Regional Outlook

Federal Deposit Insurance Corporation — Fourth Quarter 2000

FDIC
Atlanta
Region

Division of Insurance

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Regional Perspectives

◆ ***A large majority of FDIC-insured commercial banks in the Atlanta Region continue to rely heavily on intermediated earnings.*** **A rate/volume analysis does not indicate a significant amount of interest rate risk during the past two years, despite large changes in the shape and level of the yield curve. In order to maintain or increase interest income, some community banks in the Atlanta Region may be assuming more credit risk as they are rapidly growing real estate and commercial and industrial lending portfolios. Interest rate risk may be on the rise as Atlanta Region community banks have increased the net duration of assets and reliance on noncore funding.** ***See page 3.***

By the Atlanta Region Staff

In Focus This Quarter

◆ ***Emerging Risks in an Aging Economic Expansion*****—This article focuses on the potential risks of current economic conditions to insured depository institutions. Although the current conditions may appear to be ideal, some imbalances are emerging: rising energy prices, tight labor markets, a less robust stock market, a large trade deficit and strong U.S. dollar, rising household debt burdens, increased corporate leverage and rising potential default risk, and, in some metropolitan areas, overheated housing and commercial real estate markets. At the same time, aggregate risk within the banking industry appears to have risen, as evidenced by softening profitability, growing reliance on noncore funding, heightened levels of interest rate risk, and increasing concentrations in traditionally higher-risk loan categories. A confluence of these trends could heighten the vulnerability of some insured institutions.** ***See page 8.***

By the Division of Insurance Staff

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REVISION:

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

Regional Perspectives

- **Despite its growing importance, noninterest or fee income represents almost 30 percent of FDIC-insured commercial bank income, and consequently, financial institutions continue to rely heavily on intermediated earnings, which may be exposed to interest rate risk.**

- **A rate/volume analysis does not indicate a significant amount of interest rate risk among the Region's community banks. However, an increase in the net duration of assets, the timing of interest rate changes, and a lag in the repricing of liabilities may understate the degree of risk.**

- **The level of interest rate risk could increase because of greater reliance on nontraditional funding sources.**

Region's Economic and Banking Conditions

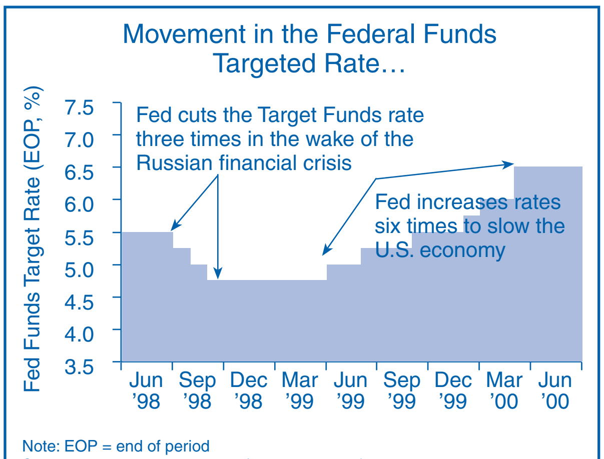
Interest Rate Risk Revisited

Despite its growing importance, noninterest or fee income represents only 30 percent of FDIC-insured commercial bank income, and consequently, financial institutions continue to rely heavily on intermediated earnings, which may be exposed to interest rate risk (IRR). If current trends in the interest rate environment persist, net interest income (NII) among Atlanta Region commercial banks may be adversely affected. Factors influencing changes in NII were analyzed as part of the ***Atlanta Regional Outlook,*** second quarter 1998. The following discussion revisits the continued importance of IRR to commercial banks, paying particular attention to rate/volume analysis.

The Changing Interest Rate Environment

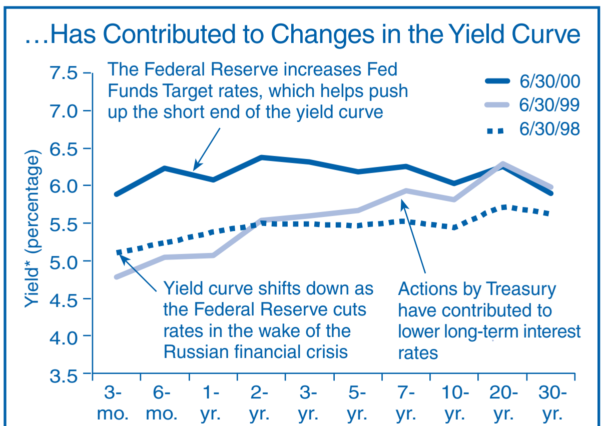
The interest rate environment faced by commercial banks has varied significantly during the past two years. Since mid-1999, the ***Federal Reserve Board*** has increased the Federal Funds target rate six times, as seen in Chart 1, to moderate the pace of economic growth. These rate hikes have contributed to a rise in short-term interest rates. Concurrently, actions by the U.S. Treasury to trim outstanding debt by repurchasing bonds have helped lower long-term interest rates. Together, the Federal Reserve and the U.S. Treasury policies have significantly affected the nation's interest rate environment, as seen by the movement in the yield curve (see Chart 2). The 5.88 percent yield on a three-month note on June 30, 2000, was 110 basis points above the year-ago mark. In contrast, 30-year rates were down 8 basis points during the same period. The rising short-term and declining long-term rates resulted in a

CHART 1



Note: EOP = end of period
Source: Federal Reserve Bank (Haver Analytics)

CHART 2



*Treasury constant maturities
Source: Federal Reserve

yield curve that was virtually flat. In fact, segments of the curve actually inverted, with the yield on the 30-year bond below all other maturities except the three-month treasury. By late September 2000, although long-term rates had recovered slightly, the overall slope of the yield curve remained negative. A financial market characterized by a *prolonged* flat or inverted yield curve typically is not considered the most conducive market for financial intermediaries, as they traditionally earn a positive spread by borrowing at lower rates at the short end of the curve and lending or investing at higher rates at the long end.

Rate/Volume Analysis

As discussed in ***Atlanta Regional Outlook,*** second quarter 1998, rate/volume analysis is "...one effective *ex post* approach to measuring interest rate risk." A bank's interest income is based on two components: the average volume of earning assets and the average yield. On the other side of the balance sheet, interest expense results from the average volume of interest-bearing liabilities and the average cost. Changes in interest income and interest expense can be determined through a rate/volume analysis, which isolates these components' effects on NII over two time intervals.

For Atlanta Region commercial banks, the rate/volume analysis suggests a minimal amount of IRR arising from changes in the yield curve during the past year. The analysis was applied to community bank data,[1] and the results are presented in Table 1 for two four-quarter trailing time periods ending second-quarter 2000 and second-quarter 1999. This group, on average, experienced an increase in NII, and the net interest spread expanded from 3.73 percent to 3.83 percent. Asset yields rose faster than funding costs, in part because of the influence of rates. However, the majority of the increase in yield occurred in the investment portfolio, which represents a smaller share of earning assets, while the yield on the loan portfolio actually declined. Conversely, total funding costs remained virtually the same; however, notable differences exist among the various funding categories. The cost of historically rate-sensitive or noncore categories—large time deposits, borrowed funds, and Federal Funds purchased—remained virtually unchanged. Core funding that normally is assumed to be less rate sensitive—small time deposits, savings, demand and money market accounts—experienced a decline in cost except for money market accounts, which saw the cost rise by 12 basis points. Despite the lower cost of most funding sources, total funding costs increased nominally because of rapid growth in noncore funding. These noncore sources increased 25 percent while total interest-bearing funds grew only 11.7 percent. As a result, noncore funding now represents a substantial and growing share of interest-bearing funding sources for community banks in the Atlanta Region at 24.1 percent, which may increase the sensitivity of net interest income to fluctuations in interest rates.

In order to maintain or grow interest income, some community banks in the Atlanta Region may be assuming more credit risk. The greatest contributor to the growth in interest income was a significant increase in the volume of real estate and commercial and industrial (C&I) loans. During the past two years, real estate and C&I loans grew by 17.7 percent and 10.9 percent, respectively. Moreover, real estate loans as a share of earning assets rose from 38.8 percent to 41.3 percent. In contrast, at community banks nationwide, real estate loans grew 8.1 percent to 33.8 percent of earning assets, while C&I loans increased 3.8 percent to 17.6 percent of earning assets. At community banks in the Region, income from real estate lending occurred at lower marginal rates as the yield declined by 8 basis points to 9.0 percent while most other asset yields were increasing. Construction and development lending, traditionally considered a higher-risk form of lending, is growing much faster among the Region's community banks compared with their national peers. As a result, the decline in yield may suggest that lenders are not being adequately compensated on a risk-adjusted basis.

Differences are evident when the rate/volume analysis is applied to community banks operating in various areas in the Atlanta Region. As seen in Table 2 (page 7), the yield or cost, composition, and growth rates in earning assets and funding at community banks vary substantially by location. Community banks headquartered in rural areas or nonmetropolitan statistical areas (MSAs) are characterized by yields and costs closer to the regional average, lower levels of lending, less reliance on noncore funding sources, and slower growth in funding sources. In contrast, community banks headquartered in urban areas or MSAs typically exhibit above-average yields and costs, higher levels of lending,

[1] Includes Atlanta Region commercial banks with assets between $25 million and $1 billion. The data set contains 763 banks and excludes de novos (banks in operation less than three years), specialty banks, and banks involved in merger and acquisition activity.

Table 1

Rate/Volume Analysis for Atlanta Region Community Banks* Depicts a Minimal Amount of Interest Rate Risk

	3Q98–2Q99			3Q99–2Q00			Rate/Volume Analysis			
	Average Balance	Income/ Cost	Rate	Average Balance	Income/ Cost	Rate	Volume	Rate	Volume/ Rate	Total
Assets										
Interest-Earning Assets										
Short-Term Investments:										
Interest-Bearing Deposits	1,116,880	63,841	5.72%	975,663	58,867	6.03%	(8,072)	3,546	(448)	(4,974)
U.S. Government Securities	19,947,524	1,243,345	6.23%	21,486,291	1,387,757	6.46%	95,913	45,026	3,473	144,412
Securities by Other Subdivisions	4,379,058	226,332	5.17%	4,774,000	242,336	5.08%	20,413	(4,044)	(365)	16,004
Equity Securities (incl. Mutual Funds)	503,385	34,857	6.92%	561,981	39,581	7.04%	4,057	597	69	4,724
Fed Funds Sold/ Repurchased	4,870,634	246,528	5.06%	3,572,473	201,875	5.65%	(65,702)	28,696	(7,648)	(44,653)
Loans										
Real Estate	37,016,323	3,359,299	9.08%	43,584,527	3,922,000	9.00%	596,077	(28,346)	(5,030)	562,701
Commercial & Industrial	16,285,653	1,513,147	9.29%	18,053,813	1,688,982	9.36%	164,285	10,419	1,131	175,835
Consumer	9,948,079	1,046,077	10.52%	10,815,864	1,112,113	10.28%	91,251	(23,192)	(2,023)	66,036
Total Loans	64,486,267	6,019,814	9.34%	73,688,100	6,824,156	9.26%	858,994	(47,827)	(6,825)	804,342
Lease Financing Receivables	134,323	9,702	7.22%	247,691	16,530	6.67%	8,188	(738)	(623)	6,828
Total Interest-Earning Assets	95,438,070	7,844,419	8.22%	105,306,297	8,771,102	8.33%	913,792	25,257	(12,365)	926,683
Liabilities										
Interest-Bearing Liabilities										
Interest-Bearing Deposits										
Transaction Accounts	10,941,968	265,282	2.42%	11,416,696	270,363	2.37%	11,510	(6,161)	(267)	5,081
Nontransaction Accounts										
MMDAs	9,968,756	344,476	3.46%	11,575,537	414,108	3.58%	55,523	12,150	1,958	69,632
Other Savings	9,179,718	267,160	2.91%	10,147,146	274,727	2.71%	28,155	(18,625)	(1,963)	7,567
Time Deposits > $100k	12,486,427	686,411	5.50%	14,349,212	787,906	5.49%	102,402	(789)	(118)	101,495
Time Deposits All Other	31,312,804	1,704,378	5.44%	33,109,769	1,773,745	5.36%	97,810	(26,889)	(1,544)	69,367
Fed Funds	2,362,782	109,252	4.62%	3,401,392	180,877	5.32%	48,024	16,394	7,207	71,625
Other Borrowed Money	1,931,944	132,544	6.86%	3,319,962	227,212	6.84%	95,227	(325)	(234)	94,668
Total Interest-Bearing Liabilities	78,184,398	3,509,503	4.49%	87,319,713	3,928,938	4.50%	438,651	(24,256)	5,040	419,435
Change in Net Interest Income	17,253,672	4,334,916	3.73%	17,986,584	4,842,164	3.83%	475,140	49,513	(17,405)	507,248

* Includes Atlanta Region commercial banks with assets between $25 million and $1 billion. The data set contains 763 banks and excludes de novos, specialty banks, or banks involved in merger and acquisition activity.
MMDA = money market deposit accounts
Source: Bank Call Reports

greater reliance on noncore funding, and more rapid growth in funding, particularly noncore funding. The majority of community banks in the six metropolitan areas detailed in Table 2 rapidly expanded real estate lending and use of noncore funding. As a result, funding costs rose more rapidly than the regional average, and community banks in **Atlanta, Birmingham, Raleigh,** and Southwest **Florida** have funding costs well above average. On the yield side, community banks in Atlanta are well above the regional average, while community banks in the other five MSAs approximate the regional average. Despite the vast differences in structure (yield and cost levels and balance sheet composition) for community banks in these locations, changes in rate did not exert a significant influence on the change in NII. Furthermore, all areas relied greatly on an expansion in real estate lending to support interest income. However, the differences in structure, particularly the greater reliance on noncore funding by urban community banks, could heighten levels of IRR. In any event, the growing use of noncore funding could increase the complexity of IRR management, as these sources typically reprice differently than other sources, a concept referred to as basis risk.

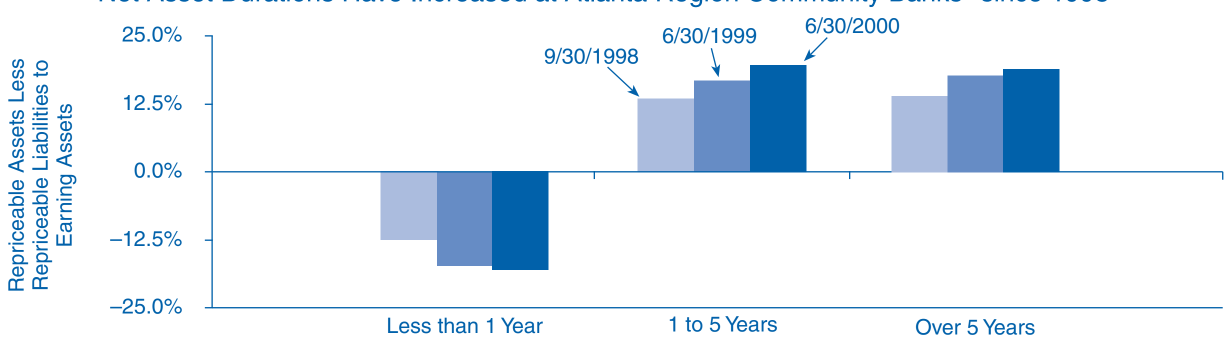
Although this analysis of past performance does not identify a significant amount of IRR, an increase in the net duration of assets, the timing of changes in the yield curve, and a lag in repricing of assets or liabilities could mask the degree of IRR. Community banks appear more susceptible to IRR as the net duration of assets and liabilities has extended. As seen in Chart 3, since the third quarter of 1998, the net duration of assets (repriceable assets less repriceable liabilities) with a repricing period of more than one year has increased from 27.2 percent of earning assets to 38.7 percent. Moreover, funding with a repricing period of less than one year has increased from 53.9 percent of earning assets to 65.9 percent. The timing of interest rate changes in tandem with the repricing structure of the assets and liabilities can significantly affect the level of IRR. Specifically, the yield curve did not shift upward and twist until early 2000. As a result, we expect the spread to expand during this period, because community banks typically hold significantly larger volumes of immediately repriceable assets (i.e., adjustable-rate loans) than liabilities. As liabilities reprice, we expect the net interest spread to narrow, given the interest rate environment. A quarterly rate/volume analysis, in fact, supports the lag effect, as the spread peaked at 4.08 percent during fourth quarter 1999 and subsequently declined to 3.99 percent by second quarter 2000. Therefore, the level of IRR risk may be greater than the long-term rate/volume analysis suggests, and margins may be under more pressure going forward.

Risks and Implications

While the rate/volume analysis has yet to show a material variation in NII, the full effect of changes in the yield curve probably has not manifested because of a lag in the repricing of liabilities. If the level and shape of the current yield curve remain constant, net interest spreads are likely to narrow over time. The substantial growth in longer duration assets (loans) and shorter duration liabilities (noncore funds) may be beneficial if

CHART 3

Net Asset Durations Have Increased at Atlanta Region Community Banks* since 1998



* Includes Atlanta Region commercial banks with assets between $25 million and $1 billion. The data set contains 763 banks and excludes banks open less than three years, specialty banks, and banks involved in merger and acquisition activity. Data are as of June 30, 2000. Yield or cost and share data is for trailing four quarters, and growth rates are based on trailing four-quarter averages.
Source: Bank Call Reports

TABLE 2

THE YIELD OR COST, COMPOSITION, AND GROWTH RATE OF EARNING ASSETS AND FUNDING VARY BY LOCATION FOR COMMUNITY BANKS[1] IN THE ATLANTA REGION

		SUBMARKET						
	REGION	ATLANTA	BIRMINGHAM	GREENVILLE–SPARTANBURG	RALEIGH	TAMPA	SW FLORIDA[2]	NON-MSA
YIELD/COST								
REAL ESTATE LOANS	9.00	9.95	9.13	8.77	9.39	8.81	8.27	9.04
C&I LOANS	9.36	9.56	8.43	9.19	8.91	9.50	8.86	9.33
TOTAL LOANS	9.26	9.83	9.31	9.07	9.38	9.05	8.61	9.39
EARNING ASSETS	8.33	8.85	8.55	8.23	8.48	8.16	8.08	8.37
INTEREST-BEARING FUNDS	4.50	4.78	4.98	4.58	4.04	4.13	4.64	4.57
NET INTEREST SPREAD	3.83	4.07	3.57	3.65	4.44	4.03	3.44	3.80
SHARE OF EARNING ASSETS								
REAL ESTATE LOANS	41.4	43.2	44.9	42.5	49.9	47.8	35.9	40.5
C&I LOANS	17.1	17.8	15.1	23.2	16.9	19.8	24.8	16.6
TOTAL LOANS	70.0	73.0	74.9	73.5	75.0	71.2	76.2	68.9
SHARE FUNDS								
CORE DEPOSITS	75.9	67.9	68.6	74.2	80.1	81.5	75.6	77.6
NONCORE SOURCES	24.1	32.1	31.4	25.8	19.1	18.5	24.5	22.4
GROWTH RATE								
REAL ESTATE LOANS	17.7	25.5	23.5	20.8	15.7	28.2	25.6	13.4
TOTAL LOANS	14.3	23.6	3.5	21.8	17.5	26.4	22.2	11.0
CORE DEPOSITS[3]	7.9	12.1	12.3	10.7	12.7	14.4	15.1	5.4
NONCORE SOURCES[4]	25.6	41.6	35.9	32.6	27.9	43.0	40.5	23.1
ALL FUNDING SOURCES	11.7	20.2	18.8	15.7	15.3	18.8	20.5	8.9

[1] INCLUDES ATLANTA REGION COMMERCIAL BANKS WITH ASSETS BETWEEN $25 MILLION AND $1 BILLION. THE DATA SET CONTAINS 763 BANKS AND EXCLUDES BANKS OPEN LESS THAN THREE YEARS, SPECIALTY BANKS, OR BANKS INVOLVED IN MERGER AND ACQUISITION ACTIVITY. DATA ARE AS OF JUNE 30, 2000. YIELD OR COST AND SHARE DATA ARE FOR TRAILING FOUR QUARTERS, AND GROWTH RATES ARE BASED ON TRAILING FOUR-QUARTER AVERAGES.
[2] INCLUDES SARASOTA–BRADENTON, PUNTA GORDA, FORT MYERS–CAPE CORAL, AND NAPLES METROPOLITAN STATISTICAL AREA (MSA).
[3] INCLUDES TIME DEPOSITS UNDER $100,000, NEGOTIABLE ORDER OF WITHDRAWAL (NOW), SAVINGS, AND MONEY MARKET ACCOUNTS.
[4] INCLUDES TIME DEPOSITS OVER $100,000, FEDERAL FUNDS PURCHASED, AND OTHER BORROWED MONEY.
C&I = COMMERCIAL AND INDUSTRIAL

short-term rates fall and the yield curve becomes positively sloped. However, there is no guarantee that this will happen. For example, a recent survey of economists by ***USA Today***[2] shows that two-thirds expected lower interest rates during the first half of 2001. The article, however, pointed out that a number of economists believe that indications of a soft landing may be premature and that the Federal Reserve actually may have to hike interest rates or leave them unchanged in 2001 to combat the potential of rising inflation. In short, as is often the case, it is not clear which way interest rates will move; as a result, extending long-term assets and shortening liabilities is a wager that could easily have a heavy cost.

—Atlanta Region Staff

[2] September 29, 2000. Interest rates likely to be cut next year, survey says. *USA Today,* 1B.

Emerging Risks in an Aging Economic Expansion

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

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

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

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

Imbalances Are Appearing amid a Healthy Macroeconomic Environment

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

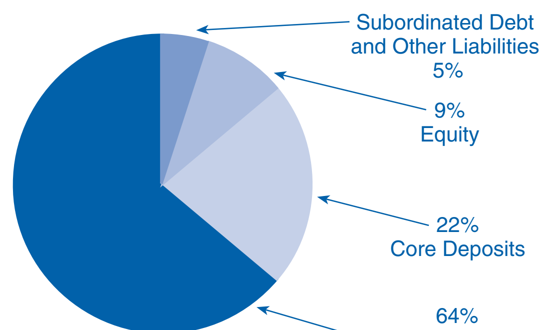
Overall industry profitability is beginning to soften, led primarily by rising commercial loan losses at large institutions and declining net interest margins in institutions of all sizes. Credit card loss rates, which had been steadily falling since late 1997, have stalled in recent quarters, suggesting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

Funding Patterns Heighten Liquidity Concerns

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

CHART 1

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



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

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

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

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

Increasing Levels of Interest Rate Risk Challenge Some Institutions

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

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

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

CHART 2

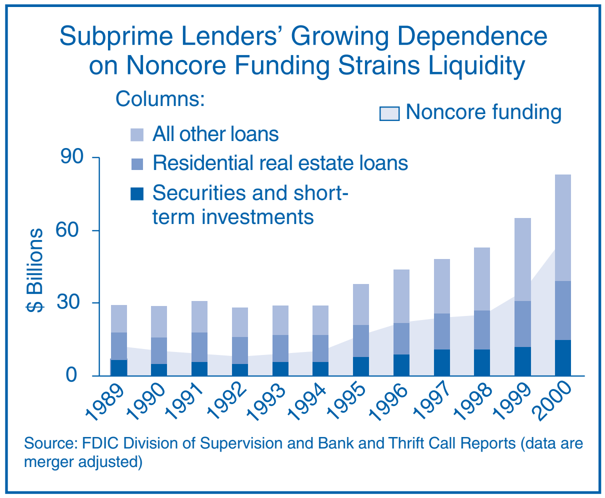
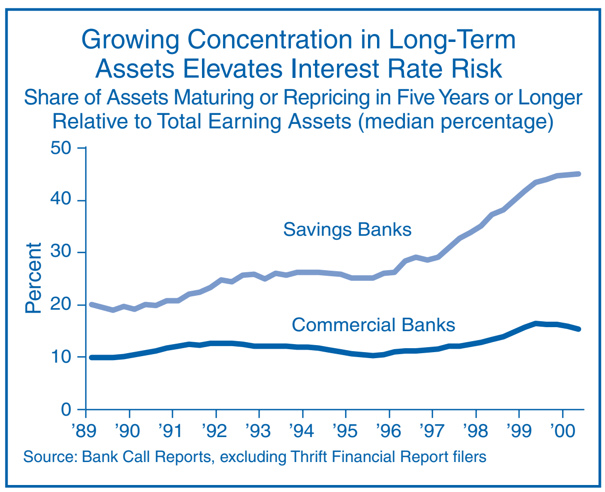


CHART 3



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

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

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

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

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

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

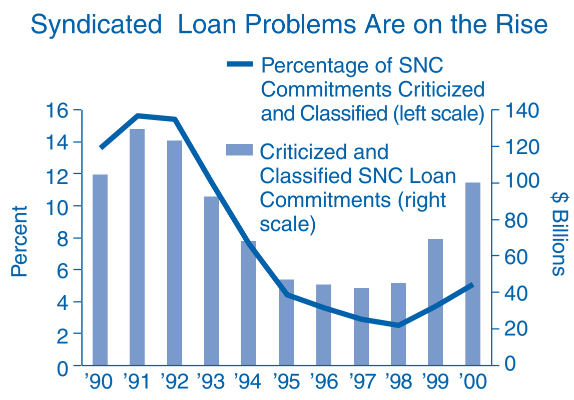
The Rising Level of Problem Business Loans Is Centered in Large Banks

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

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

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

CHART 4



Note: C&I = commercial and industrial; SNC = shared national credit
Source: Shared National Credit Program

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

Industry Sector Weaknesses

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

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

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

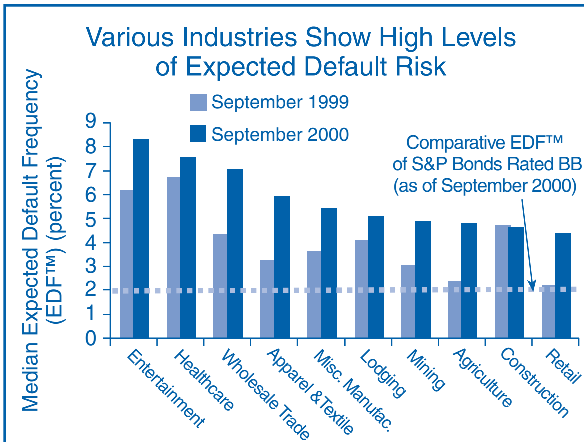
KMV's model is used by many lenders to monitor and evaluate obligor risk and credit risk trends. Applied to the analysis of industries, the output of KMV's model is just one of a number of indicators that suggest weaknesses in certain industry sectors.

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

Rising Corporate Debt Burdens

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

CHART 5



Source: Credit Monitor™ ©2000, KMV LLC, all rights reserved

Seasoning of 1997–1998 Vintage Loans

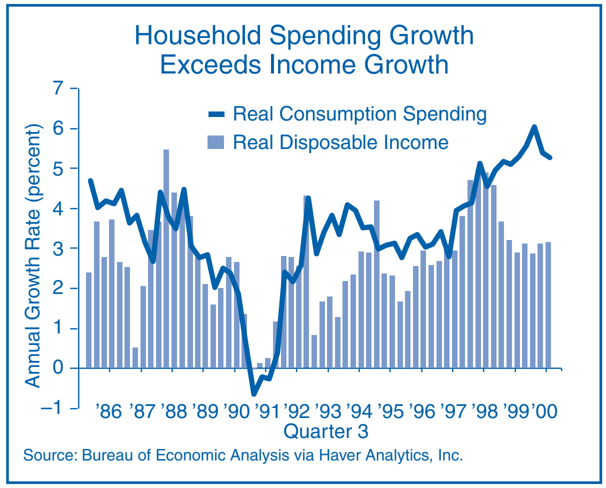
Results of recent supervisory surveys suggest that banks are tightening terms and conditions on loans to small-, middle-, and large-market obligors. However, this tightening follows a relaxation of standards in prior years that has contributed to a heightened level of risk in banks' loan portfolios.[4]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

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

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

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

CHART 6



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

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

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

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

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

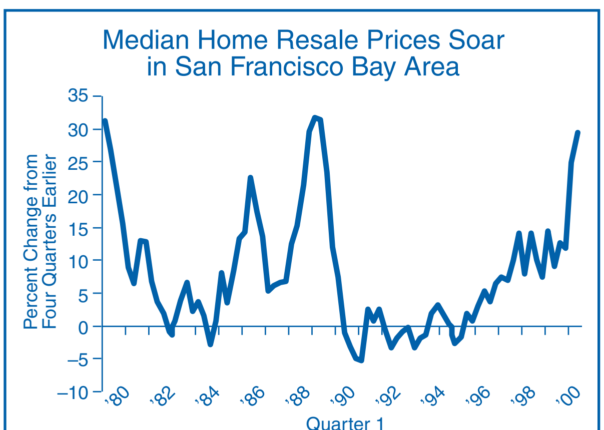
enhanced by gains in wealth rather than in income. Even so, similar surges in home resale prices in the past often were not sustainable. The subsequent years of stagnant or falling collateral values caused financial stress among some homeowners and their lenders. Further concern about residential real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

Construction and Development Loan Growth Is Accelerating

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

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

CHART 7



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

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

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

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

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

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

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

TABLE 1

HIGH C&D LOAN EXPOSURE APPEARS IN VARIOUS MSAS		
MSAS WITH 15 OR MORE NONSPECIALIZED COMMUNITY INSTITUTIONS*	SHARE (%) OF INSTITUTIONS* WITH C&D CONCENTRATIONS > OR = 100% OF TIER 1 CAPITAL	AGGREGATE C&D LOANS RELATIVE TO AGGREGATE TIER 1 CAPITAL (AS %) IN THIS MSA*
ATLANTA, GA	**65**	**156**
PHOENIX–MESA, AZ	**56**	**131**
MEMPHIS, TN–AR–MS	52	154
PORTLAND–VANCOUVER, OR–WA	**47**	**146**
OAKLAND, CA	47	163
NASHVILLE, TN	44	103
RIVERSIDE–SAN BERNARDINO, CA	42	110
SAN DIEGO, CA	41	90
GRAND RAPIDS–MUSKEGON–HOLLAND, MI	40	81
SEATTLE–BELLEVUE–EVERETT, WA	**39**	**98**
SALT LAKE CITY–OGDEN, UT	**38**	**56**
FORT WORTH–ARLINGTON, TX	**38**	**110**
DALLAS, TX	**36**	**95**
LAS VEGAS, NV–AZ	**35**	**119**
LEXINGTON, KY	34	80
DENVER, CO	**33**	**113**

*SAMPLE INCLUDES INSTITUTIONS WITH TOTAL ASSETS UNDER $1 BILLION THAT ARE NOT SPECIALTY INSTITUTIONS SUCH AS CREDIT CARD OR TRUST BANKS.
NOTE: BOLDFACE INDICATES MAJOR MSAS IDENTIFIED AT RISK FOR EXCESS COMMERCIAL REAL ESTATE CONSTRUCTION IN REGIONAL OUTLOOK, THIRD QUARTER 2000.
C&D = CONSTRUCTION AND DEVELOPMENT, MSA = METROPOLITAN STATISTICAL AREA
SOURCE: BANK AND THRIFT CALL REPORTS FOR JUNE 30, 2000

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

Farm Sector Challenges Continue

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

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

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

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

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

Summary

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

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

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