a learning curve for adopting new technologies and that technology diffusion is an inherently slow process. David, Paul A. Organization for Economic Cooperation and Development. 1991. Computer and Dynamo: The Modern Productivity Paradox in a Not-Too-Distant Mirror. In *Technology and Productivity: The Challenge for Economic Policy*, 315-47.

CHART 3



have generated demand for credit that is supplied, in part, by banks and thrifts. Perhaps most important, the recent large-scale industrial restructuring has been highly supportive of strong business credit quality. This process has moved economic resources to more productive uses in an orderly fashion, without the high levels of bankruptcies and defaults that often accompany industrial restructuring. Given the volumes of corporate assets that have changed hands in recent years (more than \$1.4 trillion in 1999 alone), it is fortunate indeed that this restructuring has proceeded in this fashion.

The Role of the Capital Markets

A critical factor in heightened business investment and restructuring during this expansion has been the remarkably favorable conditions in the financial markets. Financial capital has generally been readily available to business borrowers, usually on favorable terms. One factor that has held down the cost of capital for publicly traded corporations has been sharply rising stock prices. Many of these firms have been able to use equity shares as a currency with which to finance mergers. Furthermore, existing accounting rules do not always require the amortization of good will that comes onto the balance sheet as a result of a merger.¹¹

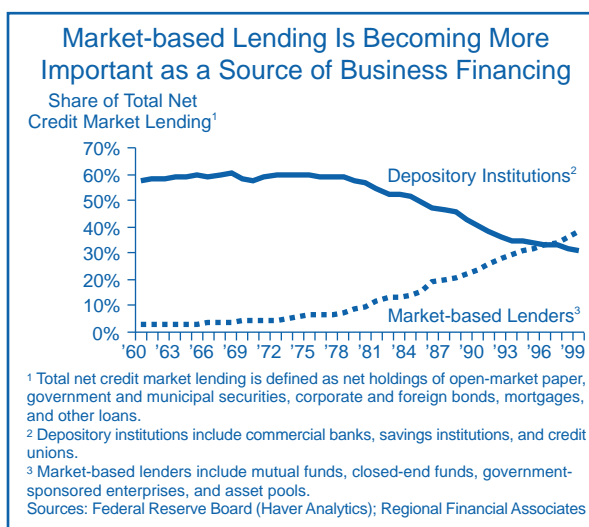
By far the largest amount of external business financing has been debt financing. U.S. nonfinancial corporations issued net debt in the amount of \$535 billion in 1999 and repurchased equity shares, on net, for the sixth consecutive year. Businesses have used this debt to purchase capital equipment, finance mergers, and buy back equity shares. This increase in debt issuance has not been limited to highly rated corporations. Venture capital financing amounted to almost \$15 billion in the fourth quarter of 1999 alone, with over 60 percent of that amount going to Internet firms.¹²

Banks have been active participants in nearly every facet of this financing activity. Syndicated loan origination volumes rose by 17 percent in 1999 to just over \$1 trillion, despite relatively high credit costs and facility fees, factors that helped keep total volume below 1997's record \$1.1 trillion in issuance. Syndicated loans to leveraged companies also rose 17 percent in 1999 to a record \$320 billion. More impressive still was the growth in high-yield transactions, which rose nearly 50

percent in 1999 to \$190 billion. It is difficult to determine precisely how much syndicated loan exposure resides on the books of insured institutions or, more important, how much high-yield exposure is retained by commercial banks. *Loan Pricing Corporation* estimates that 64 percent of high-yield volume in the first half of 1999 was retained by banks.¹³ Insured commercial banks are the dominant originators of syndicated loans, with a 79 percent market share of investment-grade originations and a 56 percent market share of non-investment-grade originations in 1999. Commercial banks have also expanded their presence in the venture capital market. For some of the largest banks, profits from venture capital operations account for a large portion of total earnings. Chase Manhattan reported venture capital investment earnings of \$2.3 billion in 1999, accounting for 22 percent of total net income.¹⁴

Innovation in the capital markets continues to provide new and more efficient vehicles for business financing. For example, issuance of asset-backed securities totaled \$346 billion in 1999, up from only \$50 billion in 1990. In this ongoing revolution in finance, market-based intermediaries, such as mutual funds and asset pools, have assumed an increasing role in the credit markets. Chart 4 shows that net holdings of credit market instruments by mutual funds, government-sponsored enterprises, and asset pools exceeded the debt held by depository institutions for the first time in 1997.

CHART 4



¹¹ April 17, 2000. Techdom's New Bean-Counting Battle. *Business Week*.

¹² May 2000. Venture financing data are derived from a PriceWaterhouseCoopers/Money Tree survey, as cited in *Upside*, 43.

¹³ September 13, 1999. Junk Loan Market Is Feeling the Pinch of Oversupply and Rising Interest Rates. *The Wall Street Journal*.

¹⁴ April 3, 2000. What's Really Driving Banks' Profits. *Business Week*.

While the expansion in market-based financing has made credit more available to business and consumer borrowers, it also creates some concerns. One issue is the susceptibility of the financial markets to periodic bouts of turmoil. These episodes, such as the one triggered by the Russian government bond default and the near-failure of the Long Term Capital Management hedge fund in the fall of 1998, can result in the interruption of capital flows even to creditworthy borrowers. During the 1998 episode, private yield spreads widened sharply as investors sought the safety of U.S. Treasury securities. Some companies that had planned to issue debt to the markets during that period were unable to do so. For companies whose business models depend heavily on a continuous supply of liquidity from the financial markets, the effects of these episodes can be catastrophic. For example, the relatively short-lived episode of financial turmoil during late 1998 resulted in significant liquidity problems for a number of commercial mortgage firms. Nomura, Lehman Brothers, CS First Boston, and others incurred losses, while Criimi Mae, Inc., was forced to declare bankruptcy.

Because market-based financing has played such a large role in facilitating the orderly restructuring of the U.S. economy through mergers and the formation of new businesses, a recurrence of financial market turmoil could contribute to the end of the current expansion. Moreover, such an event could have serious consequences for business credit quality. A prolonged interruption of market-based financing could, in this very competitive economic environment, prevent businesses from restructuring themselves through mergers and deprive them of capital needed to invest in cost-cutting technologies. The loss of financial flexibility would leave businesses much more vulnerable to the effects of

competition and could result in more firms seeking bankruptcy protection. Such a scenario has the potential to bring about a significant increase in charge-off rates for business lenders.

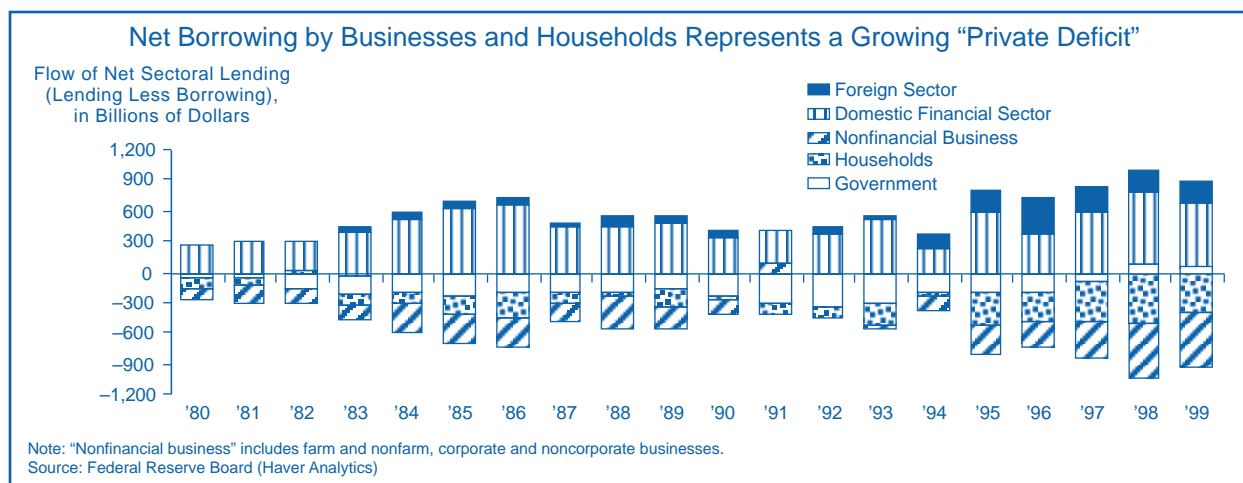
Financial Imbalances

Another concern that arises from increased dependence on market-based financing is that it may contribute to the emergence of financial imbalances in the economy. These imbalances could, in turn, increase the potential for financial market turmoil as a result of some unforeseen shock to the markets.

As recently as 1993, the public deficit was near the top of the list of economists' concerns about the U.S. economy. During that year, the combined deficit of the federal, state, and local government sectors exceeded \$300 billion. However, on the strength of a long economic expansion, lower interest rates, and lower federal spending on defense, the consolidated government sector posted its second consecutive surplus in 1999 (Chart 5).

As the government has moved from deficit to surplus, households and businesses have continued to borrow hundreds of billions of dollars every year. Taken together, the annual net borrowing of businesses and households has been referred to as the "private deficit." In 1999, the private deficit narrowed to \$913 billion from a record \$1.02 trillion the year before. Although this private borrowing indicates confidence on the part of consumers and businesses about future prospects, it also raises concerns about the ability to service debt if interest costs rise or if incomes level off or decline.

CHART 5



The largest part of the private deficit was again financed in 1999 by domestic financial institutions (\$649 billion) and an inflow of capital from abroad (\$207 billion). Both of these sources of financing are potential causes for concern. The rapid expansion in credit created by the financial sector raises questions about credit quality. Financial institutions theoretically serve as the gatekeepers of the economy, financing only the most creditworthy projects and rejecting those that are not viable. The sheer volume of credit extended to businesses and households—almost \$1.4 trillion in new net lending over the past two years—raises the possibility that underwriting has become more lax and that average credit quality is slipping. (See the inset box on page 17 for a discussion of recent trends in commercial credit quality.)

Reliance on inflows of foreign capital raises a different set of issues. The fact that the U.S. economy has been growing significantly faster than the economies of its major trading partners has contributed to a U.S. trade deficit that reached \$268 billion in 1999 and could exceed \$300 billion in 2000. This deficit puts hundreds of billions of dollars annually in the hands of foreign investors. As long as foreign investors largely choose to reinvest their excess dollars in U.S. factories and financial instruments, as has been the case in recent years, the United States can continue to enjoy a strong dollar and relatively low inflation and low interest rates. However, if foreign investors should choose to invest elsewhere, they must sell their dollars in foreign exchange markets. Doing so would put downward pressure on the dollar and upward pressure on U.S. inflation and interest rates.

Recent Shocks to the U.S. Economy

Despite the potential for a declining dollar as a result of U.S. reliance on foreign capital, other adverse developments have confronted the U.S. economy over the past year. The two factors of most consequence to the macroeconomic outlook have been rising energy costs and rising interest rates. These trends have played a role in recent equity market volatility that may have implications for the future direction of the economy.

Rising Energy Prices. After declining to a low of around \$10 per barrel in December 1998, oil prices have risen dramatically over the past year and a half. The spot price per barrel of West Texas Intermediate crude peaked in March 2000 at just under \$30 before declin-

ing slightly in April. The rapid increase in oil prices during 1999 was sparked by a cutback in output by oil-producing nations that was instituted just as global economic growth was recovering from the crisis of 1998. The OPEC nations and other major oil producers reached a new agreement in March 2000 that provides for a production increase of some 1.5 million barrels a day. But, because demand is rising and gasoline inventories remain lean, analysts do not look for a significant decline in gasoline prices in the near term.¹⁵

The effects of higher oil prices on the U.S. economy at this time are uncertain. According to some estimates, the economy is only half as dependent on oil as it was 25 years ago, when the United States was experiencing the effects of its first “oil shock.”¹⁶ Still, higher oil prices were responsible for nearly all the increase in consumer price inflation during 1999. While year-over-year growth in the Consumer Price Index rose from 1.6 percent in December 1998 to 2.7 percent in December 1999, the core rate of inflation (excluding food and energy items) actually fell. The question now is whether higher energy prices will be passed along to the rest of the economy through rising wage and price demands during the remainder of 2000.

Rising Interest Rates. From low points at the end of 1998, both short-term and long-term interest rates have risen substantially, contributing to a higher cost of debt service for businesses and households. At the short end of the yield curve, the Federal Reserve (the Fed) raised the Federal Funds rate six times between June 1999 and May 2000, for a total increase of 175 basis points. While part of this increase merely reversed the reduction in rates that took place in late 1998, the Fed also voiced concerns that inflationary pressures might be emerging because of continued rapid U.S. economic growth. Given the stated commitment of the Federal Reserve to price stability, most analysts expect the Fed to continue to push short-term rates higher until growth in the economy slows to a more sustainable pace.¹⁷

Bond markets also pushed up long-term interest rates during this period. The yield on the ten-year Treasury

¹⁵ Energy Information Agency (U.S. Department of Energy). April 2000. Short-Term Energy Outlook. <http://www.eia.doe.gov/emeu/steo/pub/contents.html>.

¹⁶ March 11, 2000. Fueling Inflation? *The Economist*.

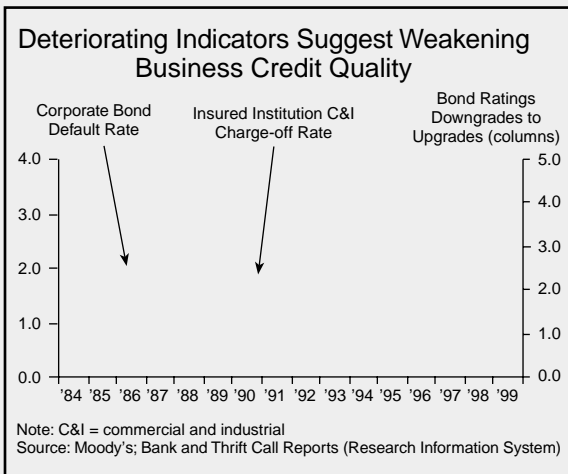
¹⁷ See, for example, U.S. House of Representatives. February 17, 2000. Testimony of Chairman Alan Greenspan Before the Committee on Banking and Financial Services. <http://www.federalreserve.gov/boarddocs/hh/2000/February/Testimony.htm>.

As Commercial Credit Quality Indicators Slip, Trends in Commercial Lending Come to the Forefront

Commercial lending, which includes both commercial and industrial (C&I) and commercial real estate (CRE) loans, represents the greatest source of credit risk to insured institutions and the deposit insurance funds. C&I loan growth continued to be strong in 1999, although it did moderate from 1998 levels, and recent underwriting surveys have reported a slight tightening of terms.¹⁸ Nevertheless, there are signs that commercial credit quality is deteriorating.¹⁹ Most notably, as seen in Chart 6, C&I loan charge-off rates, corporate bond defaults, and corporate bond rating downgrades relative to upgrades have all been trending upward recently. For example, C&I loan loss rates rose to 0.56 percent of total loans in 1999, nearly double the rate of loss experienced in 1997. Although C&I loan loss levels are well below historical highs experienced throughout the 1980s and early 1990s, these signs of credit quality deterioration are occurring despite extremely favorable economic conditions.

At least three factors have contributed to weakening in corporate credit quality. First, corporate indebtedness has

CHART 6



¹⁸ Both the 1999 *Senior Loan Officer Opinion Survey* (Federal Reserve Board) and 1999 *Survey of Credit Underwriting Practices* (Office of the Comptroller of the Currency) point to more stringent C&I loan terms since the latter part of 1998. This tightening follows a four-year period of easing C&I loan standards and predominantly reflects an increase in loan pricing.

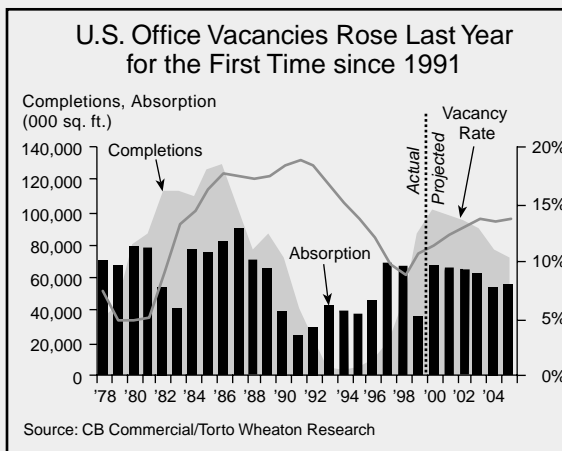
¹⁹ For additional detail, see Sothoron, Arlinda, and Alan Deaton. FDIC Division of Insurance. First quarter 2000. *Recent Trends Raise Concerns about the Future of Business Credit Quality. Regional Outlook*. <http://www.fdic.gov/bank/analytical/regional/ro20001q/na/Infocus1.html>.

been rising, as businesses have been spending to increase productivity, cut costs, repurchase equity, and finance mergers and acquisitions. The second factor relates to a greater risk appetite in the financial markets. For example, originations of leveraged syndicated loans—in particular, highly leveraged loans—have tripled over the past five years. Finally, stresses within industry sectors hard hit by structural changes, global competition, and deflationary pressures have resulted in challenges for borrowers.

Construction and development (C&D) lending continues to be one of the fastest growing segments of banks' loan portfolios, while loss rates among CRE and C&D loans remain extremely low. However, there are indications that conditions could be worsening in some markets. In particular, as shown in Chart 7, strong office completions and construction activity have begun to outpace absorptions and are projected to continue to do so over the next several years. Moreover, these trends have implications for vacancy rates. The national office vacancy rate moved higher during 1999 for the first time since 1991 and is projected to climb higher.

In addition, some local CRE markets continue to show signs of overbuilding. Last year, the FDIC's Division of Insurance identified nine markets in which the pace of construction activity threatened to outstrip demand for at least two property sectors.²⁰ Seven of these nine markets reported an increase in office vacancy rates in 1999.

CHART 7



²⁰ These markets are Charlotte, Orlando, Salt Lake City, Dallas, Las Vegas, Phoenix, Nashville, Atlanta, and Portland. See Burton, Steve. FDIC Division of Insurance. First quarter 1999. *Commercial Development Still Hot in Many Major Markets, But Slower Growth May Be Ahead. Regional Outlook*. <http://www.fdic.gov/bank/analytical/regional/ro19991/na/Infocus2.html>.

note rose from a low of 4.5 percent in October 1998 to 6.5 percent by May 2000. Analysts have cited renewed demand for credit by a recovering world economy as well as concerns about inflation arising from the increase in energy prices as factors behind the rise in long-term rates.

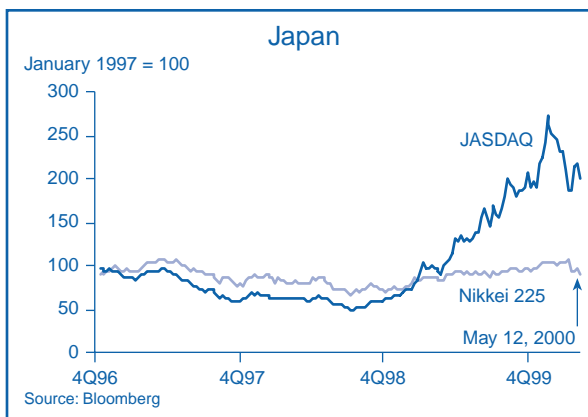
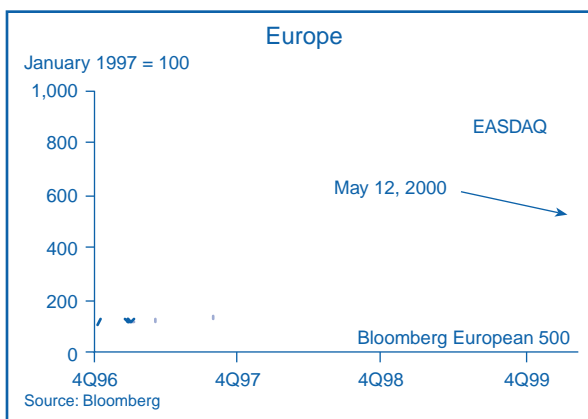
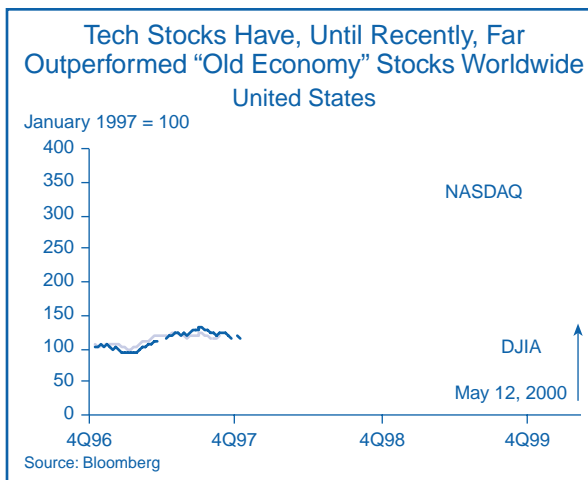
Higher energy costs and higher interest rates do not appear to have significantly slowed the pace of U.S. economic activity during the first quarter of 2000. The preliminary estimate of real gross domestic product growth during the quarter was 5.4 percent—a slowdown from the 7.3 percent rate of the fourth quarter of 1999 but still well above what is considered a sustainable pace. Home construction, usually a sector that is particularly sensitive to movements in long-term interest rates, has remained surprisingly resilient. Still confident of their future prospects, homebuyers have increasingly turned to adjustable-rate mortgages to avoid some of the immediate costs of higher fixed mortgage rates.

As for the business sector, higher costs for energy and debt service are most significantly affecting “Old Economy” firms that purchase commodity inputs and carry significant debt on their balance sheets. Airline companies in the S&P 500, for example, posted a year-over-year decline of 27 percent in net income from continuing operations during the first quarter of 2000.²¹ Analysts have argued that New Economy firms, by contrast, are less vulnerable to recent economic shocks because they tend to carry little debt and consume relatively little energy.

Equity Market Volatility. The notion that New Economy firms are less vulnerable to the effects of higher energy costs and higher interest rates may be one of the reasons that equity shares of firms in the technology sector began to dramatically outperform the broader market, beginning around the middle of 1999. Chart 8 shows that the technology-heavy NASDAQ index performed more or less in tandem with the Dow Jones Industrial Average between the end of 1996 and the middle of 1999, but thereafter the NASDAQ soared far ahead of the Dow. Between October 1, 1999, and February 29, 2000, the NASDAQ rose by 72 percent while the Dow declined by 4 percent. Moreover, this striking divergence between the equity returns of Old and New Economy companies was not limited to the U.S. markets. Parallel trends were observed in Europe, Japan, Korea,

²¹ Bloomberg. The S&P 500 airline industry is composed of AMR Corp., Delta Air Lines, Southwest Airlines, and U.S. Airways Group.

CHART 8



and Hong Kong. The similarity in performance of the high-tech sectors across three continents suggests a worldwide flow of liquidity from investors to the shares of technology firms.

However, emerging concerns about the technology sector contributed to significant volatility in technology

shares during March and April 2000. The NASDAQ index lost 30 percent of its value between March 10 and May 12, 2000. Analysts cited the Justice Department finding against Microsoft and doubts about the ultimate profitability of business-to-consumer Internet firms as two factors in the sell-off.

Equity market volatility also poses a threat to the economic outlook. One concern is the so-called “wealth effect” that a declining stock market may have on consumer spending. Since 1995, rising stock prices have helped raise the market value of equities held by U.S. households, plus their holdings of mutual funds, by some \$5.7 trillion. This windfall is an important reason that households have continued to reduce annual personal savings (to just 2.4 percent of disposable income in 1999) and increase spending on homes, autos, and other consumer goods. Although it is uncertain what effect a prolonged stock market correction might have on consumer spending, the potential wealth effect has surely grown as more households hold a higher percentage of wealth in corporate equities and mutual fund shares. (See the inset box at right for a discussion of how financial market volatility could affect banks.)

The Economic Outlook

Despite the effects of rising energy costs, increasing interest rates, and equity market volatility, the U.S. economy continues to grow at a robust pace. The consensus forecast of 50 corporate economists surveyed by the May 1999 *Blue Chip Economic Indicators* suggests that the economy will grow by 4.7 percent in 2000, while consumer prices are projected to rise by 3.0 percent from 1999 levels. Short-term interest rates are projected to rise only slightly by year-end from early May levels. In short, the consensus forecast indicates that the New Economy formula of rapid economic growth combined with low inflation will continue for the foreseeable future. If actual events conform to this forecast, the result will likely be another year of generally low loan losses and solid earnings for much of the banking industry. (See the inset box on the following page for a discussion of other risks to watch in banking.)

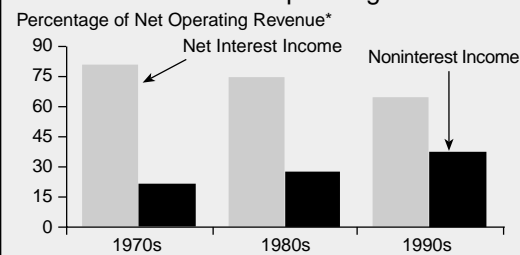
Clearly, risks are associated with the economic outlook. Recently, higher oil prices and higher interest rates have been the most visible signs of trouble for the economy. New Economy companies may be less vulnerable to these effects, but even these firms have experienced a sharp decrease in equity valuations as investors reeval-

Financial Market Volatility Could Pare Earnings for Banks Most Reliant on Market Sources of Revenue

FDIC-insured banks are deriving an increasing proportion of earnings from noninterest sources (see Chart 9), particularly market-sensitive sources of revenue. This is especially true for larger institutions. According to *Deutsche Banc Alex. Brown*, the 18 most active generators of market-sensitive sources of revenue earned over 25 percent of net operating revenue from these potentially volatile business lines.²² While market-sensitive sources help to diversify revenue streams, they can also introduce increased income volatility in the event of financial market turbulence. Deutsche Banc Alex. Brown also reports that for those 18 banks that generated the largest amounts of market-sensitive revenues during the third quarter of 1998, the share of total revenue derived from market-sensitive sources declined from 23 percent to 13 percent. Thus, a more sustained downward trend in the financial markets could particularly affect the earnings of large banking companies that rely heavily on income from sources such as venture capital, asset management and brokerage services, and investment banking.

CHART 9

Noninterest Revenues Account for a Growing Share of Bank Net Operating Revenue



* Net operating revenue is the sum of net interest income and noninterest income.
Sources: FDIC Historical Statistics on Banking; FDIC Quarterly Banking Profile

²² Net operating revenue is the sum of interest income and noninterest income less interest expense. According to Deutsche Banc Alex. Brown, these companies are Bank of America Corporation; Bank of New York Company, Inc.; Bank One Corporation; Bank Boston; BB&T Corporation; Chase Manhattan Corporation; Citigroup, Inc.; First Union Corporation; FleetBoston Financial; JP Morgan; KeyCorp; Mellon Financial Corporation; National City Corporation; PNC Bank Corp.; SunTrust Banks, Inc.; US Bancorp; Wachovia Corporation; and Wells Fargo & Company.

Other Risks to Watch in Banking

Subprime Lending

- ***Subprime consumer loan portfolios contributed to the large losses associated with recent high-cost bank failures.*** During 1999, the FDIC reported the first annual loss for the Bank Insurance Fund since 1991. The loss was primarily the result of an uptick in unanticipated and high-cost bank failures. FDIC-insured institutions with at least 20 percent of Tier 1 capital in subprime loans accounted for 6 of the 13 bank failures that occurred between January 1998 and March 2000. Fraud and inappropriate accounting for residuals also played a role in some of these failures.²³
- ***Subprime lending remains an area of concern.*** Insured depository institutions that engage in subprime lending represent a disproportionate share of problem institutions. Of the 79 banks and thrifts on the problem bank list as of year-end 1999, 21 percent were institutions with at least 20 percent of their Tier 1 capital in subprime loans.²⁴

Agricultural Lending

- ***While a majority of agricultural institutions remain relatively strong, external conditions have put pressure on some agricultural producers.*** Many agricultural areas are experiencing low commodity prices as well as weather- and disease-related problems. Strong global competition and high worldwide production over the past several years have resulted in increasing inventories of many crops and poor prospects for a price turnaround in the near term. Moreover, in spite of record government farm payments in 1999, the U.S. Department of Agriculture projects that in the year 2000 one in four farms will not cover cash expenses, up to 20 percent of farmers will experience repayment problems, and 5 percent of farmers will be “vulnerable.”²⁵

²³ See Puwalski, Allen. FDIC Division of Insurance. Second quarter 1998. Gain-on-Sale Accounting Can Result in Unstable Capital Ratios and Volatile Earnings. *Regional Outlook*. <http://fdic01/division/doi/outlook/2q1998/atlanta/infocus1.html>.

²⁴ The problem bank list includes all insured depository institutions rated a composite “4” or “5.”

²⁵ “Vulnerable,” as defined by the U.S. Department of Agriculture Economic Research Service, applies to institutions that have debt/asset ratios above 0.40 and negative income such that they cannot meet current expenses or reduce existing indebtedness.

- ***Some signs point to growing stress for agricultural institutions.*** Forty-two percent of FDIC-supervised banks active in agricultural lending showed a moderate or sharp increase in the level of carryover debt during third quarter 1999, compared with just 26 percent during third quarter 1998.²⁶ In addition, net loan loss rates for agricultural production loans increased in 1999 to the highest level since 1991. However, at 0.32 percent, the 1999 net loss rate is just one-tenth the rate experienced during the height of the agricultural crisis of the mid-1980s.²⁷

Operational Risk

- ***Operational risks are becoming more prominent in the banking industry.*** Driven by consolidation and expansion into new product lines and markets, financial institutions are seeing an increase in operational complexity. Operational risk encompasses a host of factors not related to credit or market activities, including risks associated with processing transactions, legal liability, fraud, strategic missteps, and internal control weaknesses. Operational risks tend to be more pronounced when institutions engage in rapid growth, far-flung operations, and complex business processes.
- ***Greater attention is being paid to operational risks in the financial industry.*** Recently, analysts have noted that the pressure to meet ambitious postmerger earnings predictions can result in cost-cutting measures that jeopardize the comprehensiveness and integrity of risk-management systems. In addition, the role that fraud has played in recent bank problems and failures reinforces the importance of adequate internal controls and audit procedures. The significance of operational risks to financial institutions has been noted in industry surveys and information-sharing efforts among financial firms.²⁸ NetRisk Inc., a Greenwich, Connecticut, consulting firm, recently estimated that operational losses among financial institutions have exceeded \$40 billion over the past five years.

²⁶ September 1999. *FDIC Report on Underwriting Practices*.

²⁷ See Anderlik, John M., and Jeffrey W. Walser. FDIC Division of Insurance. Third quarter 1999. Agricultural Sector Under Stress: The 1980s and Today. *Regional Outlook*. <http://www.fdic.gov/bank/analytical/regional/ro19993q/kc/agricult.html>.

²⁸ For additional detail, see March 2000. Operational Risk: The Next Frontier. *RMA/PricewaterhouseCoopers Survey*. April 6, 2000. Tech Bytes: Banks Join Forces Against Operational Risk. *American Banker*.

uate the long-term prospects. Equity market volatility threatens to dampen consumer confidence and the ability of businesses to continue to merge, restructure, and invest.

The economy has become particularly dependent on financing delivered through the capital markets. In this more permissive financial environment, rising debt levels and greater dependence on foreign capital have emerged as financial imbalances that may contribute to future problems for the economy. Businesses and households with high levels of debt are more vulnerable to problems if interest rates continue to rise or income growth falters. Rapid credit creation by the domestic financial sector suggests the possibility of lax credit underwriting standards. Reliance on foreign capital raises concerns about what would happen to the value of the dollar and to domestic inflation if foreign investors decide to invest elsewhere.

Some analysts suggest that the New Economy, driven by increased productivity, heightened competition, and robust investment, may be characterized by longer expansions. Financial market imbalances may, however, contribute to deeper recessions and more sluggish recoveries compared with earlier business cycles.

For the banking industry, it is clear that a recession would mean slower loan growth, deteriorating credit quality, and impaired profitability. But the biggest threat to the banking industry is a recession that is tied to disruptions in the financial markets. The ready availability of financing to start new businesses and restructure old businesses has been key to the New Economy. The process by which businesses have invested and restructured in response to competition has been orderly from the perspective of bank creditors. If this process should be disrupted, we could see a much more disorderly process, with more bankruptcies and higher losses to lenders.

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

*Maureen E. Sweeney, Associate Director
Paul C. Bishop, Senior Financial Economist
Richard A. Brown, Chief, Economic and Market Trends Section
Steve Burton, Senior Banking Analyst
Steven C. Cunningham, formerly Chief, Financial Institutions Section
Alan Deaton, Economic Analyst
Diane Ellis, formerly Senior Financial Analyst
Mary L. Garner, Senior Financial Analyst
Brian Kenner, Financial Analyst
Thomas A. Murray, Senior Financial Analyst
Allen Puwalski, Senior Financial Analyst
Arlinda Sothoron, Senior Financial Analyst
Ronald Spieker, Chief, Regional Programs and Bank Analysis*

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