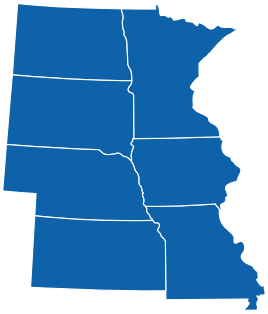
Regional Outlook

Federal Deposit Insurance Corporation — Second Quarter 2000

FDIC
Kansas City
Region



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Regional Perspectives

◆ ***The Region's Economic Conditions*—Prices for major field crops are expected to remain depressed in 2000, while livestock prices will likely improve. Farm incomes will continue to depend on the level of government payments approved this year. Performance in the Region's farm banks remains strong. Higher vacancy rates in the St. Louis office market may suggest a risk of overbuilding, as population and employment growth appear insufficient to support the current level of construction activity.** *See page 3.*

By Troy D. Osborne, Financial Analyst
Jeffrey W. Walser, Regional Economist

In Focus This Quarter

◆ ***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 13.*

By the Analysis Branch Staff

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Regional Perspectives

- **Prices for major field crops are expected to remain depressed in 2000, while livestock prices will likely improve. The Region's farm incomes will continue to depend on the level of government payments approved this year.**

- **Performance of the Region's farm banks remains strong based on aggregate earnings, capital, and delinquent loan levels.**

- **Higher vacancy rates in the St. Louis office market may suggest a risk of overbuilding, as population and employment growth appear insufficient to support the current level of construction activity.**

Agricultural Conditions Remain Depressed, with Little Improvement Expected in 2000

The cumulative effects of four consecutive years of bumper crops in major agricultural countries continue to depress prices for the major field crops. As Table 1 shows, prices for corn, wheat, and soybeans have declined dramatically since 1996. A long run of unusually favorable weather, both at home and abroad, led to the increasing accumulation of stocks, which is the most important determinant of field crop prices.

Although corn production declined last fall as farmers reduced planted acreage in response to low prices, ending stocks are forecast to remain nearly unchanged, resulting in even lower average prices this year. Similar to the situation for corn, wheat production declined in 1999, but accumulated stocks should continue to depress prices in 2000. Soybean production set another record in 1999 as farmers continued to increase planted acreage. Soybean plantings have increased steadily since the Federal Agriculture Improvement and Reform (FAIR) Act of 1996 abolished the traditional system of deficiency payments that tended to favor planting corn. Year-end soybean stocks are forecast to be comparable to last year's, resulting in prices significantly below $5 per bushel.

Table 1

Agricultural Prices Are Expected to Remain Depressed through 2000

	1996	1997	1998	1999	Proj. 2000
Corn	3.24	2.71	2.43	1.94	1.91
Soybeans	6.72	7.35	6.47	4.93	4.70
Wheat	4.55	4.30	3.38	2.65	2.50
Hogs	53.39	51.36	34.72	34.00	44.50
Cattle	65.06	66.32	61.48	65.56	69.50

Notes: Grain prices refer to crop's marketing year. Crop quantities are per bushel; livestock are per hundredweight.
Source: U.S. Department of Agriculture, April 11, 2000, World Agricultural Supply and Demand Estimates

The outlook for livestock prices is more optimistic. Pork producers reduced breeding inventories in 1999 in response to the disastrously low prices in the winter of 1998–99. As a result, pork industry analysts expect prices to rise above $40 per hundredweight for 2000. Similarly, cattle prices appear headed for improvement this year. While cattle numbers have been declining since 1996, beef production has not declined significantly until this year's forecast.

However, long-range trends in both the cattle and hog industries will likely constrain significant, permanent price improvements. During the 1990s, the hog industry consolidated rapidly, shifting partially to integrated production systems that have benefited from many cost-saving technological and managerial innovations. As production costs continue to decline, prices have tended to follow. Many industry analysts believe that this reduction in prices could be permanent, reflecting the changing structure of the industry. The cattle industry, of major importance in the Plains states, is facing long-run difficulties of another kind: beef producers continue to lose market share to the more technologically savvy poultry and pork industries. The poultry industry, and more recently the pork industry, has achieved high degrees of vertical integration, followed by advances in

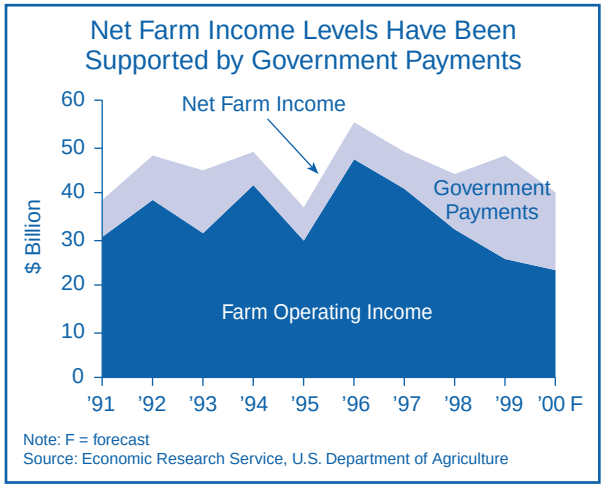
genetics and improved feeding practices. In contrast, the highly fragmented cattle industry has not adopted competitors' integrated supply chain strategies and has been slow to respond to shifting consumer tastes.

Record Government Payments Are Supporting Farmers' Incomes

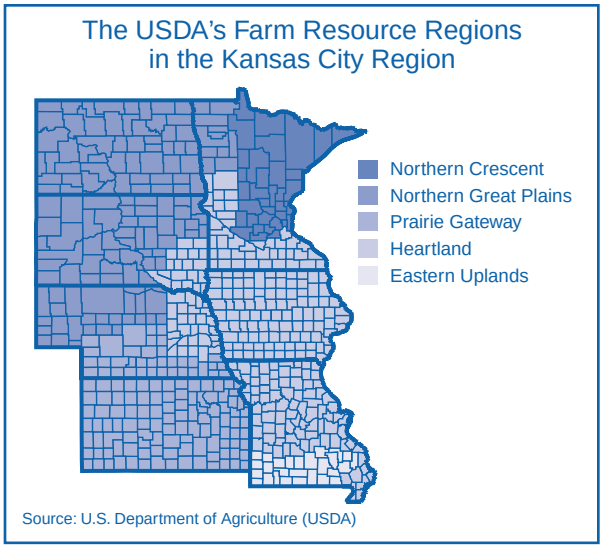
The U.S. Department of Agriculture (USDA) forecasts that U.S. net farm income will decline from $48.1 billion in 1999 to $40.4 billion in 2000. Much of the decline is based on assumptions of lower government payments in 2000. Chart 1 displays the trend of net farm income in the 1990s and the increasing importance of government payments. Despite the FAIR Act's phase-out of government support, substantial payments were made to farmers in 1998 and 1999 in the form of emergency aid and loan deficiency payments. The USDA forecast for 2000 does not assume additional emergency aid in 2000, but this cannot be ruled out in an election year, as congressional candidates from agriculture-dependent areas of the country try to appeal to their constituents.

In 1999, the USDA began to regionalize its forecasts, based on the crops and livestock grown in different parts of the country. Map 1 shows how the USDA's regional analysis applies to the Kansas City Region. The Region's seven states make up parts of five USDA regions. **North Dakota** and most of **South Dakota** are in the USDA's Northern Great Plains; Northern **Minnesota** is in the Northern Crescent; **Iowa,** most of **Missouri,** and parts of **Nebraska,** South Dakota, and

Chart 1



Map 1

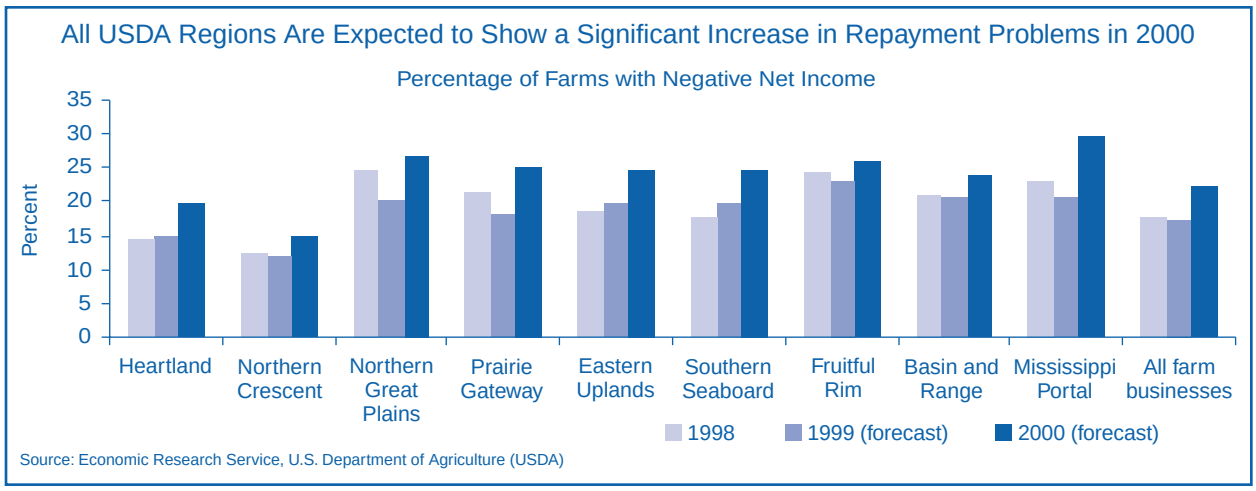


Minnesota are in the Heartland; **Kansas** and southern Nebraska are in the Prairie Gateway; and a small portion of southern Missouri is in the Eastern Uplands.

The USDA's regional forecast is shown in Chart 2, which presents the proportion of farms with negative net cash incomes, comparing 1998, 1999, and the forecast for 2000. As the chart indicates, all USDA regions are expected to show increases in farms with net losses in 2000. The Heartland, which recorded a low incidence of farms with negative net cash income in 1998, was only one of three regions to experience an increase in such farms in 1999, despite the high level of government payments. In contrast, the Northern Crescent, the Northern Great Plains, and the Prairie Gateway showed some improvement in 1999, although these regions are expected to experience an increase in the number of farms showing net losses in 2000.

Another indicator of potential problems in the Region can be found in an ***Iowa State University*** (ISU) analysis. This analysis, based on surveys of 1,076 Iowa commercial farms, assesses prospects for grain and livestock farms if commodity prices remain at 1999 levels through 2001. The study is summarized in Chart 3, which compares the financial conditions of the farms under three scenarios: (1) actual conditions that prevailed in 1997; (2) conditions forecast by ISU in its 1998 survey, which assumed 1998 commodity prices would prevail through 2000; and (3) conditions forecast by the current study. The study concludes that 49 percent of Iowa's commercial farms will be characterized by "weak" or "severe" financial conditions by year-end

CHART 2

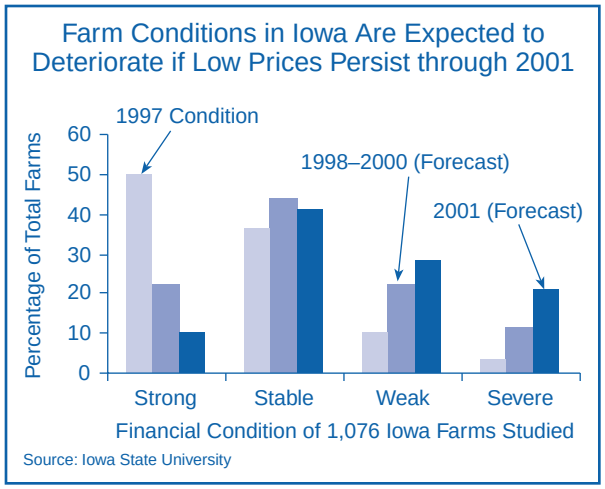


2001, even after factoring in expected governmental support. The results of the Iowa State study may also apply to other states in the Region—such as Minnesota, Nebraska, and Missouri—that depend on similar commodities.

The Future of Farm Policy Remains Uncertain

The direction of farm policy has far-reaching implications for the Region's farmers. While many farmers considered the FAIR Act a fundamental shift in farm policy, permanently reducing the federal government's role in agriculture, events since then have cast doubt on this assessment. In 1996, when high commodity prices prevailed, FAIR Act supporters argued convincingly for phasing out the traditional deficiency payments in return for ending planting restrictions. However, three years of low prices have resulted in many questioning the wisdom of the FAIR Act. The decision by Congress to appropriate emergency funds for farmers in 1998 and 1999 suggests that lawmakers continue to be willing to support the agricultural sector during periods of stress.

CHART 3



At the USDA's annual Agricultural Outlook Forum in February 2000, U.S. Secretary of Agriculture Dan Glickman suggested that the farm bill to be debated in 2002 should continue income support for farmers and broaden the federal government's role in agriculture. In particular, Secretary Glickman suggested that farm policy should be (1) directed toward supporting the incomes of farmers most in need rather than the producers of particular crops; (2) broadened to include farmers outside the traditional agricultural states; and (3) integrated with rural development policy to the benefit of all rural citizens.

The future of farm policy remains uncertain, and the next two years undoubtedly will be critical in determining the government's strategy for supporting this sector.

Reported Farm Bank Results Remain Positive

In the aggregate, as of year-end 1999, the Region's 1,279 farm banks[1] continued to report sound conditions. Earnings remained strong, as seen by the aggregate 1.18 percent return on assets (ROA) ratio, contributing to adequate reported capital levels. Record government

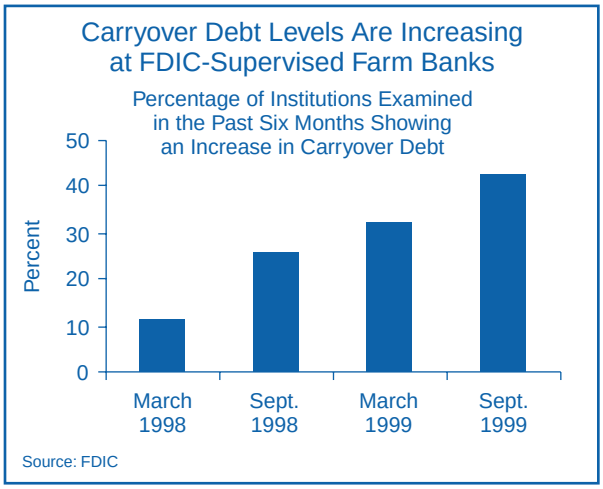
[1] Farm banks are defined by the FDIC as insured financial institutions with farm loans and loans secured by farm real estate totaling at least 25 percent of total loans.

payments to farmers partially offset the impact of low commodity prices in 1999, resulting in moderate levels of problem loans and reserve levels sufficient to provide a cushion against potential loan problems. Funding is a concern as farm banks continue to have difficulty increasing core deposits and are turning instead to noncore funds to support asset growth. Noncore funds, such as large time deposits, Federal Home Loan Bank borrowings, and brokered deposits, typically are more expensive and volatile than core deposits. As a result, increased interest expenses, coupled with more intense competition for loans, have put moderate pressure on net interest margins. Farm banks in the Region reported an aggregate net interest margin of 4.09 percent in 1999, down from 4.15 percent in 1998 and 4.25 percent in 1997.

In addition, though aggregate past-due loan ratios remain moderate, stress in the farm lending industry can be seen in increased carryover debt at farm banks. Typically, farm sector problems do not adversely affect loan portfolios for two to three years because unpaid operating loans are carried over into the next operating cycle. For example, farm banks' reported conditions in the 1980s did not deteriorate significantly until 1984, three years into the farm crisis. Historically, in prolonged crises, increases in carryover debt foreshadowed increases in delinquent loans and charge-offs. FDIC examiners evaluate farm banks' carryover debt levels, and as part of an underwriting survey completed at the end of each exam, examiners indicate whether they have identified an increase in carryover debt compared with the previous examination. As Chart 4 illustrates, examiners are reporting higher carryover debt levels at many farm banks nationally.

Another area of concern is farm banks' increasing loan-to-asset (LTA) ratio. Farm banks in the Region reported an aggregate LTA ratio of 61.6 percent at year-end 1999, up from 60.1 percent a year before and significantly higher than the 46.3 percent ratio reported at year-end 1989. ***Kansas City Regional Outlook*** (third quarter 1999) reported that a bank's LTA ratio was the most significant indicator of bank failure during the farm crisis of the 1980s. Loans typically carry more risk than other bank investments. Management that opted to increase loan volumes in the 1980s may have had a higher tolerance for risk and, as a result, relaxed underwriting standards. Current high LTA ratio levels, if considered alone, are not necessarily cause for concern. However, if accompanied by lax underwriting practices or a higher-than-average tolerance for risk, these higher levels could become more problematic.

Chart 4



The St. Louis Office Market Is Heating Up

Economic prosperity is boosting real estate activity in the **St. Louis** metropolitan real estate markets. Beneficiaries include the suburban submarkets as well as the much-beleaguered downtown submarket. At a local level, factors such as the city's relatively low cost of living, low unemployment level, and a diversifying industrial base are fueling real estate activity. Commercial construction starts in 1998 reached a peak for the decade, and residential building permits are not expected to slow. However, even during a robust real estate market, characterized by rising rental rates and increasing property values, the potential for overbuilding exists. For example, office construction vacancies climbed from 8.8 percent at the end of 1998, the lowest level in more than a decade, to 12.1 percent at June 30, 1999. This article analyzes the potential for overbuilding in the St. Louis office market and the possible effects on commercial banks operating in the metropolitan area.

Vacancy Rates

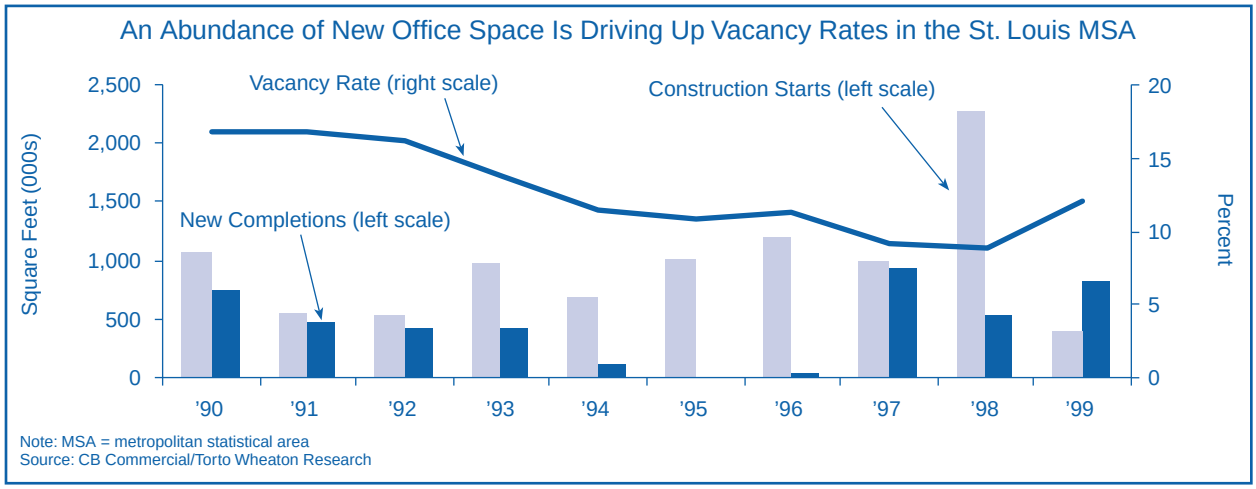
Office vacancy rates jumped during the first half of 1999, prompting concern about whether this increase is a temporary distortion or the beginning of a long-run buildup in surplus office space. Since 1989, St. Louis's office vacancy rate fell gradually from near 18 percent to below 10 percent in 1997 and 1998 (see Chart 5). Despite double-digit vacancies, the city's office vacancy rate was at or below the national average for most of the 1990s. The building boom of the 1980s created surplus office space and low rental rates, keeping new construction at low levels during the first half of the 1990s.

Vacancy rates not only represent normal turnover of rentable space, but can also reflect the existence of functionally obsolete and therefore difficult-to-rent office space. Nearly 61 percent of the office space in St. Louis is class B and class C space, compared with only 46 percent nationally.[2] Many of these buildings, especially in the downtown submarket, are old and obsolete, resulting in declining or depressed rental rates. Many of today's office users demand sophisticated lighting, wiring, and environmental standards to accommodate computer and communications technology, much of which is beyond the capacity of older office space. The costs to update and equip older office buildings to match the needs of present-day office users are often prohibitive compared with the alternatives of more recently constructed office space. St. Louis has nearly 1.8 million square feet (41 percent of all office vacancies) of vacant class B and class C space in the downtown submarket alone, the highest of all St. Louis submarkets. Typically, it takes years for the value of these older, vacant buildings to drop to a level low enough to justify renovation or conversion to a less intense use, such as residential space.

As in other metropolitan areas, St. Louis's class A office space shows lower vacancies than its class B and class C office space. In the past few years, however, the vacancy rate spread between classes has declined. At the end of 1997, 5.4 percent of class A space and 12.1 percent of class B and class C space were vacant. As of June 1999, these percentages rose to 9.4 percent and 13.8 percent, respectively.

Compared with the high office vacancy rates in the 1980s, St. Louis's average 12.1 percent rate is not yet high enough to cause investor concern, even though it is higher than the 9.5 percent national average. Some analysts suggest that the large volume of class B and class C space in the downtown area actually masks the strength of the St. Louis office market.[3] What may be of concern, however, is the concentration of vacant class B and class C office space within the downtown submarket. The vacancy rate in downtown St. Louis averages 17.0 percent, while the vacancy rate in the suburbs averages 9.4 percent. Renewed interest and investment in revitalizing downtown St. Louis may have unanticipated effects on other submarkets. To better understand the direction of the St. Louis office market and to help

Chart 5



[2] Torto Wheaton Research. Fall 1999. *Office Outlook.*

[3] National Real Estate Index, Third Quarter 1999, Metro Market Facts states that nearly 720,000 square feet is vacant in the class C inventory in the downtown and northwest county submarkets. This space accounts for 25 percent of the metropolitan area's total vacancy.

answer the question of whether it may be at risk from overbuilding, it is necessary to examine the factors that affect office space demand and supply.

Population and Employment Flows Influence Office Demand

Taken together, it does not appear that population and employment flows will be able to sustain an increase in office demand during the next few years. Without some indication that office demand is trending upward, or at least approximating the national average, any significant surplus in office space will not likely be absorbed quickly, which could place downward pressure on rents and asset values.

Population Flows

As in the majority of other metropolitan statistical areas (MSAs), St. Louis's population has flowed away from the central city and into the suburbs since the 1950s (see Table 2). But the degree to which St. Louis City has lost population has had a profound effect on economic growth and real estate development in the metropolitan area.

Older industrial central cities, such as those in St. Louis (referred to as St. Louis City), **Cleveland,** and **Detroit,** lost about half their populations between 1950 and 1990. The magnitude of St. Louis City's continuing population decline, however, is legendary among U.S. cities. Between 1950 and 1998, St. Louis City lost more than one-half million residents, or 60 percent of its population. Compared with other central cities in the nation, this is the highest percentage of population decline. During the 1990s alone, St. Louis City lost nearly 15 percent of its population. Table 2 shows the changes in population over time in St. Louis City and the effect on the larger metropolitan area's population growth. It also shows that St. Louis City's political boundary remained fixed at a relatively small size. St. Louis's current boundaries were established in 1876, when voters approved separating the city from St. Louis County. As noted in one history of the city, "Since the charter set the city-county boundary permanently, the city cannot annex new territory. While other cities can expand their territorial reach to include new and future

Table 2

The Region's Major Metropolitan Areas Have Grown despite Central City Population Declines

	1950	1960	1970	1980	1990	1998
St. Louis						
City Population (000s)	**857**	**750**	**622**	**453**	**397**	**339**
MSA Population (000s)	1,681	2,060	2,456	2,417	2,496	2,564
City/MSA Population Ratio	51.0	36.4	25.3	18.7	15.9	13.2
City Land Area (Sq. Mi.)	61	61	61	61	62	N/A
Minneapolis/St. Paul						
City Population (000s)	**833**	**796**	**744**	**641**	**641**	**609**
MSA Population (000s)	1,117	1,482	2,026	2,208	2,548	2,831
City/MSA Population Ratio	74.6	53.7	36.7	29.0	25.2	21.5
City Land Area (Sq. Mi.)	106	109	107	108	108	N/A
Kansas City, KS/MO						
City Population (000s)	**586**	**597**	**675**	**609**	**587**	**583**
MSA Population (000s)	814	1,039	0,385	1,452	1,587	1,737
City/MSA Population Ratio	72.0	57.5	48.7	41.9	37.0	33.6
City Land Area (Sq. Mi.)	99	170	373	424	419	N/A

Note: MSA = metropolitan statistical area
N/A = not available
Source: U.S. Census

industrial parks, housing developments, retail centers, and manufacturing interests, St. Louis cannot. It must attract those tax-paying entities back to the city, reversing local and national trends."[4] After World War II, central city residents and companies left the crowded living and working conditions for the less dense suburbs. As a result, St. Louis City's average population per square mile dropped from more than 14,000 in 1950 to about 5,400 in 1998. Other cities—such as **Minneapolis** and **St. Paul,** Minnesota; **Kansas City, Kansas;** and **Kansas City, Missouri**—also experienced population density declines over the same time. However, each city's political boundary was large or flexible enough to allow it to retain much of the population outflow.

St. Louis City's population decline and the resulting metropolitan area's slow population growth place this MSA at a competitive disadvantage with other MSAs, which are competing for consumers and businesses. For example, from 1990 to 1998, the St. Louis MSA grew by 2.9 percent, far below the national average growth rate of 8.7 percent. Its population growth rate also lags the Region's other large MSAs, Kansas City and Minneapolis, which grew 9.7 and 11.5 percent, respectively.

Despite significant population declines in St. Louis City, the MSA grew.[5] The severity of population losses in St. Louis City disguises the strength of its suburban markets, which is important because most new office development has taken place in the suburban submarkets. Population gains in the areas outside St. Louis City have increased demand for new office development in those areas, but they do not justify a large surplus of office space.

Employment Flows

Along with population flows, employment flows also help determine office demand. The trend in St. Louis's employment growth does not suggest that local office employment growth will equal or exceed the national growth rate over the next few years. Slow population growth has prompted some analysts to predict slower employment growth for the St. Louis MSA over the near term.

The St. Louis labor market displays a number of positive characteristics: unemployment is low, employment is diversified across a number of industries, and high-technology employment as a percentage of total employment ranks respectably among the top metropolitan areas. Despite these generally positive signs, overall job formation in St. Louis is slow relative to the rest of the nation, restraining potential economic growth. From 1990 to 1998, overall employment growth was 11.2 percent for St. Louis and 18.0 percent for the nation.

One way to measure the demand for office space is to assess the growth in office employment, a subset of total employment growth.[6] Except for 1991, St. Louis's office employment growth has been positive during the past 20 years. Office employment growth in the 1990s slowed since the previous decade. Chart 6 (next page) shows that the city's office employment growth during the 1990s tracked the national average until 1997, when it dropped below the national average. These trends suggest that St. Louis is unable to support a surplus in office space that exceeds the national average.

Slowing office employment has driven down absorption, which is the net change in physically occupied space. Holding other factors constant, such as the amount of office space per worker, if office demand is heating up, then net office absorption should also be increasing. Chart 6 shows the relationship between the nation's and St. Louis's office employment growth and net office absorption. This chart shows that net office absorption appears to lag office employment growth by about a year. The trend in net office absorption is down, except for 1997. Average net office absorption dropped from over 1.1 million square feet annually during the 1980s to about 0.6 million square feet during the 1990s. More recently, net office absorption appears to be dropping as office space supply grows more rapidly.

The Office Supply Cycle

Notwithstanding the importance of office demand factors, the office cycle is thought to be more closely tied to its own supply cycle than to market demand.[7] This contrasts with the supply of other types of real estate, such as retail space, which is more closely tied to market demand generated by the general economy. The major risk with regard to office property investment is

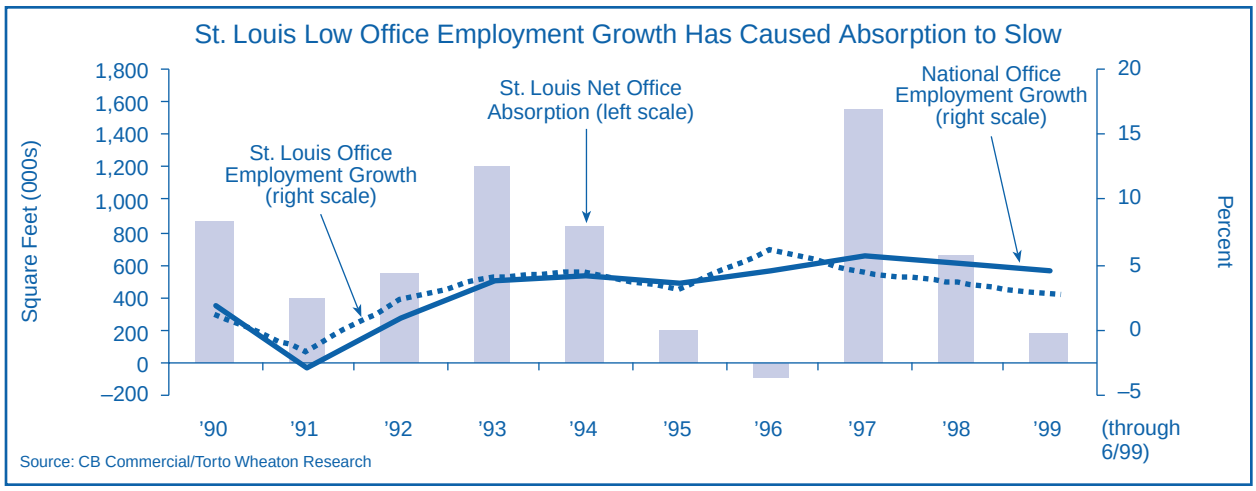
[4] The Relationship between People and Government. *St. Louis Historic Context: People and Government.* http://stlouis.missouri.org/government/heritage/history/popgov.htm

[5] Rybczynski, Witold, and Peter D. Linneman. Spring 1999. How to Save Our Shrinking Cities. *Public Interest.*

[6] DiPasquale and Wheaton. 1996. *Urban Economics and Real Estate Markets,* Englewood Cliffs, N.J., Prentice Hall, Inc., 270: "Over the long term, the growth of office space seems to match reasonably closely with the growth of office employment."

[7] Torto Wheaton Research. *Real Estate Cycles & Outlook 1999,* 2.

CHART 6



the tendency for periodic "boom-to-bust" cycles that are unrelated to general economic demand factors. The St. Louis office market seems to be going through such a period of overbuilding.

Developers of office space project market demand using current and estimated information, but these projections are far from perfect. It is difficult, if not impossible, to know with any degree of accuracy where rental rates, interest rate levels, or attractive submarkets will be in two years. It could take this long to plan and complete an office building—and several newly planned projects could be competing for expected future office demand. Consequently, this competitive pressure to build may result in an oversupply.

St. Louis office rental rates increased steadily during the 1990s, prompting developers to build and plan additional office space. Office construction starts trended upward during the second half of the 1990s, averaging nearly 1.3 million square feet annually, compared with about 0.8 million square feet during the first half of the decade (see Chart 6). In contrast, the net amount of physical office space being absorbed was greater in the first half of the 1990s and has declined in the second half of the decade. Net office absorption averaged nearly 0.8 million square feet during the first half of the decade and approximately 0.5 million square feet during the second half. ***Torto Wheaton Research*** estimates that new office completions will total 1.8 million square feet for 1999 and 2000 combined, far above the amount that net office absorption appears to be able to support. The net effect is that developers are constructing more office space than can be absorbed in the short run, resulting in a rising vacancy rate.

In addition to office construction starts, other indicators point to an increase in future office supply. For example, office construction projects in the early planning stage have grown significantly since 1995.[8] Anecdotal evidence also suggests that aggressive community revitalization efforts are encouraging the rebuilding of public infrastructure and the renovation of office space.[9]

Overbuilding could result from the rush to capitalize on rising rents. The expected increase in new completions, coupled with a significant amount of planned activity and slowing office demand, may result in an oversupply of office space. Office construction is now most robust in suburban submarkets, particularly in west, northwest, and mid-county. However, planned office construction includes significant amounts of office space downtown and in the suburbs, and the rationalization for this is not immediately apparent. Population flows would seem to justify new office development in the suburbs, rather than downtown, where population declines continue. Employment flows may warrant some amount of new office development, but perhaps not enough to sustain the present amount of planned office projects for the MSA.

[8] *FDIC Real Estate Report.* Various issues.

[9] The Downtown Now! Action Plan identifies four focus areas for revitalization and includes a program for each area. The plan calls for almost 2,700 new housing units; nearly 2 million square feet of office, retail, and other nonresidential space; a major new cultural facility; a pedestrian promenade between the Arch and the Old Courthouse; and nearly 6,000 new parking spaces.

Will the St. Louis Office Market Become Overbuilt?

Developers sometimes overshoot expected office demand, and our analysis suggests that the St. Louis office market is in such a period of overbuilding. The extent to which the St. Louis office market may become overbuilt is of concern to commercial bankers and other real estate creditors.

Torto Wheaton Research predicts that, along with a rise in vacancy rates, rents will peak during 1999 and begin a long period of decline as newly completed office space comes on line. As evidence of the boom-to-bust phenomenon, Torto Wheaton also predicts that vacancy rates will rise to 18 percent by 2002. A glut of office space can produce unanticipated competitive effects in a metropolitan area. For example, newly completed downtown office space will directly compete with suburban office space. The result might be a shift in vacancy rates between submarkets. Torto Wheaton expects office vacancies downtown and in the suburbs to converge in the double-digit range, which is a significant change from the present.

The consensus among a sample of other real estate analysts is that the St. Louis office vacancy rate will rise over the next year, but these analysts stop short of forecasting an 18 percent office vacancy.[10]

Implications for Commercial Banks

How could rising vacancies affect the credit risk levels of commercial banks[11] headquartered in St. Louis? Although office building loans are not reported separately from other commercial real estate loans, we can look at the growth in nonresidential real estate loans to determine potential areas of credit risk. For our analysis, the Kansas City and Minneapolis MSAs serve as benchmark comparisons.

Table 3 shows a snapshot of real estate loan composition at banks in the St. Louis, Minneapolis, and Kansas City metropolitan areas at December 31, 1999. Nearly three-fourths of total loans at St. Louis's commercial banks were secured by real estate, compared with about one-half of total loans for banks in Kansas City and Minneapolis. The same trend holds true for nonresidential real estate loans as a percentage of total loans.

Chart 7 (next page) displays the relationship over time of commercial real estate loans to total assets for commercial banks in the three metropolitan areas. As the chart shows, commercial banks in St. Louis have increased holdings of commercial real estate loans to a greater degree than have banks in the comparison MSAs. Since many commercial banks make loans secured by office buildings, this exposure could be problematic should overbuilding occur in this sector.

The implications of an overbuilt office market to community banks are clear. Higher office vacancies could result in projects that generate less net operating income, which translates into less cash available to service debt. In addition, expectations of slower rental rate

Table 3

St. Louis Commercial Banks Hold Large Portfolios of Commercial Real Estate Loans

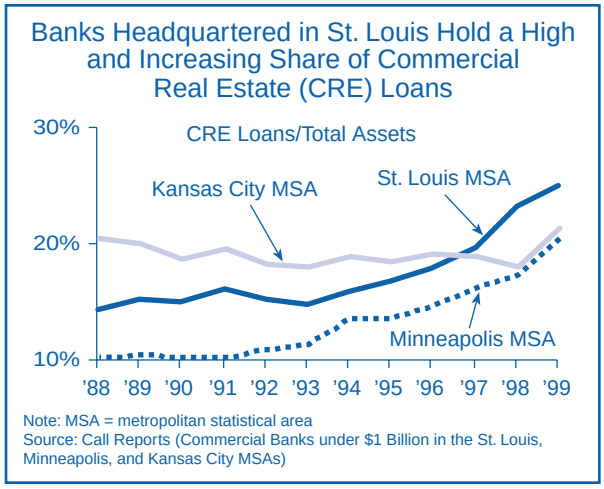
	% of Total Loans as of December 31, 1999		
	St. Louis	Minneapolis	Kansas City
All Real Estate Loans:	72.1	55.7	54.1
Commercial Real Estate	**36.5**	**30.8**	**33.3**
Multifamily Residential	2.8	1.7	1.9
1-4-Family Residential	28.3	18.1	15.7
Home Equity Loans	2.8	3.9	1.6
Farm Loans	1.7	1.1	1.6

Note: Commercial real estate loans include construction loans and loans secured by nonresidential real estate.
Source: Bank Call Reports (Commercial Banks under $1 Billion in Assets as of December 31, 1999)

[10] ReiSource America expects vacancies to climb to near 12 percent by the end of 2000. According to this group's analysis, slow population growth may actually prevent the office market from overheating. Landauer Real Estate Counselors forecasts a generally positive near-term outlook for the St. Louis office market. Landauer expects absorption, construction, and vacancies to increase between 1 and 5 percent, while rents should remain stable.

[11] Commercial banks holding less than $1 billion in assets as of December 31, 1999, and headquartered in the 11-county metropolitan statistical area (MSA). The MSA's Missouri counties include Franklin, Jefferson, Lincoln, St. Charles, St. Louis, and Warren, and the city of St. Louis. The MSA's Illinois counties include Clinton, Jersey, Madison, Monroe, and St. Clair. The asset level of $1 billion ensures that a significant proportion of each institution's business was conducted in the MSA.

CHART 7



increases or declining rents will depress the market value of office buildings that serve as collateral. Importantly, because of lending limitations, smaller commercial banks are more likely to fund class B and class C buildings, and these types of properties appear to be experiencing the greatest competitive pressure.

Troy D. Osborne, Financial Analyst
Jeffrey W. Walser, Regional Economist

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.

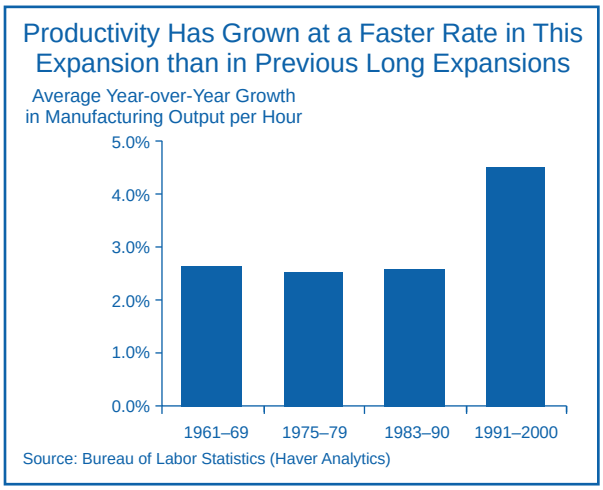
An early Wall Street description of the New Economy appeared in an article released by ***Goldman Sachs*** in January 1997.[8] It describes a number of fundamental changes in the economy—driven by global competition and advancing technology—that may permit business cycle expansions to last longer than 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. 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



[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.

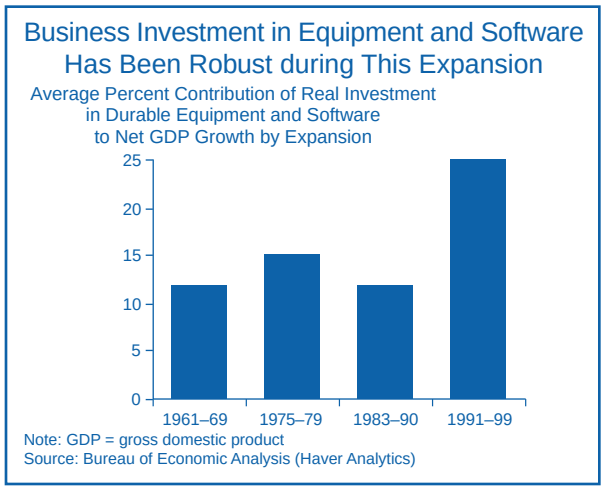
[9] FDIC Division of Research and Statistics. 1997. *History of the Eighties: Lessons for the Future, Vol. 1, An Examination of the Banking Crises of the 1980s and Early 1990s,* 16–17. http://www.fdic.gov/bank/historical/history/contents.html.

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, compared 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.

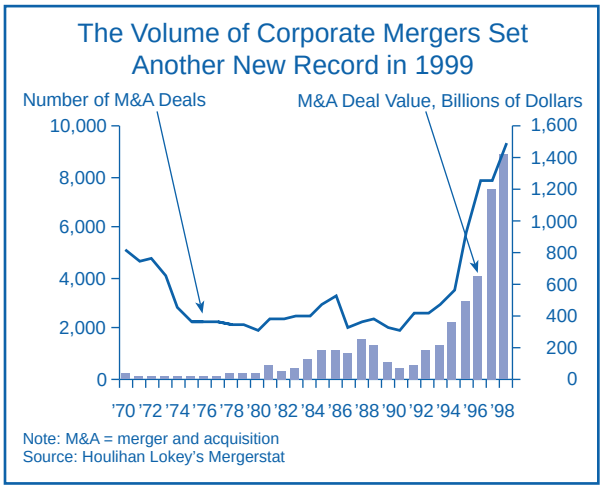
CHART 2



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 depository institutions. Higher rates of business investment

CHART 3



[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.

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

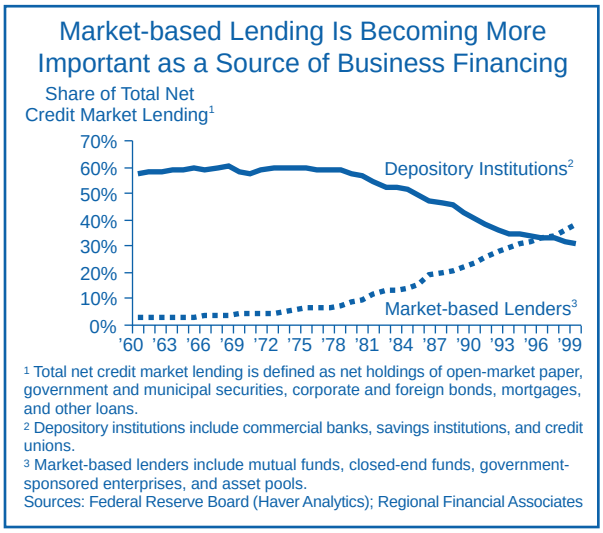
A critical factor in heightened business investment and restructuring during this expansion has been the remarkably favorable conditions in the financial markets. Financial capital has generally been readily available to business borrowers, usually on favorable terms. One factor that has held down the 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.

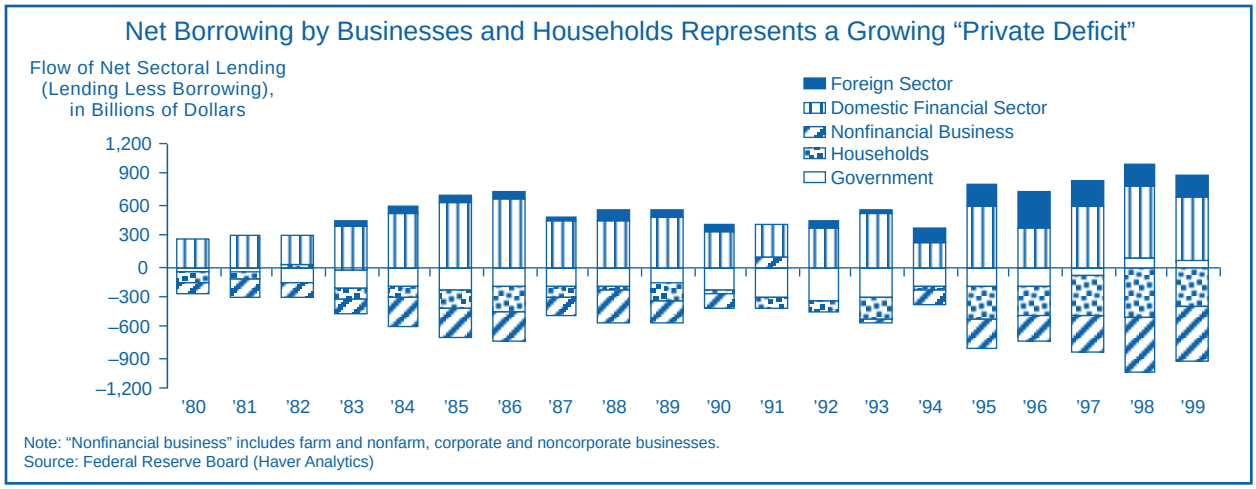
Financial Imbalances

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 declining 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 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 6

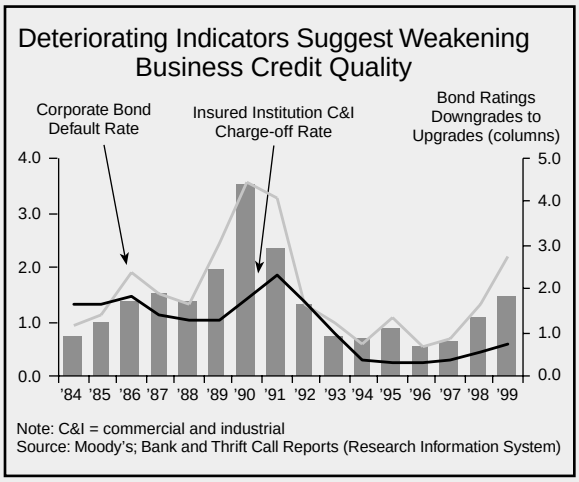
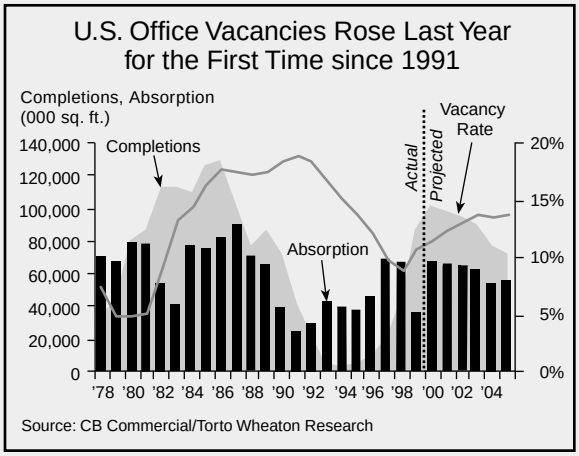


Chart 7



[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.

[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.

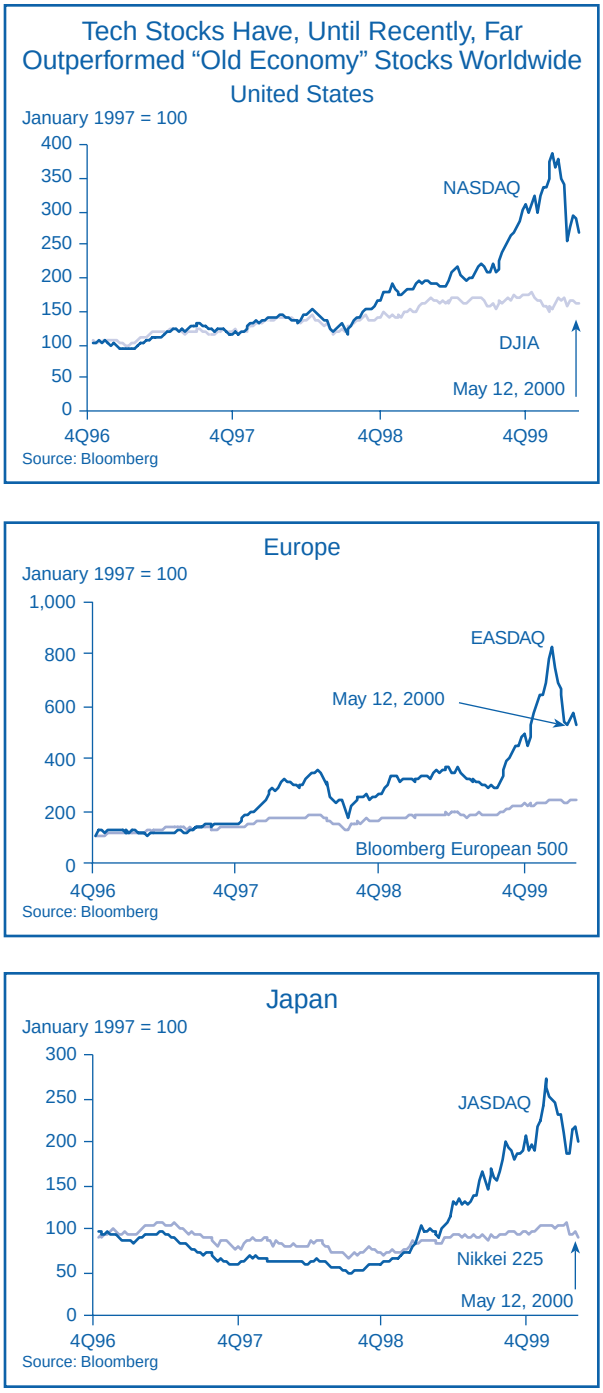
note rose from a low of 4.5 percent in October 1998 to 6.5 percent by May 2000. Analysts have cited renewed demand for credit by a recovering world economy as well as concerns about inflation arising from the increase in energy prices as factors behind the rise in long-term rates.

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, 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.

CHART 8



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

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

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

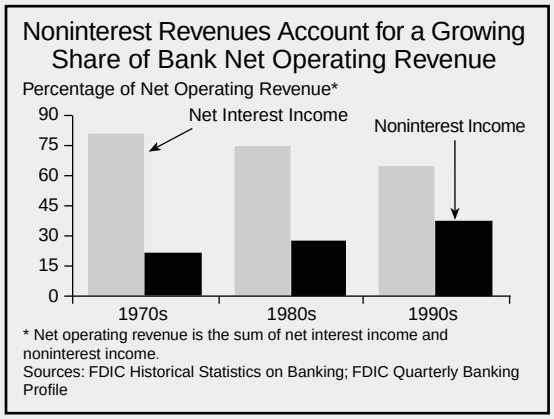
Despite the effects of rising energy costs, increasing interest rates, and equity market volatility, the U.S. economy continues to grow at a robust pace. The consensus forecast of 50 corporate economists surveyed by the May 1999 ***Blue Chip Economic Indicators*** suggests that the economy will grow 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



[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]

- ***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.

[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.

[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.

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