
◆ Regional Outlook ◆

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In Focus This Quarter

◆ ***Gain-on-Sale Accounting Can Result in Unstable Capital Ratios and Volatile Earnings***—The accounting for transferring and servicing financial assets causes asset sellers, particularly high-growth lenders, to recognize significant noncash income related to retained economic interests in the sold assets. This is true whether a company securitizes its own assets or sells its assets as a conduit to another securitizer. Values are often driven by management assumptions about future performance of the sold assets. Major writedowns of gain-on-sale assets by some finance and mortgage companies underscore the importance of careful scrutiny of these assumptions by banks and their supervisors. *See page 3.*

By Allen Puwalski

◆ ***How Will the Expansion End?***—Analysts are now focusing on when and how the current expansion will end. Although no one can accurately predict when a recession will begin, two possible scenarios have emerged. Each scenario has important implications for lenders as they prepare for the possibility of slower economic growth or recession. *See page 7.*

By Paul C. Bishop

◆ ***Trends Affecting the Allowance for Loan and Lease Losses***—In today's environment, in which loan availability is abundant, growth is strong, and competition is fierce, some industry leaders and regulators have expressed concern about the loosening of underwriting standards and greater risk in bank loan portfolios. At the same time, the allowance for loan and lease losses (ALLL) relative to total loans at many insured institutions is declining. As the economic expansion reaches an advanced age, an important question for insured institutions is whether their ALLLs adequately reflect the risks associated with changing industry practices. *See page 11.*

By Andrea Bazemore

Regular Features

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By Gary C. Zimmerman

◆ ***Regional Banking***—Banks and thrifts in the San Francisco Region posted their strongest performance in more than a decade...farm lending faces risks from the loss of federal price supports and weakened demand from Asia...some new banks are concentrating their lending in high-risk real estate lending. *See page 22.*

By Catherine I. Phillips-Olsen, Roger Stevens

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Gain-on-Sale Accounting Can Result in Unstable Capital Ratios and Volatile Earnings

- **Gains generated from asset sales under SFAS 125 rely on management assumptions about the lifetime performance of the assets sold and may not materialize in cash if the assumptions prove incorrect.**
- **Gain-on-sale accounting has been most significant to securitizers, but nonsecuritizers can and do retain economic interests that give rise to significant gain-on-sale assets.**
- **Finance companies seeking to shift attention from gain-on-sale assumptions may find willing bank correspondents.**
- **The rating services have modified capital and earnings analysis in order to lessen what they consider distortions caused by SFAS 125.**

Statement of Financial Accounting Standards No. 125 (SFAS 125), Accounting for Transfers and Servicing of Financial Assets and Extinguishing of Liabilities, causes asset sellers, particularly high-growth lenders, to recognize significant noncash income. Applying SFAS 125, which became effective on January 1, 1997, can give rise to significant noncash gains and related assets if an economic interest is retained in assets sold. The value of retained interests in assets sold is quantified on the basis of management's assumptions about future charge-off rates, repayment rates, and the rate used to discount the expected cash flows from the loans sold. Because the value of these assets changes when actual performance deviates from the assumptions, the quality of earnings, capital, and liquidity for a lender that relies significantly on gains on sale must be considered carefully.

The recent writedowns of interest-only (IO) assets by a few major finance companies have led to a higher level of scrutiny of companies whose financial statements are influenced significantly by gain-on-sale accounting. The Securities and Exchange Commission has recently increased its scrutiny of publicly traded companies that use gain-on-sale accounting, and it may soon require assumptions regarding defaults, prepayments, and discount rates to be disclosed in financial statements. The same companies that enjoyed soaring stock perfor-

mance thanks to high earnings growth caused by gain-on-sale accounting have seen their stock values tumble as they have had to write down their gain-on-sale-related assets.

Several major credit rating companies have recognized the significant effect of gain-on-sale accounting under SFAS 125 on interpreting financial statements. These companies have issued comments or reports dealing with SFAS 125's effect on the quality of earnings and capital of the companies they rate and how they adjust their analysis as a result. The consensus of these papers is that gain-on-sale accounting for companies that securitize often results in significantly higher reported earnings and equity compared to balance sheet lenders—without, in many cases, materially changing the underlying economics or credit risk to the originator of the assets.¹ Generally, the rating services have modified capital and earnings analysis in order to lessen what they consider distortions caused by SFAS 125.

There Are Risks Associated with Gain-on-Sale Accounting

The asset booked in connection with an SFAS 125 loan sale is an IO strip that represents the present value of future excess spread cash flows generated by the transferred assets. Generally, asset-backed securitizations, including some classified as mortgage-backed securities, are structured so that each month the expected cash flows from the underlying assets will be sufficient to pay the investor coupon, the trust expenses, the servicing fee, and net charge-offs. The cash flow that the underlying assets will generate each month cannot be known with certainty because the underlying asset may allow for variable principal payments (e.g., credit card accounts), or the borrowers may default. Securitizations are structured so that there is enough cushion between the *expected* cash flows and the required payments and

¹ Duff & Phelps Credit Rating Company, "Securitization and Corporate Credit Risk." *Special Report Financial Services Industry*, July 1997; T. E. Foley and M. R. Foley, "Alternative Financial Ratios for the Effects of Securitization Tools for Analysis." *Moody's Special Comment*, September 1997; H. L. Moehlman, R. W. Merritt, and N. E. Stroker, "Capital Implications of Securitization and Effect of SFAS 125." *Fitch Research*, September 16, 1997.

expected charge-offs to absorb fluctuations in actual cash flows and actual charge-offs. This cushion is excess spread. As actual cash flows vary from projections, so does the excess spread generated.

According to SFAS 125, when a company sells assets and retains the right to future excess spread cash flows, the calculation of the gain on the sale includes the capitalization of this right. In many transactions, the gain on sale consists entirely of the fair value of the IO strip that represents this right—none of which is necessarily received in cash. In addition, with many transactions, cash receipt is further delayed while cash flows go to fund the spread account, which is analogous to an internal loan loss reserve.

SFAS 125 states that quoted market prices in active markets are the best evidence of fair value and should be used whenever available. Although there have been some sales of these IO strips, the number of sales is not yet sufficient to constitute an active market. When market prices are not available, SFAS 125 states that the estimate of fair value should be based on the best information available. In practice, fair value of the excess spread is determined by present valuing the expected cash flows using a discounted cash flow model.

The value of the right to future cash flows is determined on the basis of management's assumptions about the charge-off rate, the average life of loans, and the rate used to discount the cash flows. *These input assumptions drive the model results and, therefore, the magnitude of the gain.* The stability of the value of the IO will depend greatly on the extent to which the input assumptions accurately describe the pool performance over the life of the transferred assets. Changes in economic or market conditions that were not anticipated in the initial cash-flow assumptions will likely cause the pool of loans to perform differently than initially projected.

Gain-on-sale accounting is significant to securitizers. To illustrate the significance of the IO account to a securitizer's reported income, consider one major subprime lender. During fiscal year 1997, this company's IO asset grew by over \$141 million. Despite a \$28 million writedown of the IO asset, the net growth of the asset constituted over half of total revenue and over eight times net income. The revaluation of the IO was necessitated by higher-than-expected prepayment rates.

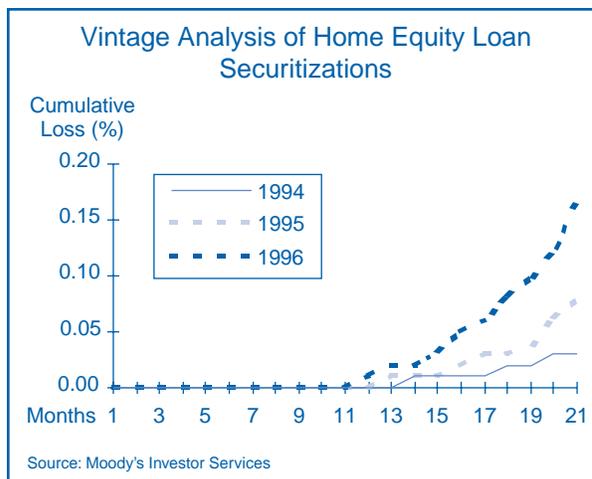
Current market conditions were not anticipated by many companies that benefited from high earnings

related to gain-on-sale accounting. Several other major securitizers have reduced the carrying value of their IO assets in the face of either rising charge-off rates or higher prepayment rates. Writing down an IO strip largely represents a company's admission that it will not generate on a cash basis income that was booked previously.

Chart 1 displays the cumulative charge-off rates by vintage for **Moody's** index of home equity loan securitizations. The index consists mostly of prime mortgages, so the loss rates are still low. However, the rising trend in losses is noteworthy and reflects the growing influence of subprime securitizations on the index and the related decline in underwriting standards as competition has increased in this market. Loans originated in 1995 and 1996 are causing progressively larger and earlier losses. After 21 months of seasoning, the cumulative loss rate on loans originated in 1996 is .17 percent—almost six times the loss rate experienced by the 1994-originated cohort at the same age. Despite the continued low loss rates for the home equity market in general, subprime lenders are experiencing accelerated loss rates that are eroding the value of their interests in excess spreads.

There may be a tendency for management to base assumptions about expected loss rates on loans sold solely on past experience with similar loans. Such an approach may not capture changes in market conditions and trends. For example, the Moody's data demonstrate that loss rates on home equity loans, including first liens, have been trending upward rapidly. This trend implies that when estimating loss rates, management should consider the potential for changes in market con-

CHART 1



ditions over the life of the sold assets as well as the past performance of similar assets.

Like loss rates, prepayment rates have risen substantially in the subprime mortgage market. Several factors have contributed to the rise. One factor is the trend toward higher loan-to-value (LTV) loans in the mortgage market, which has allowed borrowers to obtain additional cash from their homes without waiting to pay down principal. Mortgage bankers report the tendency of some subprime borrowers, often debt consolidators, to maintain outstanding balances at the highest possible LTV. With maximum LTV ceilings rising, debt consolidators can refinance home equity loans without having to amortize existing debt.

Another important factor contributing to rising prepayment rates is competition among lenders for volume growth. To continue to grow volume, lenders have been sacrificing margins on loans to offer a better rate to borrowers. When estimating prepayment rates for subprime borrowers, it has been normal to expect that they would need to improve their credit rating, or "credit cure," before they would find it economical to refinance. Stiff competition for volume has allowed borrowers to find better rates without credit curing and has stimulated them to refinance prior to the time estimated at origination. Falling interest rates and a relatively flat yield curve are likely to increase prepayment rates.

In standard finance theory, uncertainty about the future level of losses and prepayment rates is compensated for by discounting the cash flows at a higher rate. Some analysts advocate using a discount rate similar to the required rate of return for equity investments. Faced with changing conditions, one large finance company that specializes in high LTV lending announced in December 1997 that it was increasing the discount rate it uses to value new IO strips from 12.5 percent to 33 percent.

The IO Strip Asset Is Growing at Insured Depository Institutions

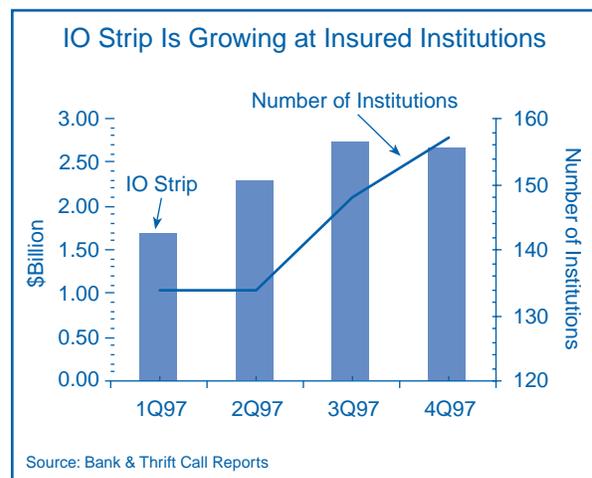
As of December 31, 1997, only 30 institutions reported this IO asset at more than 5 percent of tier 1 capital. However, some institutions have booked gains that should have given rise to a call-reportable IO strip but did not properly report the assets. Therefore, the current reporting may understate the prevalence of the asset.

Furthermore, the recent attention to gain-on-sale accounting from the public equity markets has at least a few large finance and mortgage companies seeking business strategies that shed IO strip-related volatility from their financial statements. One such strategy already in use is to leave the economic interest in excess spread with the correspondents that originate the loans. This is done as follows: The correspondent originates loans for purchase by a finance company. The finance company pays par for the loans, and instead of being paid an origination fee or a premium for the loans, the *seller* retains the right to excess spread generated over the life of the loan. The seller books a gain and an IO asset that capitalizes this right to receive future cash flows. The nature of the IO asset is exactly the same whether it arises directly from a securitization or from a sale of loans to a securitizer. *If this strategy is used widely by finance and mortgage companies, then IO strips are likely to grow among institutions that originate loans for sale to these companies* (see Chart 2).

For insured depository institutions, the capital effects of SFAS 125 need to be evaluated carefully. Analysis of the financial statements and leverage ratios of insured institutions should consider fully issues related to the quality of earnings and the stability of capital posed by the volatility of the IO strip. Insured institutions that engage in significant asset sales while retaining economic interests that give rise to SFAS 125-related assets are subject to distortions similar to those of nonbank financial companies.

The activity of originating and selling loans and booking associated gains can lead to capital ratios that

CHART 2



appear high by traditional bank standards. For several reasons, the leverage ratio can appear particularly high. First, although the asset may be more volatile than mortgage serving rights, there is no limit to the amount of IO strip that a bank can include in tier 1 capital. Second, the amount of IO strip booked increases capital by a gain on the net of the tax effect. The extent to which the amount remains in capital depends, of course, on the institution's dividend policy. Third, the denominator of the leverage ratio is reduced by the sale because the loans are no longer assets of the bank. The cumulative result can be a significant boost to the leverage ratio.

Several insured institutions report an IO strip at greater than 25 percent of tier 1 capital. For an institution whose primary line of business is originating and selling subprime mortgages, the asset can quickly reach a level exceeding tier 1 capital. In a little more than a year of originating and selling subprime mortgages to a major securitizer, one institution has amassed IO assets that it has valued at more than 150 percent of tier 1 capital.

The institutions that have concentrations of 25 percent or more of tier 1 capital in IO assets have a median

leverage ratio of about 11 percent. In contrast, the median equity capital ratio for nonbank mortgage securitizers tracked by *SNL DataSource* is about 30 percent. Public debt markets or banks that lend to these finance companies appear to require significantly higher capital levels than regulatory minimums required for banks.

The potential for growth of the IO strip asset at insured institutions seems strong. In some circumstances, minimum capital standards for banks may require significantly less capital for IO asset exposure than the public equity markets. Perhaps more important, the quick rise of the significance of gain-on-sale accounting to the mortgage and consumer credit markets exemplifies the speed with which exposure to risk can be acquired through the securitization market. Strong demand for asset-backed securities coupled with changing accounting emphases, which in this case favor asset sellers, can lead quickly to substantial exposures.



Allen Puwalski, Senior Financial Analyst

Risk-Based Capital (RBC) Treatment of the Gain-on-Sale–Related IO Asset

If the IO asset derives from excess spread that absorbs charge-offs from the sold assets, then the IO strip constitutes recourse from the sold assets for RBC purposes. RBC standards require capital to be held against this exposure. In general, the capital requirement for this exposure is the amount of capital that would have been required for the assets had they not been sold. If the sold assets are one- to four-family residential mortgages, they may receive a 50 percent risk weighting. Subprime mortgages are not necessarily precluded from receiving this weighting.

In order to apply the 50 percent risk weighting, the capital standards require that one- to four-family residential mortgages be fully secured and prudently underwritten. The “fully secured” requirement precludes high-LTV loans with LTV ratios of greater than 100 percent from receiving reduced capital requirements, but the language of the RBC regula-

tions does not necessarily preclude subprime mortgages in general from receiving the reduced risk weighting. Although the capital standards require that mortgages be prudently underwritten to qualify for the 50 percent risk weighting, it is not entirely clear how the term “prudently underwritten” applies to subprime mortgages. A higher expected loss rate alone may be insufficient cause for presuming that the mortgages are not prudently underwritten.

The rationale for reducing the capital requirement for traditional one- to four-family mortgage lending is related to the maturity of the market and consistently low loss rates. As noted above, the subprime mortgage market is changing rapidly, and loss rates can be much higher than in traditional mortgage lending. Accordingly, bank managements need to be aware of the potential volatility and risks associated with gain-on-sale assets associated with subprime mortgages.

How Will the Expansion End?

- **Despite a very low unemployment rate and high industry capacity utilization, inflation has been unusually subdued during this expansion, with price declines in some sectors.**
- **After seven years of expansion, most analysts expect the economy's growth to slow in the coming months.**
- **The last seven expansions have ended with an inflation-driven increase in short-term interest rates; in contrast, some analysts believe that the next recession will be caused by a period of falling prices for commodities, finished goods, and perhaps wages.**
- **Insured institutions that base lending and strategic decisions on assumptions of continued robust economic growth should scrutinize and test those decisions against possible adverse change in economic conditions.**

The current economic expansion is the third longest on record since World War II. Since mid-1991, when the expansion began, more than 15 million new jobs have been created and inflation-adjusted gross domestic product (GDP) has increased by nearly 20 percent. In fact, the unemployment rate reached a 24-year low when it fell to 4.6 percent in November 1997 and again in February 1998. At the same time, inflation has remained unusually low, at only 2.3 percent during 1997.

Analysts are now focusing on when and under what circumstances the current expansion will end. While no one can accurately predict *when* the expansion will end, two related but competing theories about *how* it will end have emerged in recent months. The first and more familiar scenario occurs when the Federal Reserve increases short-term interest rates to prevent a rapid increase in inflation caused by an overheating economy. The second scenario, a deflation-induced contraction, is less familiar in the context of recent recessions. This scenario posits a period of falling prices for commodities, finished goods, and, under the most severe circumstances, even wages.

Whatever the cause of the next downturn, its effects are likely to be important for the performance of lenders.

During the 1990–91 recession, for example, the widespread deterioration of economic conditions was reflected in a number of indicators: Inflation-adjusted GDP fell by 2 percent; the number of business failures rose by nearly 40 percent; unemployment increased by more than 40 percent to 9.8 million; the unemployment rate peaked at more than 7 percent; single-family housing starts fell by almost 22 percent; and the bank card delinquency rate increased from 2.4 percent to 3.3 percent. This experience suggests that no matter what triggers the next downturn, dramatic adverse changes in the drivers of bank performance will likely result.

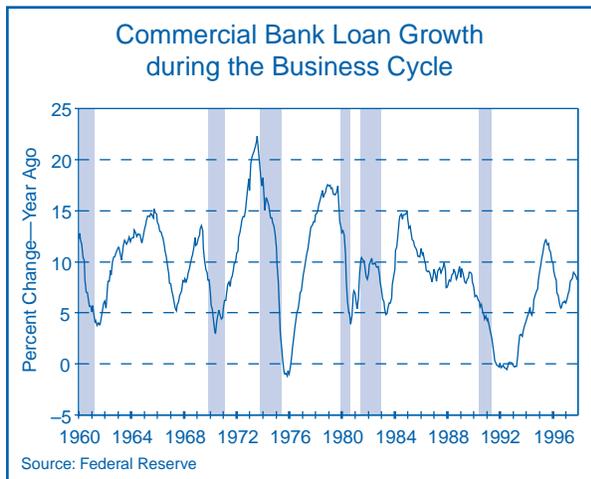
How Have Economic Expansions Usually Ended?

Although to some extent each business cycle is unique, virtually all of the post–World War II expansions have shown a similar characteristic: Toward the end of the expansion, inflation has accelerated. As the economy expands, the prices of inputs, including the wages of workers, are bid up as firms compete for resources to meet demand. The overall inflation rate will rise if prices increase across a large number of industries. Left unchecked, an increase in the overall price level may itself feed back into the labor market through demands for higher wages.

By raising short-term interest rates, the Federal Reserve can limit what might otherwise lead to a rapid increase in both wages and prices. Higher interest rates will reduce sales of capital goods, housing, and consumer durables, the demand for which is very sensitive to the level of interest rates. One reflection of this sensitivity is the changing pattern of loan growth over the business cycle. During periods of expansion, the demand for loans grows rapidly as businesses and households borrow to finance purchases of capital goods and consumer durables. If short-term interest rates are increased in response to inflationary pressures, loan growth will slow as businesses and consumers reduce their demand for loans. If interest rates continue to increase, loan growth may decline as it has done before and during each recession. The cyclical movement of loan growth (with vertical bars indicating periods of recession) is shown in Chart 1 (next page).

Looking more closely at short-term interest rates, Chart 2 (next page) illustrates the federal funds rate during the

CHART 1

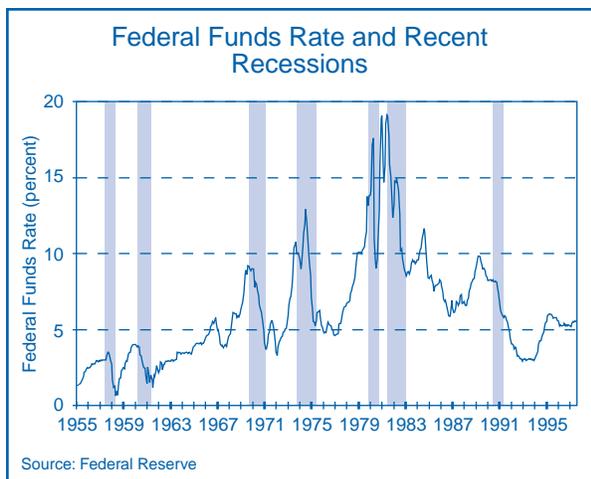


last seven business cycles. While an increase in short-term interest rates has preceded each recession, it should be noted that an increase in rates is not sufficient to induce a recession. An increase in rates in 1984 was followed by a period of rapid growth that lasted until 1990. More recently, the increase in rates during 1994 was accompanied by a slowdown in the economy, but not a recession.

What Is Different about Inflation during This Expansion?

With history as a guide, one would expect inflation to rise as the current expansion matures. Chart 3 illustrates consumer price inflation during the four longest postwar expansions, including the current one. The chart shows the inflation rate at various points after the

CHART 2



expansion began. During the expansion between 1975 and 1980, for example, the inflation rate was nearly 12 percent at the start of the expansion but fell to just over 6 percent after four quarters. Inflation remained at approximately 6 percent until the twelfth quarter of the expansion, after which it accelerated to more than 12 percent by the end of the 20-quarter expansion.

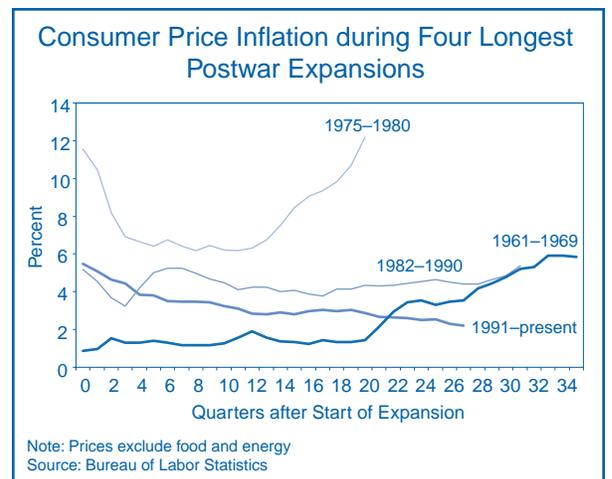
The current inflation trend differs from previous expansions in two ways. First, by the later stages of previous expansions, inflation was accelerating (see Chart 3). In contrast, there are few signs of accelerating consumer price inflation during the current expansion. In fact, it appears that the rate of inflation is declining; the United States has experienced disinflation.¹ Second, among expansions that have lasted more than 20 quarters, the current rate of inflation is one of the lowest since World War II. Consumer inflation is both decreasing and low by historical standards.

What Are the Two Views about Future Inflation?

Two views have developed about how the current expansion will end. The debate, couched in terms of the expected rate of future inflation, is of more than academic concern. The Federal Reserve's decision about

¹ In popular discussions of inflation rates and the price level, terminology is sometimes used loosely. To clarify, a declining rate of inflation, properly described as disinflation, means that prices are increasing at a progressively slower rate over time. Deflation is defined as a generally falling price level or, equivalently, a negative inflation rate.

CHART 3



whether to change short-term interest rates may be influenced by arguments on either side of the debate.

The Traditional View

Although inflation has been tame during this expansion, adherents of the traditional view believe that impending inflation still poses a danger to the longevity of the expansion. Evidence cited to support this view includes a very low unemployment rate and rising inflation-adjusted wages. The reasons for the low inflation rate include low energy prices, inexpensive imports, and brisk domestic and international competition. These factors have delayed the onset of inflationary pressures, but they will not remain favorable indefinitely. The underlying dynamics have not changed significantly from those that led to rising inflation during every other recent economic expansion. This is also the view of the Federal Reserve Open Market Committee, as stated in the minutes of its November 12, 1997, meeting:

The reasons for the relative quiescence of inflation were not fully understood, but they undoubtedly included a number of special factors...the risks remained in the direction of rising price inflation though the extent and timing of that outcome were subject to considerable debate.

—*Federal Reserve Bulletin, February 1998, p. 104*

The Deflation View

Alternatively, some analysts suggest that a recession may be brought about by a period of deflation. Advocates of this scenario base their view on the unusually low and falling inflation rate in the United States, even after seven years of economic expansion. They also suggest that the national economy of the 1990s is markedly different from that of the 1970s and 1980s. Intense global competition is now the norm and not the exception. Worker productivity growth is believed to be higher than the official data show, meaning that wage growth will not translate as readily as before into price increases. The U.S. economy is more prone to a period of falling prices than at any time in the recent past, especially in view of decreasing rates of inflation and deflationary forces originating from the ongoing Asian financial crisis.

What Does the Evidence Show?

Because determining economic policy is necessarily a forward-looking process, policymakers look at many

indicators to determine the likely future course of inflation. A brief review of some of the more popular indicators reveals contradictory readings that can support either the inflation or deflation scenario.

Wage Growth

The national unemployment rate is currently very low, signaling that labor markets are near capacity in terms of their ability to create new jobs. The nation's unemployment rate was below 5 percent for nine months during 1997. This rate has been well below what many analysts thought possible without a sharp rise in inflation. As labor market conditions have tightened, wage growth has increased. Since 1993 the rate of growth has been on a steady upward trend, from a low of just over 2 percent to about 4 percent in the first quarter of 1998.

Capacity Utilization

Capacity utilization, the percentage of industrial capacity that is currently in use, has risen since early 1997. Utilization has been around 83 percent since mid-1997, a threshold rate that has traditionally signaled impending inflationary pressures at factories, mines, and utilities.

Commodity Prices

Many commodities, such as metals, crude oil, and unprocessed food products, have exhibited weak prices during the past several months. Between mid-1996 and early 1998, the *Knight-Ridder Commodity Research Board Price Index* fell by more than 15 percent. Key to the decline was a 35 percent decrease in crude oil prices.

Finished Goods Prices

Since the data show that both labor and physical capital are at high rates of utilization, the traditional inflation scenario suggests that there will be increasing price pressures. In the manufacturing sector, such price pressures would likely show up first in the prices of goods as they leave the factory. The price of finished goods rose by only 0.4 percent during 1997, however. On a monthly basis, prices declined during eight months in 1997.

Service Sector Prices

The service sector accounts for a growing portion of all output and employment in the U.S. economy. Labor costs generally account for a much higher percentage of input costs in the service sector than in the manufactur-

ing industries. Additionally, many service industries operate in local markets and are insulated from national or global competition. Consequently, inflation rates in the service sector are generally higher than in the goods sector. Service sector inflation has, however, been on a downward trend, falling from 5.5 percent in 1990 to 3.1 percent in 1997.

Import Prices

Since early 1996, import prices have fallen precipitously. The decline is due in part to the rising value of the dollar, which has reduced the cost of imports. Non-petroleum import prices have fallen by 5 percent since early 1996. Within that group, capital goods prices have decreased by 12 percent over the same period.

One factor that will continue to put downward pressure on prices is the turmoil in Asian markets. Asian exporters are now much more competitive with the rest of the world, following the drop in the value of their currencies. Consequently, U.S. firms that compete with Asian producers will be under greater pressure to cut prices. At the same time, reduced Asian demand for U.S. exports could lead to a ballooning trade deficit and a softening of export prices. In January 1998, for example, the United States reported a record-breaking trade deficit of \$12 billion, caused in part by slower export growth.

From this brief review, it is apparent that signs of impending inflation are at best mixed. Clearly, U.S. labor markets are at or near full effective capacity, and the utilization of factories and physical capital is also very high. There is little evidence that these factors are causing an increase in prices at either the producer or consumer levels.

How Will the Expansion End?

Although no one can accurately determine when the expansion will end, most analysts are predicting slower economic growth in the second half of 1998. Indicators such as the unemployment rate suggest that growth will be limited by the availability of labor needed to produce an increasing supply of goods and services. Weak or declining output prices in some sectors could act as a further constraint on economic growth.

Among economists, the traditional view that the expansion will end following a rise in inflation and an increase in short-term interest rates appears to be the more prevalent view. Nevertheless, the possibility that the next economic downturn might be triggered by the ripple effects of declining output prices should not be dismissed, especially in light of the potentially adverse and less familiar risks associated with deflation. What is clear for insured institutions is that at this stage of the economic expansion, lending and strategic decisions predicated on an assumption of continued robust economic growth should be carefully scrutinized and considered in light of a possible deterioration of economic conditions.

Paul C. Bishop, Economist

Why Might Deflation Be a Concern?

The most significant difference between the inflation and deflation scenarios is reflected in the response of financial markets. One of the consequences of inflation is that a dollar in the future is of less value than today's dollar. In a deflationary environment, the opposite is true—a dollar in the future will buy more goods and services than a dollar today.

In a deflation scenario, debtors would see the real value of their financial obligations rise and might therefore be hesitant to borrow. A fixed monthly mortgage payment, for example, would be paid back with increasingly valuable dollars over time. Asset values could fall, especially since the purchase of an asset, such as a house, would require inflation-adjusted debt repayments that increase through time. Likewise, consumer credit debt obligations, such as payments on outstanding credit card balances, would become increasingly onerous. For households already experiencing credit problems, the prospect of a period of sustained deflation would worsen their financial position. At the very least, deterioration in credit quality would be expected, along with an increase in the number of business and personal bankruptcies.

Trends Affecting the Allowance for Loan and Lease Losses

- **Allowance for loan and lease loss (ALLL) levels are declining relative to total loans.**
- **Some industry leaders and regulators have expressed concern about the loosening of underwriting standards and greater risk in bank loan portfolios.**
- **Significant growth in riskier loan types calls attention to the need to scrutinize closely the adequacy of the allowance.**

Weakening underwriting standards and significant growth in riskier loan types have increased the risk exposures of some insured institutions to an economic downturn. Meanwhile, the ALLL relative to total loans has declined in recent years. This article provides information on trends in the ALLL over time and by loan type and discusses the factors analysts consider when evaluating the adequacy of the ALLL. Special attention is given to issues related to the volatility of loan losses and the composition of the loan portfolio.

Historical Perspective on the Allowance for Loan and Lease Losses

The nation is currently witnessing one of the longest economic expansions since World War II. It is to be expected that some institutions will reduce their ALLL

coverage during periods of improved economic conditions. However, in the current environment—in which loan availability is abundant, growth is strong, and competition is fierce—some industry leaders and regulators have expressed concern about the loosening of underwriting standards and greater risk in bank loan portfolios. At the same time, the ALLL relative to total loans for commercial banks has declined to the lowest point in a decade (see Chart 1). This allowance ratio has diminished because commercial banks' loan loss provisions have not kept pace with new loan growth. In some cases, banks have determined that their allowances are higher than necessary and have taken negative loan loss provisions, which are credited back to income.

This decline in reserve coverage has been broad based, with the exception of credit card specialists. Commercial banks with concentrations in commercial lending and large multinational banks have significantly reduced the level of reserves to total loans in recent years. Table 1 (next page) shows that since 1993, ALLL ratios at both commercial lending banks and multinational banks have declined 31 percent. Moreover, commercial lending banks with assets exceeding \$10 billion have reduced ALLL ratios by slightly over 37 percent, or 98 basis points, over the same period.

The low level of nonperforming and charged-off loans, coupled with prevailing favorable economic conditions, is doubtless a significant factor in the reduction of

CHART 1

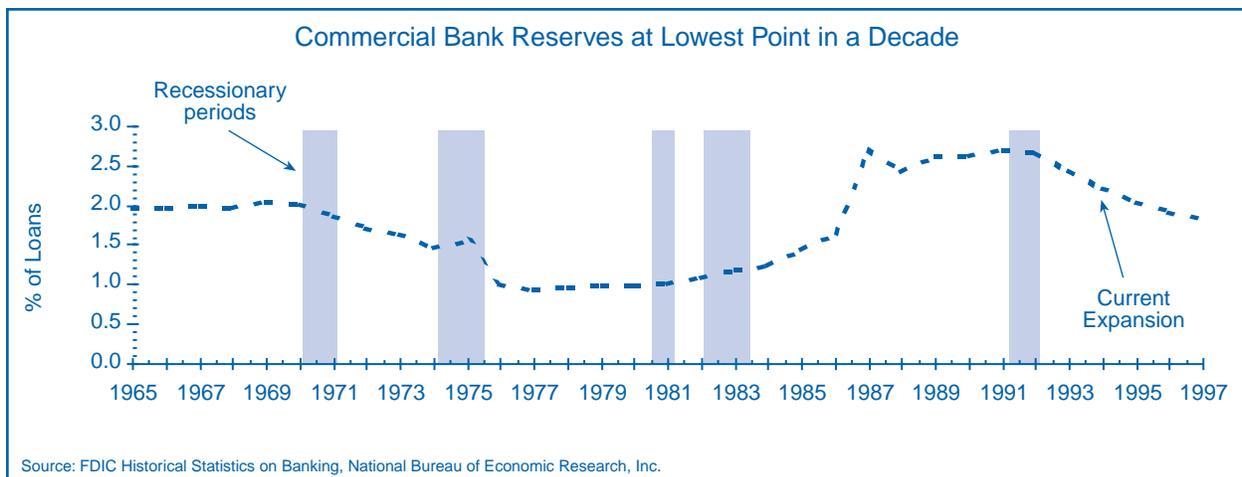


TABLE 1

COMMERCIAL BANK ALLOWANCE FOR LOAN AND LEASE LOSSES TO TOTAL LOANS BY LENDER TYPE							
TYPE OF LENDER	NUMBER OF BANKS	ASSETS (\$BILLIONS)	1997	1996	1995	1994	1993
MULTINATIONAL	11	\$1,383	2.14	2.25	2.55	2.83	3.10
COMMERCIAL	3,207	\$1,915	1.63	1.71	1.90	2.16	2.37
CREDIT CARD	67	\$202	4.21	3.48	3.21	2.89	3.35
MORTGAGE	286	\$120	1.26	1.45	1.45	1.69	1.87
AGRICULTURAL	2,373	\$120	1.53	1.66	1.69	1.75	1.83

DEFINITIONS FOR LENDER TYPES BY ORDER OF PRIORITY: MULTINATIONAL—ASSETS >\$10 BILLION AND FOREIGN ASSETS >25% OF ASSETS; COMMERCIAL—C&I PLUS CRE LOANS >50% OF ASSETS; CREDIT CARD—CREDIT CARD LOANS >50% OF ASSETS; MORTGAGE—1- TO 4-FAMILY MORTGAGES AND MORTGAGE-BACKED SECURITIES >50% OF ASSETS; AGRICULTURAL—AGRICULTURAL PRODUCTION AND AGRICULTURAL REAL-ESTATE LOANS >25% OF TOTAL LOANS.
SOURCE: BANK CALL REPORTS

ALLL levels. Asset quality indicators such as nonperforming loans and loan loss rates are at historically favorable levels. At year-end 1997, the banking industry's nonperforming loans were just under 1 percent of total loans, the lowest in 13 years. The industry's loan charge-off rates (with the exception of consumer loans) are also at historical lows. (See the *Regional Outlook*, first quarter 1997, for a detailed discussion of consumer loan losses.) However, even with the problems in consumer lending, the banking industry's aggregate loan loss rate is down significantly from levels in the early 1990s (see Chart 2).

As the economic expansion reaches an advanced age, an important question for insured institutions is whether their ALLLs adequately reflect the risks asso-

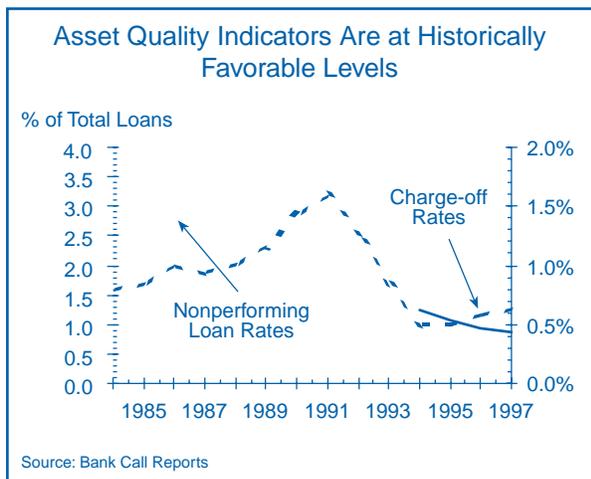
ciated with changing industry practices. Insured institutions could experience strains on profitability and capital if allowance levels are inadequate. Given changing underwriting trends and loan delinquency patterns, a related question is whether reliance on past loss experience in setting the allowance will be an adequate measure for current losses.

Trends in Underwriting Prompt Regulatory Cautions

Over the past year, various underwriting and lending practices surveys by the FDIC, the Office of the Comptroller of the Currency (OCC), and the Federal Reserve have noted easing of terms and weakening underwriting standards on loans, especially in commercial loan portfolios. *It is important to note that, in 1997, nearly two-thirds of the commercial banking industry's loan growth was centered in the commercial real estate (CRE) and commercial and industrial (C&I) loan categories* (Chart 3).

In the FDIC's *Report on Underwriting Practices* for April 1997 through September 1997, examiners noted "above-average" risk in current underwriting practices for new loans at almost 10 percent of the 1,233 FDIC-supervised institutions examined. Of the institutions with above-average risk, 12 percent did not adjust pricing for loan risk. Examiners noted that several of the 852 institutions examined that were making business loans had poor underwriting standards, including lack of documentation of the borrower's financial strength

CHART 2



(21 percent) and poor and unpredictable loan repayment sources (14 percent). Also, of the 571 institutions specifically involved in asset-based business lending, 20 percent often failed to monitor collateral. Furthermore, 20 percent of the 398 institutions examined that were actively engaged in construction lending repeatedly failed to consider alternative repayment sources, and 29 percent often funded speculative projects. In contrast, just one year earlier, in the *Report on Underwriting Practices* for April 1996 through September 1996, examiners reported that only 11 percent of the institutions examined that were actively engaged in construction lending often funded speculative projects.

The Federal Reserve's *Senior Loan Officer Opinion Survey* for November 1997 and February 1998 both indicated some easing of commercial business lending terms and standards. Also, the OCC's *1997 Survey of Credit Underwriting Practices* stated that the level of inherent credit risk continues to increase for components of both commercial and consumer loan portfolios. These underwriting trends have resulted in increased risk profiles for some insured institutions, while ALLL ratios at some institutions continue to decline.

In August 1997, the OCC issued an Advisory Letter voicing its concern about declining allowance levels in commercial banks. The OCC cited as primary concerns the apparent increases in credit risk reported by examiners, such as weakening underwriting trends in the syndicated loan market, easing of other commercial underwriting standards, and consumer lending delinquency and charge-off trends. Moreover, the OCC found that some banks were using flawed reserve

methodologies for estimating loan loss rates, including an overreliance on historical loss rates.

Factors Affecting Adequacy of the ALLL

In using offsite data to assess allowance adequacy, analysts consider financial ratios such as the allowance to total loans, reserve coverage (allowance to nonperforming loans), loan loss provisions to charge-offs, and loan delinquency levels. These ratios are evaluated against historical benchmarks. At the same time, however, analysts supplement the analysis with consideration of the potential effects of current industry trends. For example, the banking industry is currently witnessing higher than normal losses in consumer lending spurred by increased bankruptcy filings and the migration of loans from current to charged off without intervening delinquencies. An institution that has a sizable consumer loan portfolio may therefore need to attach more weight to recent loan loss data in setting the allowance, since historical trends may not adequately reflect reserving needs.

Insured institutions exhibit different management and portfolio characteristics that significantly influence the level of the allowance. These characteristics include the diversification of a loan portfolio (diversification by borrower, loan type, geography, or industry), the history and recent trends of credit losses, management's practices in the recognition of losses, trends in past-due and nonperforming loans, underwriting practices, and economic conditions.

New techniques continue to be developed to improve the reliability of allowance estimates. Management information systems, which enable the collection of more refined historical data, coupled with the application of statistical techniques, are helping some institutions formulate more statistically reasoned allowance estimates. Loan management tools such as credit scoring systems, risk rating systems, and consideration of economic cycles in the review of historical loss and delinquency data all are aiding bankers in the reserving process. While these new techniques provide more analytically defensible estimates, they do not diminish the role of judgment in assessing ALLL adequacy.

The role of judgment in setting the ALLL is underscored by the volatility of loan losses over time.

CHART 3

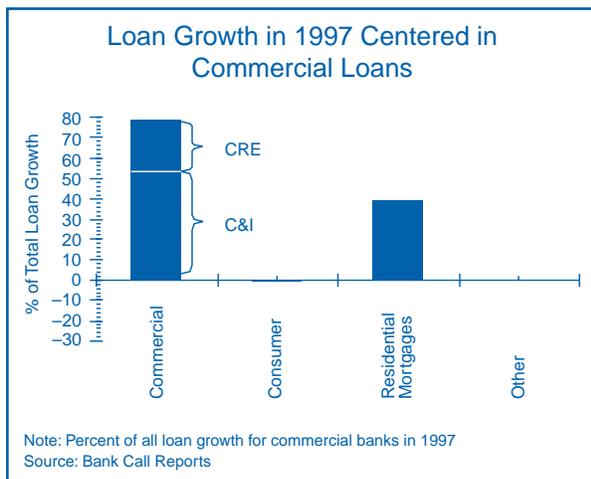
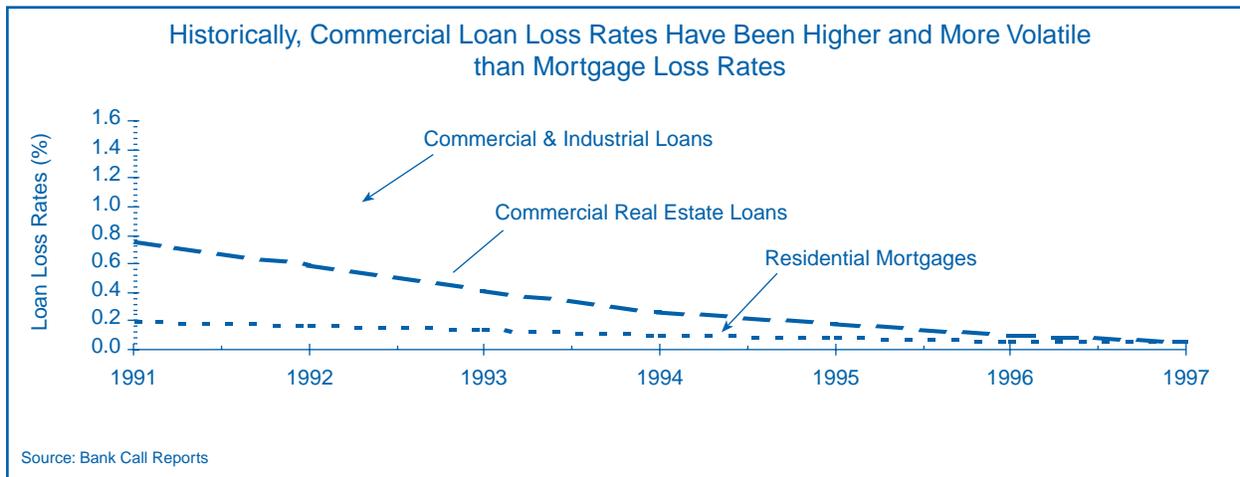


CHART 4



“Volatility” in this context refers to the degree to which loan losses have diverged or might diverge from the long-run averages. Volatility in loan losses can result from changes in the business cycle, local economic events, and major one-time events. For example, a bank relying on a historic average loan loss calculation to derive its reserve level could find itself underreserved if it does not adjust its historical loss rates for deteriorating economic conditions and suddenly incurs greater loan losses than it had anticipated simply on the basis of past performance.

Generally, different types of loans experience varying loan loss rates because of the inherently different risks and varying levels of volatility within each type. Chart 4 shows that commercial loans, such as commercial and industrial loans and commercial real estate, historically have had greater losses than residential loans. Furthermore, the loss rates on commercial loans have not only been higher, they have been more volatile over the years, while average losses on mortgage loans have varied little.

Volatility in loan losses is determined not only by economic events but also by banks’ willingness to take risk. Banks that adopt more liberal underwriting policies and high loan growth objectives may experience greater loan default risk and greater volatility in loan loss rates than suggested by their own past experience. For example, Chart 4 shows that mortgage lending has had low and stable loss rates on average. The recent growth in subprime and high loan-to-value mortgage lending, however, may result in increased volatility and losses for some lenders going forward.

All of these factors suggest that ALLLs would be expected to vary considerably both over time and across loan types. Table 2 shows that this has been the case. The ALLL is reported as a single line item on the Call Report. This makes it difficult to estimate how much of the ALLL is attributable to a particular loan type or to compare allowance levels for banks with significantly different loan portfolios. Table 2 shows the results of a statistical regression estimation of commercial bank allowance allocations across the various loan types for

TABLE 2

ALLL ALLOCATIONS HAVE VARIED OVER TIME AND BY LOAN TYPE (COMMERCIAL BANKS UNDER \$1 BILLION)*							
LOAN TYPE	1997 (%)	1996 (%)	1995 (%)	1994 (%)	1993 (%)	1992 (%)	1991 (%)
C&I	1.71	1.85	1.87	2.06	2.14	2.29	2.45
CRE	1.44	1.54	1.77	1.83	1.97	2.02	1.99
MORTGAGES	0.92	1.00	1.05	1.19	1.22	1.07	0.91
CREDIT CARDS	4.47	4.42	3.32	3.11	3.20	3.29	3.59

* ESTIMATED REGRESSION RESULTS
SOURCE: BANK CALL REPORTS

1991 through 1997 for commercial banks with under \$1 billion in assets. Not surprisingly, CRE and C&I loans received relatively higher allowance allocations than residential mortgage loans, indicating that banks saw greater risk in these loan types. Also, credit card loans consistently received higher allocations than the other loan categories, and the allocations have increased in recent years owing to the increased delinquencies and charge-offs in this area.

Conclusions

The adequacy of the ALLL is measured not only relative to historical loan loss experience but also relative to current conditions that may cause losses to differ from

past experience. Increased losses could result from adverse economic developments, from changes in banks' appetite for taking risk, or both. In this regard, reported weakening in underwriting standards is increasing some banks' risk exposure to an economic downturn. Institutions with high concentrations in riskier loans, significant growth in riskier loans, or weaknesses in underwriting may be most at risk. Especially for such institutions, the adequacy of the ALLL and its methodologies merits close scrutiny.



Andrea Bazemore, Banking Analyst

Strong Economic Growth Is Expected to Continue in the San Francisco Region despite Potential Fallout from the Asian Crisis

- The San Francisco Region added jobs at a rapid 3.6 percent pace in 1997, much faster than the nation's 2.7 percent growth rate.
- The Asian crisis is likely to have a more significant effect on the San Francisco Region than on most other parts of the nation; still, most forecasters do not expect it to be a major stumbling block in 1998. Its impact on the various states and industries will not be uniform; effects on high tech, aerospace, and tourism could be sizable for some states.
- The 1998 outlook for most of the Region's states remains positive, with another year of robust expansion projected, although at somewhat reduced growth rates.

San Francisco Region Continued to Lead the Nation in Growth

The San Francisco Region's economic performance, driven by a surging California economy and generally rapid growth throughout much of the Region, was robust in 1997. The Region led the nation in job growth rates for the third consecutive year in 1997, adding 815,000 jobs (seasonally adjusted) between December 1996 and December 1997, a 3.6 percent rate of increase. **Arizona, Nevada, Utah, California, Oregon, and Washington** were among the nation's 13 fastest growing states; all exceeded the nation's 2.7 percent job growth rate, as shown in Chart 1. The Region's economic expansion was generally reflected in strong banking industry performance as well. The Region posted a return on assets (ROA) of 1.19 percent in 1997, the highest in at least a

decade, and matched the performance for the nation (see *Current Regional Banking Conditions*).

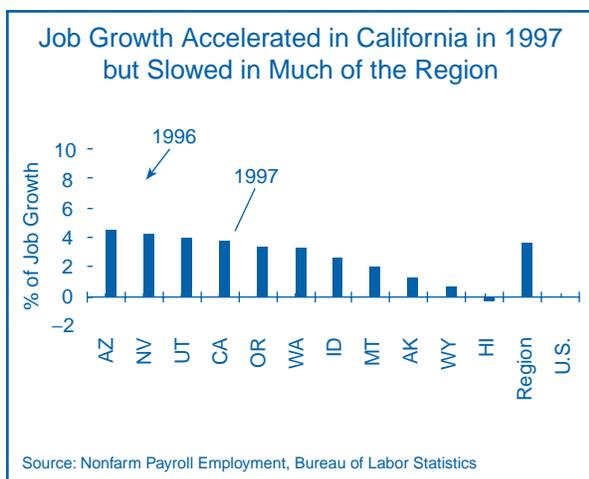
Asian Crisis Creates a Risk

Despite the strong performance of the Region and the banking industry as a group, there are still risks ahead. The greatest risk on the horizon in 1998 is the crisis in Asia, which has the potential to weaken the entire San Francisco Region. The initial effects of the Asian crisis likely will be felt in key sectors—manufacturing, export services, and agriculture—and may be concentrated in several states. The Asian crisis is not the only risk facing the Region. **Alaska**, for example, faces the risk that low oil prices will slow its economy.

The major currency devaluations suffered by a number of the Asian Tiger economies in 1997 force them to make serious economic adjustments that will dramatically slow their economies. The crisis is most often associated with the "Asian 10" group, henceforth referred to as "Asia": China, Hong Kong, Indonesia, Japan, Malaysia, the Philippines, Singapore, South Korea, Taiwan, and Thailand. Asia's economic turmoil could affect the Region's economy in 1998 in many ways, including:

- reduced Asian demand for U.S. exports;
- lower prices on Asian goods, which may weaken the market share of U.S. manufacturers in both domestic and international markets;

CHART 1



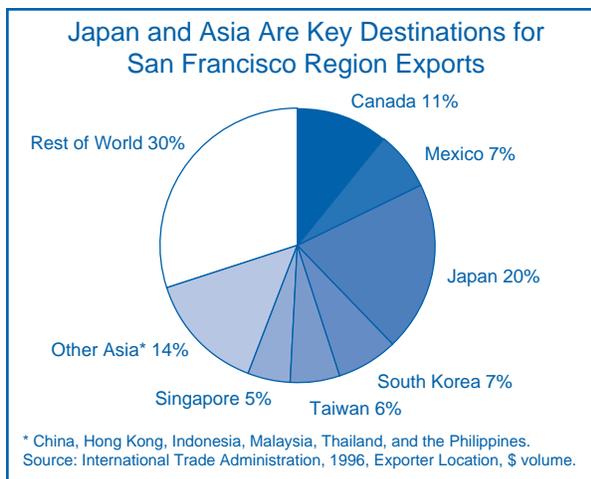
- reduced spending in the United States by Asian visitors; and
- lower prices in Asia, which may attract more U.S. visitors and slow tourism in the United States and Hawaii.

Crisis May Have a Proportionately Larger Impact on the San Francisco Region

The ill effects of the Asian crisis have particular relevance for the San Francisco Region. *International Trade Administration* Exporter Location data for 1996 indicate that about 52 percent of the Region’s merchandise exports were shipped to Asia; elsewhere in the nation the comparable figure was 22 percent. The Region’s largest export markets are shown in Chart 2. The Region also may have a higher share of service exports, including business, personal, and transportation and trade services; however, the following analysis focuses on merchandise export exposure, which for most states is much larger and for which statistics are available.

A disproportionate number of metropolitan areas in this Region are heavily dependent on merchandise exports; **San Jose** leads the nation in exports for metropolitan areas. **Los Angeles, Seattle, Portland, San Francisco, Orange County, Phoenix, Oakland,** and **San Diego** are among the top 20 metropolitan export centers. Ports in these areas may be affected by changes in both export and import volumes.

CHART 2



Not only are the Region’s exports heavily weighted toward Asia, but in 1996 over three-quarters of the dollar volume of all exports fell in three categories of goods—high technology, aerospace, and agriculture. All three of these export categories are vulnerable to cutbacks in Asian sales. The Region’s merchandise export composition is shown in Chart 3.

Finally, as illustrated in Chart 4 (next page), the ill effects will not be evenly distributed across the states in the Region. Four states rank among the top five nationally in merchandise exports relative to gross state product (GSP): Washington, Oregon, California, and Arizona. Nationally, 1996 exports to Asia represented about 2.5 percent of gross domestic product; as a percentage of the total economy this may appear small. However, the share of exports to GSP in these four states and in selected industries is much higher than for the nation and may represent a significant share of economic activity. Some key areas of exposure for the Region, by state and industrial sector, are as follows:

- High-tech exports to Asia are about 3.5 percent of GSP in Arizona and California, and about 2 percent in **Idaho** and Oregon.
- Aerospace exports to Asia are over 4 percent of Washington’s GSP but have slipped to under 1 percent of California’s GSP.
- Agricultural exports to Asia from Oregon and Washington are about 3.5 and 1.5 percent of state GSP, respectively.
- Tourism is the major industry in both Nevada and **Hawaii**; Hawaii is especially dependent on Asian travelers.

CHART 3

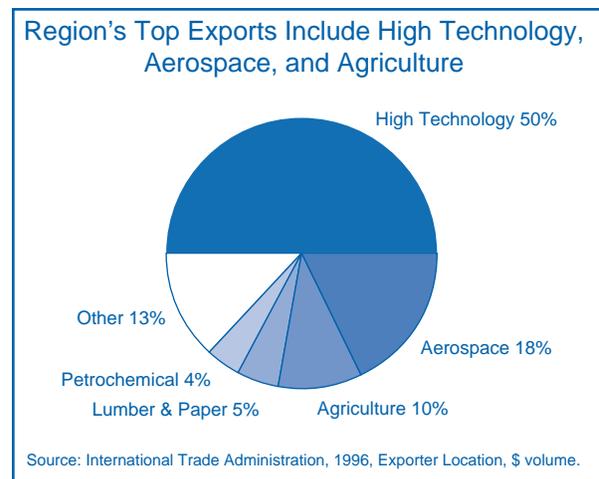
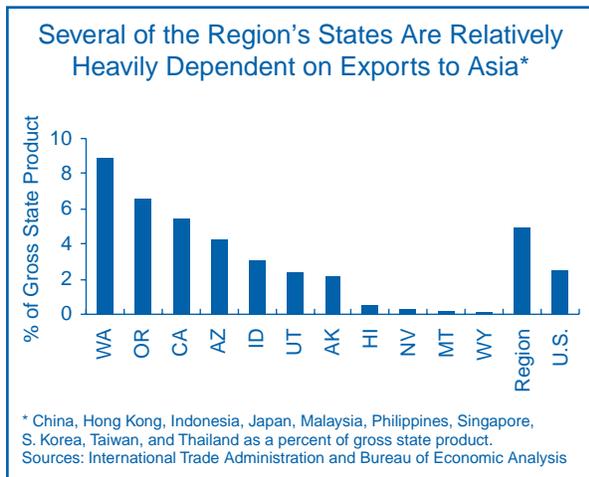


CHART 4



Are There Mitigating Circumstances?

Several factors, including the strong national economy, moderate interest rates, and low prices for oil and Asian imports, are expected to help sustain the Region's expansion. Consequently, most forecasters believe that the Asian crisis will lower the Region's growth rate but will not cause a significant downturn. Still, considerable uncertainty remains about the ultimate size of the impact and when will it be felt. At the industry level, the crisis may dampen the growth of the Region's booming high-tech and commercial aircraft industries. Some agricultural exports, like Alaskan seafood, Idaho potatoes, and fruits and vegetables, also may be hurt (see *Current Regional Banking Conditions*).

Implications: Banks should be aware of the uncertainties created by the Asian crisis when evaluating the financial health of their market area and their borrowers. Because the Asian crisis, at least initially, will hit selected states and key industries, the paragraphs that follow briefly examine each state's vulnerability to the crisis and its outlook for 1998. States are presented in order of their projected exposure to the Asian crisis.

Washington Has the Highest Exposure but a Positive Outlook

Washington's economy depends heavily on exports of aerospace, timber and wood products, and agricultural goods to Asia. As shown in Chart 4, exports to these countries represented about 9 percent of Washington's GSP, compared with about 2.5 percent for the nation. As a share of GSP, Washington's exposure is the highest in

the nation. Thus, there is potential for considerable disruption to Washington's export-based economy, especially if Asian airlines cancel a significant number of orders for commercial aircraft. Fortunately, Boeing has a huge backlog of orders, and these long-term purchases often may just be postponed.

The state of Washington's 1997 *Labor Market and Economic Report* projects "modestly slower growth in 1998 but basically a continuation of present trends." Job growth is expected to increase about 3.5 percent in 1998, keeping the state among the fastest growing in the nation.

Oregon Looks for Continued Growth but Needs to Watch the Exports

State analysts issued a warning about Oregon's vulnerability to the crisis in Asia, noting that it "will almost certainly have a disproportionate impact on the state because of the region's importance as an export market and as a source of foreign direct investment." Exports to Asia represent nearly 7 percent of GSP, the second-highest share in the nation. Risk is concentrated in agriculture, high technology, and lumber and wood products.

Like Washington, Oregon's economy is expected to grow more slowly in 1998. *The 1998 Oregon Economic and Revenue Forecast* projects that employment will grow 2.5 percent in 1998, down from 3.4 percent in 1997 when the state ranked tenth nationally in job growth. Manufacturing, as well as construction, showed signs of slowing in the second half of 1997, which is consistent with this outlook.

California's 1998 Outlook Is Upbeat, but High Tech Needs Watching

The Asian crisis is expected to have an impact on California's high-tech sector and to a lesser extent the state's agricultural industry, but the crisis probably will not affect the state's four-year-old expansion. Still, California, especially the Silicon Valley, is much more vulnerable to the crisis than the nation as a whole. High-tech exports to Asia accounted for about one-third of California's \$99 billion in merchandise export sales in 1996. Asian exports are about 5.5 percent of GSP, third highest in the nation. Analysts will be watching for signs of declining sales of computers and electronic equipment

or reduced profitability at high-tech firms. Analysts also will want to monitor changes in the farm sector (see *Current Regional Banking Conditions*).

Despite the Asian situation, California's employment growth in 1998 is expected to exceed the national growth rate while slowing to a 2.5 to 3 percent growth range. The strong national economy and a booming service sector in California are expected to continue to help boost the California recovery, much as they did in 1997 when the state added jobs at a 3.8 percent rate.

Arizona Is the Fastest Growing State

Arizona's dependence on exports to Asia as a share of GSP ranks fifth nationally, at over 4 percent. Moreover, exposure is highly concentrated: over 80 percent of the state's exports to Asia are high-tech products, which increases the state's risk from a high-tech slowdown.

Arizona's economy has been growing rapidly; in 1997 it overtook Nevada as the nation's fastest growing state in terms of job growth. Moreover, employment growth was well balanced across the economy as it added 4.5 percent more jobs in 1997. The *Arizona Department of Commerce* estimates that 1998 employment growth will be 3.3 percent, the slowest rate of growth since 1992. Nonetheless, Arizona would remain among the fastest growing states in the nation.

Asian Situation Clouds the Outlook for Hawaii and the Pacific Islands

Hawaii's primary exposure to the Asian crisis lies in its main industry, tourism, rather than in exports to Asia. Asian tourists make up a large share of the state's visitors, and Japan accounts for nearly one-third of all visitors and more than one-third of all spending. The yen's depreciation has reduced Japanese spending in Hawaii. While the other Asian Ten nations account for only about 5 percent of visitors, their numbers and spending are expected to be sharply curtailed as a result of the severe devaluation of their currencies in 1997, which further contributes to the weak outlook for tourism.

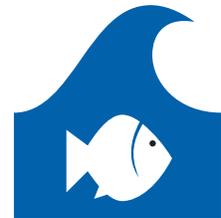
Most analysts expect the state's economy to remain stagnant in 1998. In the 1990s, the Hawaiian economy appears to have been driven more by the weak performance of Japan than by the expanding U.S. economy. In

1998, international forces and the continued weak Japanese economy should again curtail tourism, as well as foreign investment, especially in real estate. Furthermore, banking industry performance in the state likely will continue to reflect the stagnant economy.

In recent years the Pacific Island Territories of American Samoa, the Federated States of Micronesia, and Guam have benefited from the rapid growth in Asia and have focused much of their economic development and export strategies on their links with Asia. While that may be a sound long-term strategy, it will create challenges in 1998 since the devaluations have made these three areas less competitive in attracting tourists from Asia and in generating export sales to Asia. Banks in these three territories reported increases in problem loan ratios in 1997; at year-end, ratios for all three areas were 6.50 percent or more of total loans.

Alaska's Guarded Outlook Hinges on Oil

Although Alaska's exports are modest, according to the Export Location data series, other series suggest that the state's exposure may be significantly larger. In both cases exports are heavily weighted toward natural resources—oil, lumber and wood products, and seafood—destined for Asia, especially Japan and South Korea. State economists expect Japan and South Korea to continue to demand sizable quantities of oil and timber, minimizing the potential impact on export sales. By contrast, Alaskan seafood exporters should face additional downward pressure on prices in 1998 as Asian consumers find prices for Asian fish products much more attractive than for Alaskan fish.



A larger concern for the Alaskan economy is oil prices, which fell to a nine-year low in March. Alaska's economy is unusual in that its economic performance depends more on conditions in the energy markets than on national economic conditions. Its 1997 performance reflected the weakness in energy prices; the state added jobs at a very slow pace—only 1.3 percent in 1997. On the positive side, state economists now expect that oil production will be “flat rather than plummeting” over the next four or five years. The improved forecast also should benefit the state government, which depends heavily on oil tax revenues.

Moderate Expansion Continues in Idaho

The Idaho economy is not heavily dependent on exports to Asia. However, almost 36 percent of that state's small volume of exports are high-tech goods destined for Asia. Agricultural products, many of which are tied to the state's large potato crop, also are exported to Asia. Nonetheless, total farm exports to Asia account for less than 11 percent of the state's exports. State forecasters expect both high-tech and food product demand to soften in 1998 as a result of the Asian situation.

Idaho's *Department of Financial Management* (January 1998) forecasts a 2.5 percent employment growth in 1998, similar to that of 1997 when the state added jobs at a 2.6 percent rate. The department foresees weakness in lumber and wood products, as well as federal government employment. The state's construction boom also appears to be over.

Strong Growth Is Expected in Utah in 1998

As is the case in Idaho, exports are less important to Utah's economy than they are to the Region as a whole. Moreover, exposure is not concentrated in any one industry or sector. High-tech goods are the state's leading export, but only 15 percent of them are high-tech products destined for Asia.

State forecasters expect that Utah will continue to expand in 1998; they also expect the slowing trend of recent years to continue. Utah added jobs at a 4 percent rate in 1997, the fifth fastest rate in the nation, but the slowest growth rate for the state since 1991. The 1998 *Economic Report of the Governor* projects robust growth for employment, at 3.6 percent. Still, the report cites several factors that justify the prediction of slower growth: lower net in-migration, reduced housing affordability and residential construction, improved conditions in other state economies, slower export growth, tight labor market conditions, and expected higher downtown office vacancy rates.

Nevada Will Have Rapid Growth but Higher Risks

Nevada's exposure to the Asian crisis arises mostly through its heavy dependence on gaming and tourism, which account for about one-third of the state's employment. While Asia may not be a major issue for Nevada

(except through its impact on gaming and tourism), other risks are of concern to the banking industry.

Nevada's booming economy is slowing; it added jobs at a 4.3 percent annual rate in 1997, only about half as fast as in 1996 when it added jobs at an extraordinary 7.7 percent rate. Nevada's huge gaming and tourism industry appears to have weakened somewhat in 1997, while construction job growth slowed dramatically. Construction of new hotel rooms is outpacing the number of visitors, and commercial office vacancy rates have climbed well above the national average. Finally, Nevada's new banks and community banks both have a high exposure to construction and commercial real estate loans, as discussed in previous issues of this publication.



Despite this high-risk profile, most forecasters expect the state's economy to continue to add jobs at a 4 to 6 percent rate in 1998; the consensus published by the *Western Blue Chip Economic Forecast* (January/February 1998) was a 5.4 percent rate of job growth for the year.

Montana and Wyoming Should Have Moderate to Weak Growth

Neither **Montana** nor **Wyoming** is likely to be significantly affected by a decline in exports to Asia. Both states' export sectors are only a tiny share of GSP, and exports to Asia are below the national average. The only major difference between the two is in the type of exports destined for Asia. Montana's exports to Asia are mainly high-tech goods, while Wyoming's are primarily agricultural.

Montana's economy likely will continue to record moderate to slow growth during 1998. The economy clearly has slowed over the past several years; its 1997 employment growth rate, 2.1 percent, was the slowest since before the 1990-1991 recession. Weak personal income growth, a rising unemployment rate, and softness in housing all contribute to the weak prognosis.

Likewise, Wyoming's outlook for 1998 is for continued weakness, especially in its large natural resources sector. The state has been hurt by falling energy prices and

declining energy production; its construction sector also contracted in 1997 as the building boom faded.

Implications: A review of the exposure of the individual states in the Region to Asia, their current performance, and their outlook for 1998 suggests that the Region in aggregate likely will be only moderately affected by the Asian situation. In general, states with large manufacturing sectors are growing rapidly and are expected to continue to expand faster than the nation in 1998; however, most are expected to slow somewhat as a result of a mix of factors, including weaker exports to Asia. Despite this concern, strong economic growth in these states may give the Region's banking institutions the opportunity for another good year in 1998, although insured institutions in these states should carefully mon-

itor the health of borrowers that depend on high technology, aerospace, farm products, or other trade that may be affected by the Asian crisis.

Unlike Hawaii, most of the states with weaker economies will not be affected directly by the Asian crisis. Still, any additional softening could expose lenders to potential asset quality problems. Furthermore, continued weak economic conditions in Hawaii and the Pacific Island Territories could result in additional deterioration in the performance of some community banks and thrifts (see *Current Regional Banking Conditions*).

Gary C. Zimmerman, Regional Economist

Current Regional Banking Conditions

- The Region's commercial banks and thrifts posted their strongest results in more than a decade at year-end 1997.
- Agricultural lending, which is prevalent in almost 60 percent of the Region's banks, may become more volatile as government payments decline and some export markets react negatively to the Asian crisis.
- Higher risk real estate concentrations in some of the Region's newly chartered banks warrant attention, especially in Nevada, where some real estate indicators are showing signs of a slowdown.

Region's Insured Institutions Report Strong Profits

Banks and thrifts in the San Francisco Region finished 1997 with the strongest earnings, lowest nonperforming loan ratios, and highest capital levels in over a decade. Despite the Region's above-average exposure to the financial turmoil in Asia, the slowdown there thus far has had only a minor impact on the health of the Region's economy and financial institutions (see *Strong Growth Is Expected to Continue in the San Francisco Region despite Potential Fallout from the Asian Crisis*).

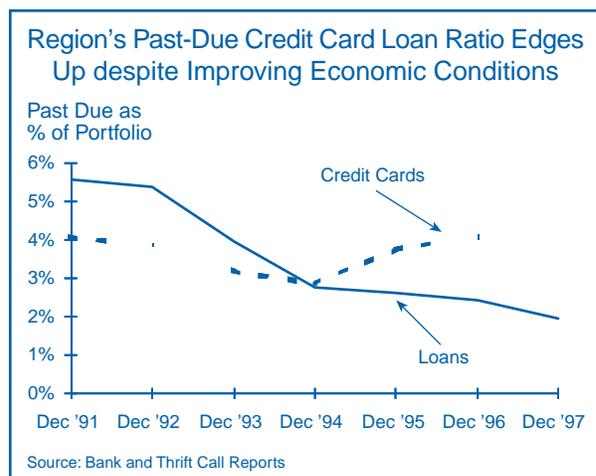
- Return on assets (ROA) at the Region's banks and thrifts mirrored national returns of 1.19 percent for the 12 months ending December 31, 1997, which is significantly above the 1996 ROA of 0.95 percent. Lower deposit insurance premiums¹ coupled with slightly higher trust fee income and noninterest income from foreign operations offset a contraction of net interest margins and a slight uptick in loan loss provision expenses at the Region's insured institutions.
- The ratio of past-due loans (loans past due 30 or more days plus nonaccrual loans) to total loans at the Region's insured institutions dropped to 1.97 percent

¹ A special assessment on SAIF-assessable deposits, including those held by Savings Association Insurance Fund members and Bank Insurance Fund-member OAR institutions, was imposed in 1996 to capitalize the SAIF at its target Designated Reserve Ratio of 1.25 percent of insured deposits. The one-time special assessment of 65.7 basis points was applied against SAIF-assessable deposits held by institutions as of March 31, 1995, and had a significant effect on 1996 earnings for institutions that paid the special assessment.

of total loans, well below the national average of 2.27 percent. The decline reflected improvement in most loan categories throughout the Region. Consumer loan portfolios are, however, still showing signs of weakness (see Chart 1). Community banks and thrifts (defined here as non-credit-card banks and thrifts with total assets of less than \$1 billion) in two of the Region's underperforming states—**Montana** and **Hawaii**—and three territories—American Samoa, Guam, and Micronesia—did buck the Region's trend by reporting increases in past-due ratios at year-end.

- Excellent earnings continue to bolster capital levels, despite a 79 percent dividend payout ratio. The aggregate tier 1 leverage ratio for the Region's insured institutions is now 7.71 percent; for institutions with assets under \$1 billion, the ratio is 9.50 percent.

CHART 1



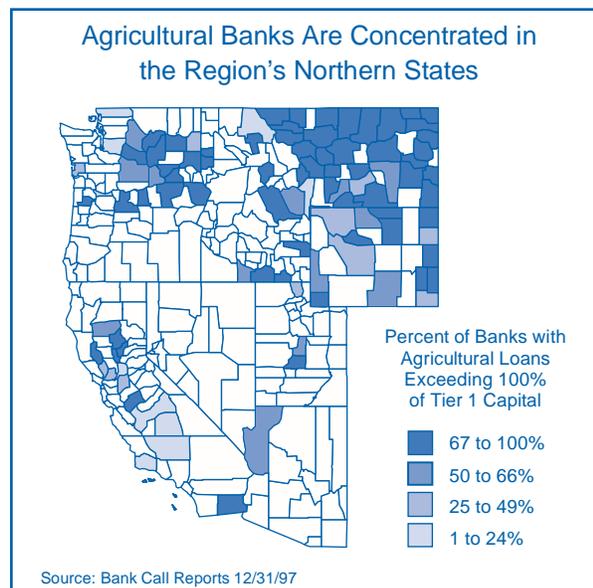
Agricultural Lending Is Prevalent throughout the Region

The health of the agriculture sector significantly influences the performance of agricultural loans in financial institutions throughout the Region. Although the Region has only 20 percent of the total U.S. population, it accounts for over 28 percent of the nation's agricultural production. **California** leads the nation in agricultural production, but **Arizona**, **Hawaii**, **Idaho**, **Oregon**, **Montana**, and **Washington** also are among the nation's top ten producers of several agricultural products.

At year-end 1997, banks and thrifts in the Region had \$7.4 billion in outstanding agricultural production loans and another \$2.2 billion in loans secured by farm real estate. Almost 60 percent (461) of the banks in the Region were involved in farm lending, 133 of these 461 banks had over 100 percent of tier 1 capital in agricultural loans. Of these *agricultural or farm* banks, 131 can be described as community farm banks, institutions with assets of less \$1 billion dollars.² The average assets of these 131 community farm banks was just under \$100 million. The number of farm banks in the San

² For this article, the 131 agricultural (or farm) banks are defined as institutions with total assets under \$1 billion (community banks) and with agricultural loans (agricultural production loans and real estate loans secured by farm properties) that constitute over 100 percent of tier 1 capital. Two banks with over \$1 billion in assets also report agricultural loans that constitute over 100 percent of tier 1 capital, but they are typically analyzed with comparably larger peers.

CHART 2



Francisco Region declined 23 percent between 1991 and 1997; over half of the reduction occurred in Montana, where a 1989 change in the state's mergers and acquisition's banking law spurred merger activity.

Most of the farm community banks are in the northern part of the Region and in California's Central Valley, as shown in Chart 2. The number of community banks with agricultural lending concentrations is significant in Montana, Idaho, and **Wyoming**, where farm banks account for 56 percent, 44 percent, and 42 percent of total banks in each state, respectively.

In addition to agricultural lending by community banks with concentrations in farm lending, four of the nation's top ten agricultural lenders, ranked by agricultural loans outstanding, are located in the San Francisco Region. These four large banks have assets ranging from \$8 billion to over \$200 billion. They have multiple branch offices in farming communities, and as a group they account for over one-half of the Region's agricultural loans. Their dominance in this market contrasts sharply with the situation elsewhere in the nation, where the bulk of agricultural loans are provided mostly through farm community banks, which typically have average assets of less than \$100 million. Two factors that contribute to the Region's agricultural lending patterns are the average size of the farms and the value of the products sold per farm, both of which are about twice the national average. In Arizona and California, the value of the products sold per farm in 1996 was almost three times the national average. The borrowing needs of these larger farms can exceed the legal lending limits of the state's smaller community banks.

1997 Was a Good Year for the Region's Farm Banks

As a group, the Region's farm banks recorded a strong performance in 1997. ROA for farm banks with less than \$1 billion in assets edged up to 1.24 percent as an increase in overhead expenses was offset by higher net interest margins. Favorable asset quality also helped maintain farm bank performance. The past-due ratio (30 days or more and nonaccrual loans) to total farm real estate loans fell from 3.01 percent at year-end 1996 to 2.58 percent at year-end 1997 for farm banks with less than \$1 billion in assets. The past-due ratio for loans to finance agricultural production also remained low for these banks, although the past-due ratio climbed from 0.21 percent at year-end 1996 to 0.39 percent at year-

end 1997. Despite excellent earnings, tier 1 leverage capital ratios at farm community banks declined from 9.68 percent at year-end 1996 to 9.50 percent of total assets on December 31, 1997, because of strong asset growth. The loan growth was almost evenly split between agricultural production loans and real estate loans secured by farm properties.

Farm Bill and Asian Crisis Mean Challenges Ahead

Notwithstanding the general good health of the farm banks, the Region's agricultural lenders may face two key challenges in the coming year. The first is the 1996 Farm Bill. Under this bill, price supports have been replaced by a series of income payments that are being phased out over a seven-year period ending in 2002. Now farmers will base expected crop returns on market prices rather than on a guaranteed target price, thus exposing agricultural producers and consequently their

lenders to new price risks. The legislation likely will result in increased price volatility for commodities because most producers are now free to determine the type of crop they wish to grow and the amount of acreage they wish to allocate. The financial transition will be greatest for farmers with the most dependence on government payments—generally wheat, cotton, and mixed-grain farmers. In the San Francisco Region, Montana's farmers may be most affected by the 1996 Farm Bill, as they are currently the most reliant on government cash payments, as shown in Table 1.

The Asian crisis is the second area that warrants additional monitoring in 1998 for its potential effects on the farm sector. Agricultural exports nationwide average about 30 percent of farm cash receipts. In 1997, \$24 billion or approximately 41 percent of the total value of U.S. agricultural exports were shipped to Asia. The five most troubled Asian economies—Indonesia, Malaysia, the Philippines, South Korea, and Thailand—account for 12 percent of U.S. farm exports. Japan and Taiwan,

TABLE 1

MONTANA FARMERS RELY MOST ON GOVERNMENT SUBSIDIES FOR THEIR AGRICULTURAL CASH RECEIPTS													
	AK	AZ	CA	HI	ID	MT	NV	OR	UT	WA	WY	REGION	U.S.
FARM FINANCIAL INDICATORS													
GOVERNMENT PAYMENTS AS % OF CASH RECEIPTS ^A	4.1%	2.63%	1.25%	0.12%	3.29%	10.62%	0.90%	2.43%	2.53%	2.67%	3.55%	2.31%	3.48%
PERCENT OF AG CASH RECEIPTS FROM EXPORTS ^A	1%	20%	31%	23%	26%	42%	3%	23%	17%	36%	7%	30%	30%
FARM DEBT-TO-EQUITY RATIO ^A	2.1%	9.1%	23.2%	4.7%	22.4%	14.8%	7.8%	13.7%	9.6%	19.0%	12.8%	NA	NA
FARM DEBT-TO-ASSETS RATIO ^A	2.0%	8.3%	18.8%	4.5%	18.3%	12.9%	7.2%	12.0%	8.7%	15.9%	11.4%	NA	NA
NET FARM INCOME CHANGE: '95 TO '96 ^A	-7.8%	9.2%	21.9%	-117.6%	27.7%	-18.9%	17.9%	72.4%	19.4%	71.4%	-26.1%	26.4%	42.1%
PERCENT W/ FARMING AS PRINCIPAL OCCUPATION ^A	53%	53%	52%	55%	59%	70%	57%	48%	46%	55%	64%	NA	NA
STATISTICS ON BANK LENDING TO FARMERS													
# OF COMMUNITY AG BANKS ^B	0	1	19	0	7	53	0	7	3	19	22	131	2947
COMMUNITY AG BANKS AS A % OF ALL BANKS ^B	0.0%	2.6%	5.7%	0.0%	43.8%	56.3%	0.0%	17.8%	7.0%	21.0%	42.3%	17.4%	31.8%
AVERAGE COMMUNITY AG BANK SIZE (\$ IN MILLIONS) ^B	\$0.0	\$246.7	\$214.1	\$0.0	\$133.9	\$48.0	\$0.0	\$202.1	\$43.8	\$91.5	\$81.1	\$98.2	\$71.4
COMMUNITY AG BANKS—PAST- DUE FARM LOAN RATIO ^{B,C}	0.00%	0.00%	0.65%	0.00%	0.26%	1.54%	0.00%	0.12%	1.37%	0.53%	1.64%	0.97%	0.89%
LARGE BANKS—PAST-DUE FARM LOANS RATIO ^{B,D}	4.28%	2.42%	2.35%	14.78%	0.25%	2.00%	0.40%	0.62%	2.97%	0.90%	2.26%	2.69%	1.46%
AG LOANS AS % OF TIER 1 CAPITAL ^{B,E}	0%	129%	150%	0%	234%	301%	0%	125%	160%	199%	196%	199%	216%
NOTE: NA=NOT APPLICABLE													
^A SOURCE: U.S. DEPARTMENT OF AGRICULTURE													
^B SOURCE: BANK CALL REPORTS 12/31/97													
^C COMMUNITY AG BANKS ARE BANKS WITH TOTAL ASSETS UNDER \$1 BILLION AND ALL AGRICULTURAL LOANS THAT CONSTITUTE OVER 100 PERCENT OF TIER 1 CAPITAL.													
^D LARGE BANKS HAVE ASSETS OF \$1 BILLION OR MORE.													
^E AGRICULTURAL LOANS HERE ARE DEFINED TO INCLUDE BOTH AGRICULTURAL PRODUCTION LOANS AND LOANS SECURED BY FARM REAL ESTATE.													

which did not experience sharp devaluations in 1997, account for an additional 25 percent. The U.S. Department of Agriculture (USDA) is projecting that U.S. agricultural exports will fall 2 percent below 1997 levels and more than 6 percent below 1996 levels because of weaker Asian demand, increased competition, and lower prices.

Farmers in the San Francisco Region are disproportionately exposed to the turmoil in Asia for two reasons: First, two of the top ten agricultural export states in the country—California and Washington—are in the San Francisco Region; California alone accounts for more than 20 percent of total U.S. agricultural exports. Second, a high percentage of the Region's exports go to Asia. Over half of California's agricultural exports go to Asia, and selected markets like the state's Central Valley ship as much as 80 percent of their cattle and cotton production to Asia. Chart 3 summarizes the major commodities in the Region that are most vulnerable to the projected reduction in exports to Asia.

Furthermore, world markets affect the value of commodities consumed domestically. Consequently, some agricultural products that are not exported directly to Asia nevertheless are being affected by the financial turmoil. For example, cattle and calves are the leading products in Wyoming, accounting for 60 percent of the state's agricultural cash receipts. However, beef exporting countries like Australia and Canada now are having difficulty selling beef in Asia, and the strong dollar has made the United States a very attractive market. While USDA economists believe that Japan will continue to import two-thirds of all U.S. beef exports, U.S. cattle production is expected to decline in 1998 because of ris-

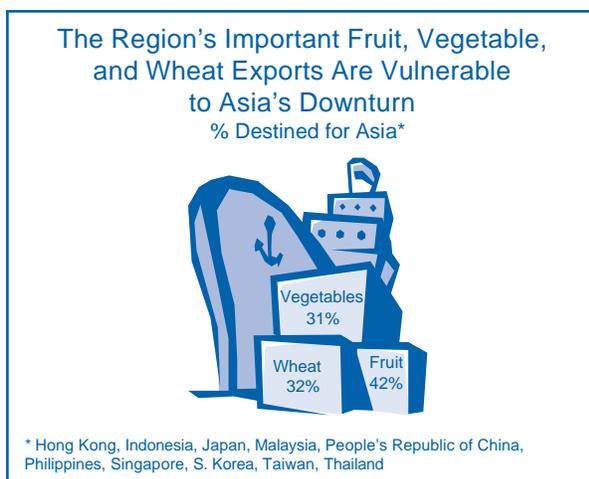
ing imports and declining exports. The rising domestic supply may affect the cash receipts and the health of the ranching industry directly.

Implications: In the coming year, both the 1996 Farm Bill and the emerging Asian crisis will affect agricultural products and prices in the San Francisco Region. Although the 1998 price outlook for major crops and livestock products—for example, beef, cotton, and wheat—are stable to slightly down, prices could be greatly undermined if economic conditions in Asia deteriorate any further. Clearly, conditions in the agricultural sector will affect the performance of farm lenders as well.

Despite the consolidation that has already occurred in Montana, farm banks in that state still may have higher than normal risk exposures. Montana's agricultural sector has a high dependence on government subsidies, as shown in Table 1. Reductions in those subsidies will increase the risk agricultural producers face from changing market conditions and may increase the importance of risk management for both farmers and farm lenders. This could be particularly important in Montana, because the farm banks in that state have an agricultural loan concentration ratio of over 300 percent of capital, the highest in the Region (see Table 1).

USDA can provide additional information on farm sector conditions. Those interested in topics such as crop prices, stages of planting, special research papers, and production forecasts may go to the USDA homepage at <http://www.usda.gov/> and the USDA Statistics Service homepage at <http://www.usda.gov/nass/>.

CHART 3



Industry Consolidates amid Rising Chartering Activity

In 1997, the arrival of nationwide interstate banking sparked merger activity throughout the Region, although many of these mergers represented consolidations of banks already operated by large multistate bank holding companies. By year-end 1997, the number of mergers and consolidations within the Region totaled 80, well above the 1996 tally of 65. Noteworthy interstate acquisitions were led by the acquisition of Great Western Bank, which is a federal savings bank with \$42 billion in assets located in California, by Washington Mutual Savings Bank, which is headquartered in **Seattle**, Washington. Many of the 1997 mergers involved affiliated institutions, as large bank holding companies

in the Region took advantage of the new interstate banking laws to merge some of their out-of-state, and in some cases out-of-Region, bank subsidiaries into their lead bank. The latter transactions shifted reported bank assets into the Region. By contrast, the acquisition of U.S. National Bank of Oregon by an out-of-Region bank shifted the reporting of over \$30 billion in assets out of the San Francisco Region. More recently, the proposed interstate merger between BankAmerica, headquartered in **San Francisco**, and NationsBank, of Charlotte, North Carolina, would continue the consolidation trend by creating the largest commercial bank in the nation.

Industry consolidation and healthy economic growth have been catalysts for new chartering activity in the San Francisco Region. In 1994, only two thrift charters and five commercial bank charters were issued, a record low. The number of insured financial institution charters tripled in 1995 to 21, edged up to 25 in 1996, and then accelerated to 37 in 1997. As a result of this increased chartering activity, financial institutions that are three years old or less now account for 20 percent or more of the banks and thrifts in **Nevada**, Arizona, Idaho, and **Utah** (see Chart 4).

Newly chartered financial institutions face a variety of challenges, not the least of which is to establish a profitable, well-balanced loan portfolio. Loan officers of

CHART 4

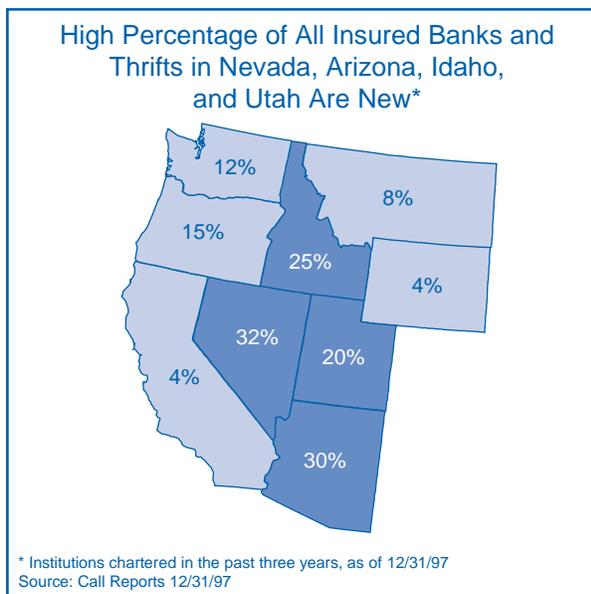
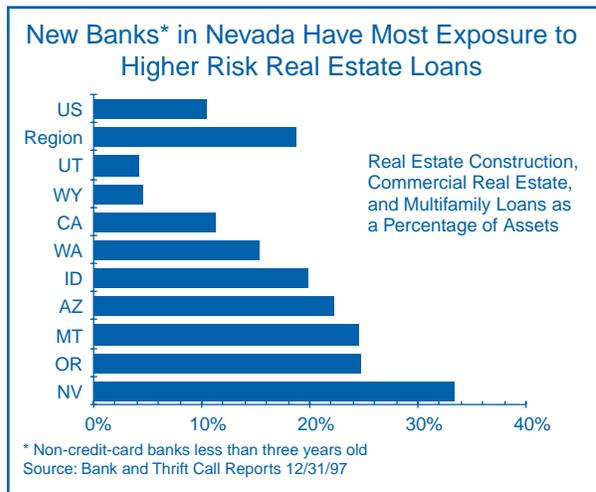


CHART 5



new institutions, especially those located in some of the Region's faster growing states, are facing stiff competition not only from large well-established institutions, but also from other newly chartered banks. Because they are located in rapidly expanding markets, some of these new institutions may develop loan portfolios that are relatively concentrated in certain types of loans, rather than being well diversified across a variety of loan types. For example, as seen in Chart 5, higher risk real estate loans account for over 33 percent of total assets at Nevada's new insured institutions, compared with just 19 percent and 11 percent for the Region and the nation's new institutions, respectively. This heavy concentration may place these institutions at risk from the effects of an economic downturn.

Implications: According to the FDIC's *History of the Eighties* report on banking problems, "**new** banks failed more frequently than existing banks, and banks that subsequently failed had significantly **more of their assets** in higher risk real estate loans." Although the San Francisco Region continues to enjoy robust economic conditions, newly chartered institutions, especially fast-growing banks with concentrations in higher risk real estate loans, may be among those institutions that are most at risk from the effects of an economic downturn. Thus, these institutions may warrant close attention from bank management and regulators.

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