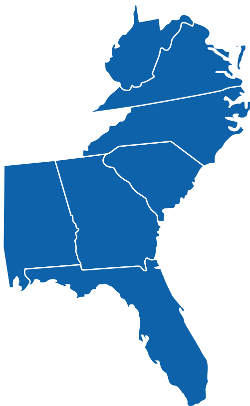
Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION — SECOND QUARTER 2000

FDIC
ATLANTA
REGION



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INSURANCE

JACK M.W. PHELPS,
REGIONAL MANAGER

SCOTT C. HUGHES,
REGIONAL ECONOMIST

PAMELA R. STALLINGS,
SENIOR FINANCIAL
ANALYST

Regional Perspectives

◆ ***Economic strength in the Atlanta Region, low interest rates, and adequate available sources of credit have promoted growth in residential real estate construction in recent years, particularly in urban areas*****—Insured financial institutions in some of the Region's metropolitan areas are providing residential financing, both permanent and construction, at a pace ahead of the national average, which may result in higher default rates in the event of an economic downturn.** *See page 3.*

◆ ***Structural and cyclical changes may heighten the risk for lenders engaged in residential real estate lending*****—Structural changes in financing have helped many first-time home buyers and allowed existing homeowners to increase their home-secured debt, which may be problematic if the economy falters and home values decline. Further interest rate increases may slow absorption of new supply and sales of existing homes.** *See page 6.*

◆ ***Commercial real estate development has increased substantially as high-tech ventures and supporting industries have moved to or expanded in the suburban Virginia portion of the Washington, D.C., metropolitan statistical area*****—Setbacks in the high-tech-fueled local economy could ultimately affect banks' construction and development loan quality. The local banking industry's ability to weather an economic or industry downturn may be further complicated by the fact that one-third of Northern Virginia's banks have not been recession-tested.** *See page 7.*

By the Atlanta Region Staff

In Focus This Quarter

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

By the Analysis Branch Staff

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Regional Perspectives

- **Some Atlanta Region metropolitan areas have outperformed national single-family and multifamily housing markets.**
- **Construction and development lending exposures for the Region's insured institutions may be increasing as residential real estate construction activity continues to expand.**
- **Changing economic drivers and the rapid pace of commercial real estate development in Northern Virginia may pose new risks to community banks located in the area.**

Residential Construction Surges in the Atlanta Region

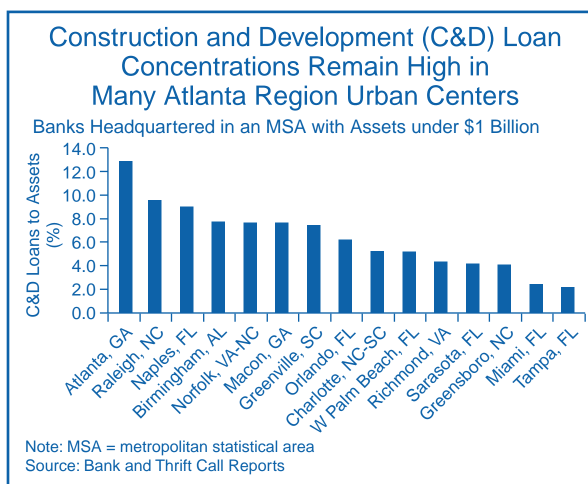
Growth in population, employment, and income, combined with low interest rates and adequate available sources of credit, has promoted growth in residential real estate construction in recent years, particularly in the Atlanta Region's metropolitan areas. Four of the Region's seven states—**Florida, Georgia, North Carolina,** and **Virginia**—rank among the top ten states nationally in terms of permit issuance. Insured institutions in some Atlanta Region metropolitan areas are providing residential financing, both permanent and construction, at a pace ahead of the national average, which may result in higher default rates in the event of an economic downturn.

In tandem with the favorable economic drivers, there have been some structural changes in residential real estate financing during this expansion that could influence loss rates in a downturn. Low mortgage interest rates, a ready availability of credit, and increases in loan-to-value ratios have contributed to the rising level of homeownership. These factors have made home buying affordable for many first-time buyers who may not have the capacity to service debt should the economy falter. Also, rapid price appreciation has allowed many consumers to increase their debt levels through home equity lines. Any significant decline in housing values could strain households that have borrowed extensively on the expectation that housing prices will continue to rise. The combination of new homeowners and increased borrowing secured by home values may expose lenders to greater credit risk.

An additional significant risk to real estate markets has been the recent rise in interest rates, which are approaching highs not seen since early 1997. According to ***Freddie Mac,*** mortgage rates as of the third week of March 2000 were at 8.2 percent, up from 6.5 percent in late 1998. Mortgage rates have not been this high since September 1996. The higher mortgage rates have yet to significantly affect permit issuance, absorption of new supply, and existing home sales in the Southeast; however, if the rates reach double digits, sales of existing homes and absorption of new supply may slow.

Residential lending exposures at some banks operating in many of the Atlanta Region's urban areas are significant. In fourth quarter 1999, construction and development (C&D) loans accounted for 6.6 percent of community bank[1] assets in the Region's metropolitan areas, which is nearly 50 percent higher than the U.S. metropolitan average. Moreover, when compared with the nation, the Region is home to urban community banks with much larger than average C&D concentrations (see Chart 1). Specifically, while the Region accounts for 15 percent of the nation's urban

CHART 1



Note: MSA = metropolitan statistical area
Source: Bank and Thrift Call Reports

[1] Defined as having assets of $1 billion or less.

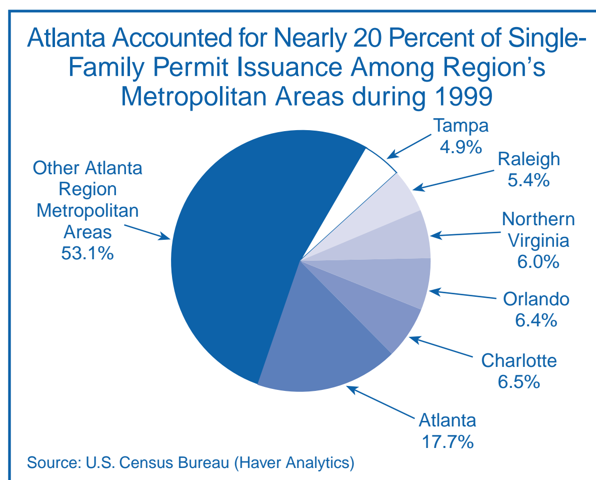
community banks, it is home to 22 percent (123 banks) with C&D loan exposures above 10 percent of assets.

Residential Construction by State

Residential construction in Georgia is at an all-time high in the single-family sector and near-record highs in the multifamily sector. Economic growth in the state is dominated by **Atlanta,** where the vast majority of jobs have been created in recent years. Rising population, higher rates of job growth, and favorable interest rates have supported the increased demand for single-family homes during the 1990s, but continued interest rate increases could soften demand and create a surplus of available homes for sale.

Single-family housing starts in the Atlanta metro area rose 13.6 percent in 1999, while total residential permit issuance increased by 5.2 percent. Single-family permit issuance has risen steadily since 1990, with the exception of a slight dip in 1997. In 1999, Atlanta accounted for nearly 20 percent of all single-family permits issued in the Region's metropolitan areas (see Chart 2). Moreover, single-family permit issuance in Atlanta for 1999 alone was greater than the total for the past three years in **Charlotte,** North Carolina, the next largest market in the Region. Demand for housing likewise appears strong, given that the Atlanta metropolitan area was ranked second in the nation by the ***Mortgage Bankers Association of America*** in its 2000 Hot Mortgage Market Index Rankings. In addition, the median existing home sales price in the Atlanta metropolitan area increased by nearly twice the national average in 1999.

CHART 2



Georgia's multifamily permit issuance also has been on the rise. Atlanta again led the state with the highest level of multifamily construction. Although this market has been quite active, low average vacancy rates have prevailed despite a shift from renters to homeowners. Still, slowing in-migration could result in overbuilding in the multifamily market. According to ***Reis.com,*** the reported average Atlanta vacancy rate in 1999 was 6.6 percent, which was unchanged from one year earlier. Lower-than-average vacancy rates in Class A units indicate that demand is strongest for upscale apartments. The **Augusta-Aiken** and **Macon** metropolitan areas also have experienced significant growth in multifamily residential real estate. Multifamily permit issuance in the Augusta-Aiken metro area rose by nearly half, while job growth increased by just 2.7 percent in 1999. Similarly, permit issuance in the Macon metro area rose 60 percent, with job growth near the national average.

Consistent with the level of building activity, C&D lending in metro Atlanta institutions is significantly higher than the national average. In fact, nearly 60 percent of Atlanta metro banks are above the 90th percentile of the share of assets nationally that are concentrated in C&D credits (9.9 percent). Real estate markets are very sensitive to the business cycle; therefore, an economic downturn may result in greater risk in the Atlanta metro area than in other parts of the Region or the nation.

Residential real estate in North Carolina, reflecting the state's robust economic expansion and population growth, has been growing rapidly throughout the decade. Existing home sales in North Carolina's residential real estate market rose by 7.8 percent in 1999, with the strongest growth occurring during the first half of the year. Statewide, the median price for single-family homes has been relatively stable, with prices rising at a rate comparable to the national average during 1999. Home sales contracts in the Charlotte metro area peaked in 1999, surpassing the 1998 level by 10 percent, according to the ***Carolina Multiple Listing Service.*** Single-family permit issuance in the Charlotte-**Gastonia-Rock Hill** metro area has recorded double-digit growth throughout much of the decade. The median price of existing single-family dwellings in Charlotte rose by only 3 percent in 1999, down significantly from the near double-digit increase in 1996. Similarly, in the **Raleigh** metro area, median prices rose modestly in 1999, a noticeable drop from the 14.6 percent increase in 1996. Residential construction activity in several of the state's metropolitan areas has been declining,

although 1999 year-over-year residential construction activity in the Charlotte-Gastonia-Rock Hill and Raleigh-**Durham-Chapel Hill** metropolitan areas continue to strengthen.

Potential overbuilding in the multifamily construction sector is of greater concern in the Charlotte and Raleigh metro areas. Permit issuance rose by nearly half in both Charlotte and Raleigh during 1999. During 1998 and 1999, more new space in the Charlotte market was completed than absorbed, and asking rents did not increase as rapidly as in the mid-1990s, both of which indicate that the market may be slowing. In addition, vacancy rates were at the highest levels since 1993.

Continued growth in North Carolina's single-family and multifamily real estate markets could negatively affect some insured institutions, particularly in the **Greensboro-Winston-Salem-High Point** metropolitan area, where 4 of the area's 20 institutions rank above the 90th percentile nationally in C&D lending exposures. The 23 institutions headquartered in the Charlotte-Gastonia-Rock Hill metropolitan statistical area (MSA) reported an aggregate C&D loan-to-asset ratio of 5.2 percent in the fourth quarter, compared with the national average of 4.6 percent. Likewise, the Raleigh-Durham-Chapel Hill MSA reported an aggregate C&D loan-to-asset ratio more than one-half percentage point above the national average.

Table 1

In 1999, Existing Home Sales Prices and New Permit Issuances Had Robust Gains in Many Areas of Florida

Area	Change in Median Price (%)	Permit Issuance Growth (%)
Daytona Beach	8.16	5.12
Fort Myers-Cape Coral	6.83	18.20
Orlando	5.81	8.91
Tallahassee	2.66	20.77
Tampa-St. Petersburg-Clearwater	5.69	13.67
Statewide	8.00	8.97

Sources: National Association of Realtors and U.S. Bureau of the Census

Population growth in Florida may be slowing, but residential real estate construction continues to heat up in many metropolitan areas. Florida's economy is robust, as it has been throughout the nation's longest running economic expansion. Job growth in 1999, at 3.6 percent, was well above the national average. Single-family housing sales were particularly strong in the **Daytona Beach, Fort Myers-Cape Coral,** and **Lakeland-Winter Haven** metro areas in 1999, while permit issuance was its most robust in the **Miami, Tallahassee,** and **Tampa-St. Petersburg-Clearwater** metropolitan areas. Statewide, existing home sales increased by 11.3 percent, according to the ***Florida Association of Realtors,*** more than twice the national rate of increase. Single-family residential real estate activity varies throughout the state's metropolitan markets (as shown in Table 1).

Multifamily construction in some of Florida's metropolitan areas is showing strong growth, despite slowing population and job growth. In the **Jacksonville** metropolitan area, for instance, permit issuance in 1999 nearly doubled, while the vacancy rate was above 7 percent for the second straight year. Likewise, the **Orlando** metropolitan area continued to add space when absorption was not keeping pace with completions. Vacancy rates in the Orlando market also edged higher, approaching 6 percent.

Despite Florida's brisk building activity, only the **Fort Walton Beach** and **Panama City** metropolitan areas have C&D exposures significantly above the U.S. average. Of the seven institutions in the Fort Walton Beach metropolitan area with assets under $1 billion, three reported C&D lending exposures in the nation's 90th percentile. The Panama City metropolitan area reported a 26.6 percent C&D loan-to-asset ratio, and two of its four institutions are ranked above the 90th percentile nationally in C&D lending exposure.

The strong **South Carolina** economy was good news for the state's realtors and builders. South Carolina's economy turned in its best performance in over a decade last year. Employment growth was well above the national average, and labor markets remained exceptionally tight, especially in urban areas such as **Charleston, Columbia,** and **Greenville.** Reflecting the strength of the state's economy, sales of existing homes and sales prices both increased rapidly. The Charleston-**North Charleston** metro area is the state's hottest single-family construction market. Based on sales of new and existing single-family homes, townhomes, and condominiums, the average sales price of a new single-

family home topped $200,000, setting a record. Existing home sales prices also reached a record high. Since the second quarter of 1996, the average home price increased by nearly half. According to a broker in the area, "The rising interest rates have knocked some people from being qualified, but that hasn't slowed down construction." Should interest rates increase in the future, a glut of homes could exist, with buyers unable to obtain approved financing or with insufficient resources to repay lenders, not only in Charleston but throughout the rest of the Atlanta Region. Multifamily construction in South Carolina's metropolitan markets has declined in all but the Columbia and Greenville-**Spartanburg-Anderson** metro areas, where activity is robust.

South Carolina's greatest exposure to residential lending is in the Greenville-Spartanburg-Anderson metropolitan area, where 7 of the state's 25 institutions reported C&D exposures above the nation's 90th percentile. In the aggregate, the 25 institutions reported a 7.5 percent C&D lending-to-asset ratio, compared with 4.6 percent for the nation.

Construction growth in **Alabama** has been skewed toward single-family dwellings, but, according to the ***Alabama Real Estate Research and Education Center,*** both sales and average selling prices of houses, condominiums, and townhomes increased in 1999. Home sales in the **Mobile** metropolitan area were the highest in the state. However, single-family permit issuance grew only modestly in 1999, signaling that construction is slowing. Conversely, some of the other metropolitan area markets may overheat if permit issuance is used to gauge future construction. The rate of increase in permit issuance in **Tuscaloosa,** for example, outpaced home sales by a wide margin. Multifamily construction is cooling in the state: permit issuance fell by nearly half in 1999.

The **Huntsville** metropolitan area has the state's highest C&D lending exposure, with two of the three institutions headquartered in the MSA reporting a C&D lending-to-asset ratio of 11.8 percent in the fourth quarter. Likewise, Tuscaloosa's C&D lending-to-asset ratio reached 9.7 percent during the same period.

Virginia's economy continues to expand at a rate comparable to that of the nation. Most of the state's employment gains have occurred in the larger metropolitan areas, which, not surprisingly, is where a large share of the residential real estate development has occurred. Statewide, home sales increased by 10 percent. Sales in the Northern Virginia area have been particularly high as a result of rapid economic development (see ***The Northern Virginia Commercial Real Estate Market***). According to a report by the ***Wall Street Journal,*** many markets, including Northern Virginia, have long waiting lists for homes that are yet to be built. Multifamily real estate also is growing rapidly in Northern Virginia; with a vacancy rate of just over 1 percent, demand is strong. An increase of nearly 10 percent in asking rents also shows that demand is expected to remain very strong.

While the **Norfolk-Virginia Beach-Newport News** metropolitan area has the state's highest residential lending exposures, none of the state's metropolitan areas exceeds the national average in C&D, multifamily, or total residential-to-asset lending. Nonetheless, 3 of the 19 institutions in the Norfolk-Virginia Beach-Newport News metro area rank above the nation's 90th percentile in terms of C&D lending.

West Virginia's population growth is the lowest in the nation, and the state's residential real estate growth is the slowest in the Region. The only hot spot in the state is in the panhandle on the edge of the **Washington, D.C.-Baltimore** metropolitan area. Now that residential growth restrictions have been implemented in **Loudoun** and **Prince William Counties** in Virginia, pressure to transform farmland into housing in the panhandle is intensifying. West Virginia's insured institutions reported the lowest aggregate C&D lending exposure for the Region, at 8.4 percent of total assets.

Implications

Overall in the Region, structural changes in real estate financing and rising mortgage interest rates may result in higher credit risk exposure. Structural changes in financing have helped many first-time home buyers and allowed many existing homeowners to increase their home-secured debt, which may be problematic if the economy falters and home values fall. Further increases in interest rates may slow new supply absorption and existing home sales. The combination of these factors may heighten the risk for lenders engaged in residential real estate lending.

The Northern Virginia Commercial Real Estate Market

Throughout the latter half of the 1990s, commercial real estate (CRE) development has increased substantially as high-tech ventures and supporting industries have moved to or expanded in the suburban Virginia portion[2] of the Washington, D.C., metropolitan statistical area. The following analysis examines the local economic drivers and their impact on supply-and-demand forces in CRE markets, and identifies potential risks to local community banks of recent economic and real estate development.

The Economy and Demographics

Like many of the Atlanta Region's metropolitan areas, Northern Virginia is undergoing an economic transformation as traditional employment sectors give way to newer types of industry. Government has long played the role of "traditional" industry. Since 1992, however, government and defense downsizing has resulted in the loss of nearly 7,000 jobs. These losses may help explain the decline in the Northern Virginia area's annual population growth from a high of 3.6 percent during the late 1980s to its nadir of 1.8 percent in 1995. By then, however, rapid economic growth had returned to Northern Virginia, as new and diversified industries emerged. According to an analyst with ***Real Estate Alert,*** "The area, dubbed *netplex,* has become a mecca for telecommunications and other high-tech companies," which has resulted in thousands of new jobs. With the expansion of the high-tech industry has come a rebound in in-migration, which has helped boost annual population growth to 2.5 percent in 1999. Although government continues to play a significant role in Northern Virginia's economy, these new high-tech industries have provided the momentum behind the recent upswing. With the emergence of apparent government budget surpluses, some analysts believe that the push to downsize government payrolls may abate. In fact, in 1999, federal government employment in the area declined by only 700. Growth in new industries and a reduction in federal government job losses have supported greater demand for locally provided goods and services, including CRE space.

Commercial Real Estate Performance

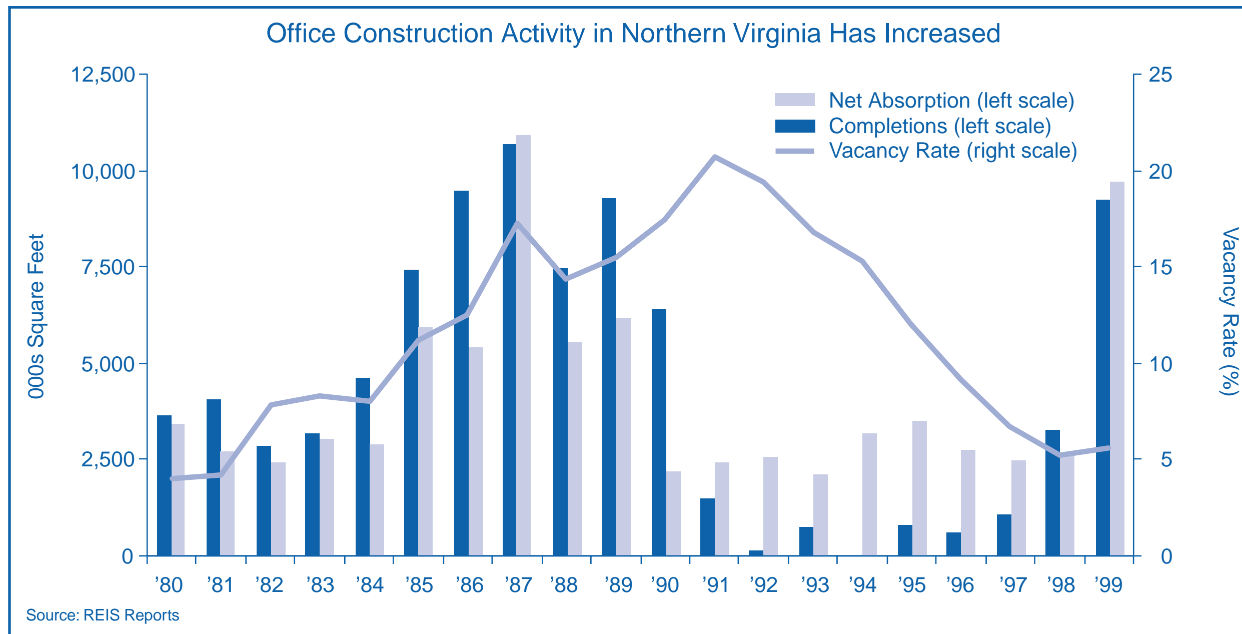
An increasing demand for CRE space has accompanied the return of sustained economic growth in Northern Virginia. The high level of CRE completions in the 1980s, the recession in the early 1990s, and the effects of federal government downsizing constrained demand for new space during the first half of the decade. From a peak 16.4 million square feet (sf) in 1989, CRE completions in Northern Virginia slumped to a low of 1.5 million sf in 1995. Since then, however, construction activity has accelerated as growth in high-tech communications, Internet, and software companies and local support industries absorbed available space. Moreover, as some CRE submarkets closer to Washington, D.C., experience vacancy rates approaching 1 percent and as congestion increasingly has become a problem, new development has dispersed, particularly toward Loudoun County along the Dulles Greenway and near Dulles International Airport. Many analysts expect this trend to continue if rapid economic growth persists. Construction levels in individual market segments (office, retail, and industrial) vary, but generally remain positive.

The Office Market

Office real estate space represents the largest component of Northern Virginia's CRE market, accounting for nearly half of all space. By virtue of the continued importance of the federal government, even in the face of recent downsizing, Northern Virginia represents the nation's seventh largest office real estate market. However, it is the nation's most *active* market, after Dallas, because of the rapid growth in the high-tech sector. In 1999, according to ***REIS Reports,*** 9 million sf of new space was added to the market (see Chart 3, next page), accounting for three-quarters of all CRE completions in the Northern Virginia area. Despite high levels of

[2] The suburban Virginia component of the Washington metropolitan statistical area or Northern Virginia, as defined by the *U.S. Census Bureau,* is composed of the following counties and independent cities: Arlington, Clarke, Culpeper, Fairfax, Fauquier, Fredericksburg, King George, Loudoun, Prince William, Spotsylvania, Stafford, and Warren Counties; and Alexandria, Fairfax, Falls Church, Fredericksburg, Manassas, and Manassas Park Independent Cities. However, Northern Virginia commercial real estate data contained in this article (much of which was supplied by *REIS Reports)* refer to a more limited definition, which excludes the outer counties of Clarke, Culpeper, Fauquier, Fredericksburg, King George, Spotsylvania, Stafford, and Warren Counties and Fredericksburg Independent City. This definition accounts for 83 percent of the population within the *Census Bureau's* definition of Northern Virginia.

Chart 3



Source: REIS Reports

construction activity, completions are just now starting to keep pace with absorption; the market's vacancy rate edged up by nearly one-half percentage point to 5.6 percent in 1999. The current market activity stands in stark contrast to conditions observed just a few years ago. In 1994, no completions were recorded and the vacancy rate was just over 15 percent. Commercial construction activity appears poised to remain at high levels: substantial amounts of development were under construction or in the planning stages at the end of 1999.

The Industrial Market

Industrial market vacancy rates rose to double digits after defense industry downsizing (see Chart 4). As industry diversified away from dependence on military contracts and high-tech companies emerged, net absorption levels became positive and rose to above 1 million sf annually during the second half of the 1990s. As new development failed to keep pace with rising demand, market vacancy rates fell by more than half, from 15.1 percent in 1995 to 6.9 percent in 1999. However, new construction activity has been rising appreciably, and in 1999, completions surpassed 1 million sf for the first time since the start of the decade. Even with this resurgence, construction activity remains well below levels experienced during the 1980s. Continued expansion in Northern Virginia civilian-oriented high-tech industries likely will remain the key driver for the industrial real estate market.

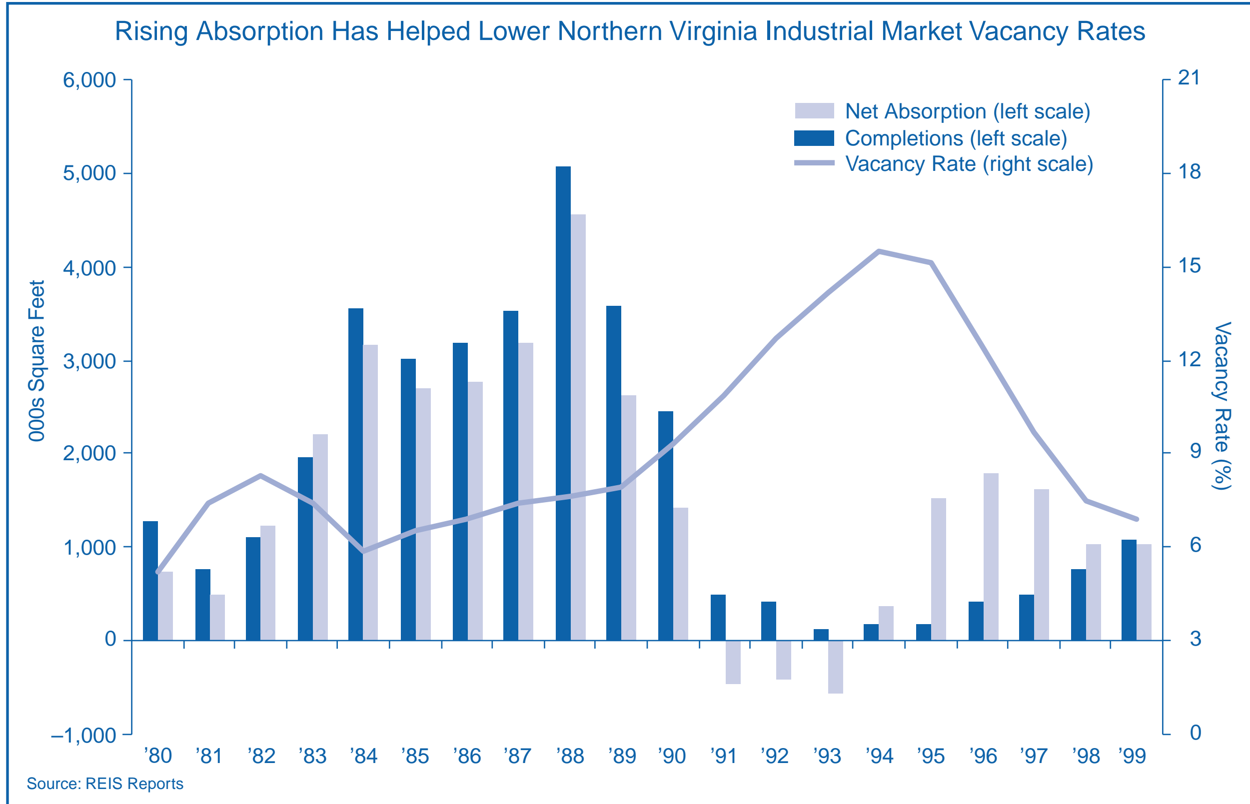
The Retail Market

Unlike the office and industrial markets, demand for retail market space is tied more directly to high-tech growth. However, a rise in *population* growth can also support an increase in demand for retail market space. During the latter half of the 1980s, annual population growth frequently surpassed 3.0 percent, while retail space completions rose to more than 3.5 million sf in 1989. During the first half of the 1990s, however, annual population growth in Northern Virginia averaged just over 2.0 percent, with retail space construction moderating. The subsequent rebound in population growth to 2.5 percent in 1999 coincided with the highest level of completions in a decade (see Chart 5). Should population growth continue and household income levels remain high, demand for retail real estate development could strengthen.

Potential Risk to the Northern Virginia Economy and Commercial Real Estate Market

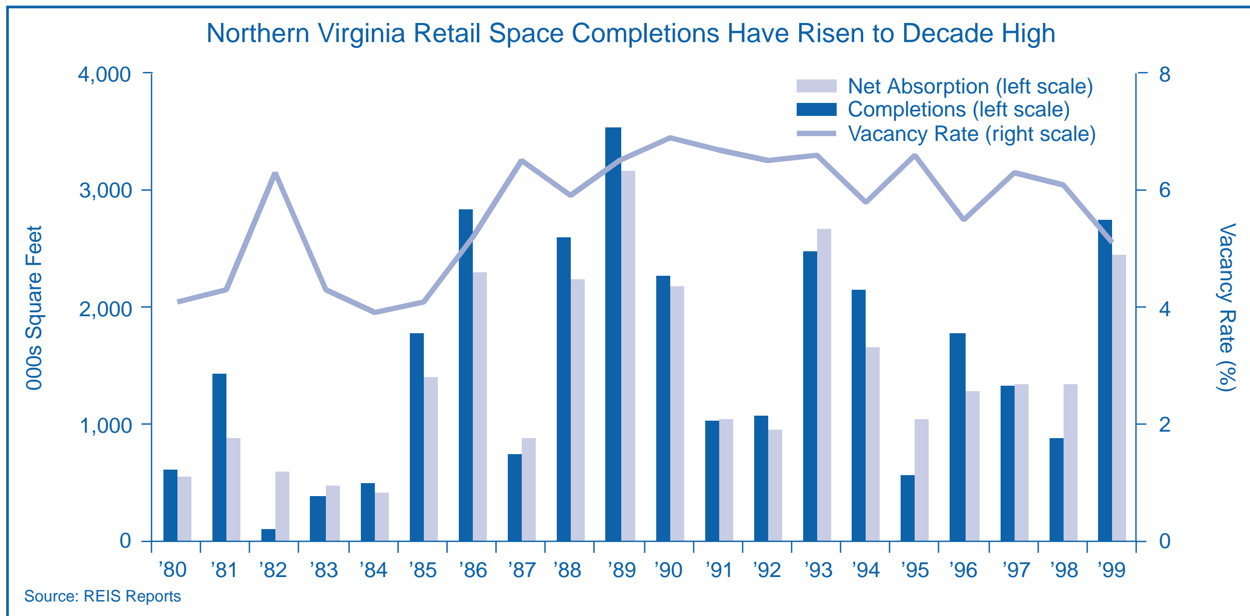
Although it signals a return to strong levels of economic growth, the transformation occurring in Northern Virginia may change the local economy's risk profile and, consequently, that of local CRE markets. In the past, the large presence of the federal government sector often helped stabilize the local economy, even during national recessions. Increasingly, however, the key to continued strong growth in Northern Virginia may be the success of companies in the high-tech sector, such as "dot-coms."

Chart 4



Source: REIS Reports

Chart 5



Source: REIS Reports

However, technologies can change, industry growth can slow, and companies can fall out of favor. Moreover, many of these high-tech enterprises are not recession-tested. The effects of setbacks in the high-tech sector likely would be felt throughout the local economy. Continued balance in Northern Virginia's CRE markets will

depend on the ability of the area's high-growth industries to continue to absorb new construction in the pipeline or in the planning stages. The effects of shocks to the high-tech industry could manifest themselves in the form of reduced levels of absorption in local CRE markets. Moreover, anecdotal evidence suggests that a growing trend in high-tech areas nationwide is that landlords increasingly are accepting equity or stock options in place of rent, which could elevate the risk associated with CRE development.[3] More immediately in terms of absorption risks, however, may be the issue of obtaining qualified labor in a time of near-record low unemployment rates.

Implications for Northern Virginia's Banks

Northern Virginia is home to 31 community banks (headquartered locally, each with assets less than $1 billion), with total assets just over $6 billion in fourth-quarter 1999. This analysis focuses on these institutions as their level of geographic diversity likely is low, and thus, asset quality may be more vulnerable to adverse local economic developments. Nearly all local community banks in Northern Virginia are actively involved in real estate lending, with C&D lending totaling more than $300 million. (***Bank and Thrift Call Report*** data limitations restrict the ability to quantify the amount of residential or commercial lending.) Some Northern Virginia banks hold C&D loans that account for more than 10 percent of total assets. Setbacks in the high-tech-fueled local economy could ultimately affect banks' C&D asset quality. Commercial absorption estimates could be reduced for specific types of space, and growth in supporting industries also could be adversely affected.

The local banking industry's ability to weather an economic or industry downturn may be further complicated by the fact that one-third of Northern Virginia's banks have not been recession-tested, having been established after 1991. During the last recession, new or non-recession-tested banks were about twice as likely to fail or be assigned poor examination ratings than established banks (see ***Atlanta Regional Outlook,*** first quarter 2000). Nine of these non-recession-tested banks are considered de novos, having been open less than three years. Lenders should be aware that the dynamics of the Northern Virginia economy have changed, and consequently, the nature of local CRE markets likely has been transformed as well.

Atlanta Region Staff

[3] See Solomon, Deborah. March 12, 2000. More Start-Ups Pay Their Bills with Stock. From Lawyers to Landlord, Options a Hot Commodity. *USA Today,* and Wilbert, Tony, and Mark, Clothier. February 11, 2000. Landlords taking a piece of tech pie in lieu of rent. *Atlanta Journal-Constitution.*

Banking Risk in the New Economy

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

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

The Longest U.S. Expansion

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

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

What Is the New Economy?

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

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

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

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

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

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

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

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

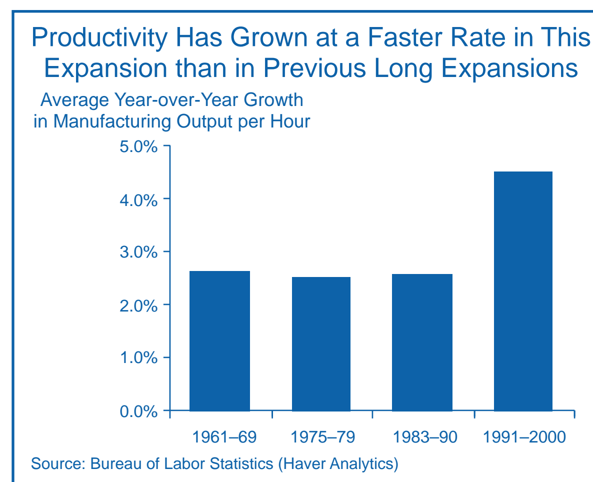
An early Wall Street description of the New Economy appeared in an article released by ***Goldman Sachs*** in January 1997.[8] It describes a number of fundamental changes in the economy—driven by global competition and advancing technology—that may permit business cycle expansions to last longer than they have in the past. At the same time, it warned that longer economic expansions might have a tendency to contribute to greater financial excess and the possibility of more severe recessions and more sluggish recoveries.

If this hypothesis is correct, and an emerging New Economy would contribute to longer expansions and more severe recessions, there may be implications for how banks manage risks. Since the Great Depression, U.S. business cycle recessions have not necessarily been catalysts for large numbers of bank and thrift failures. During the period from 1983 to 1989, when the U.S. economy was in the midst of a long expansion, some 1,855 insured banks and thrifts failed. This wave of failures has been attributed to a variety of factors, including severe regional economic downturns, real-estate-related problems, stress in the agricultural sector, an influx of newly chartered banks and banks that converted charters, and high nominal interest rates.[9] However, the potential for significantly more severe national recessions would represent largely uncharted territory that could cause losses and loss correlations to depart from historical norms, posing a new set of risk management challenges for the industry going forward.

The Productivity Revolution

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

CHART 1



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

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

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

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

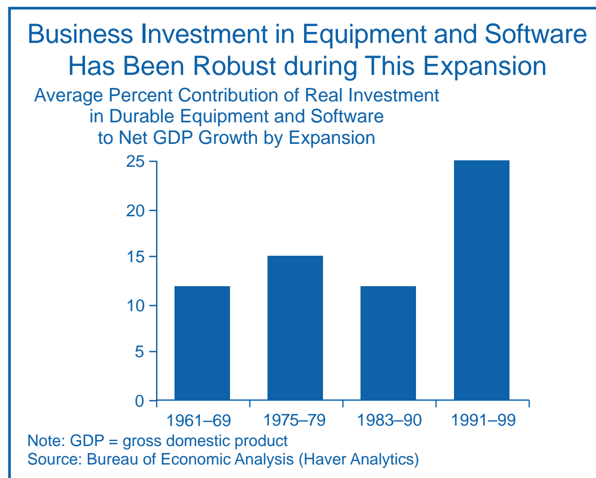
[9] FDIC Division of Research and Statistics. 1997. *History of the Eighties: Lessons for the Future, Vol. 1, An Examination of the Banking Crises of the 1980s and Early 1990s,* 16–17. http://www.fdic.gov/bank/historical/history/contents.html.

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

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

Expanded Investment. U.S. firms of all sizes have invested in new technologies at a rapid pace during this expansion. Chart 2 shows that business investment in equipment and software represents almost one-quarter of total net GDP growth during this expansion, compared with around 15 percent or less during previous long expansions. While this investment has been motivated by the need to cut costs, it has also been fueled by the availability of new computer technologies that have fallen in cost over time and by the ready availability of financial capital on favorable terms.

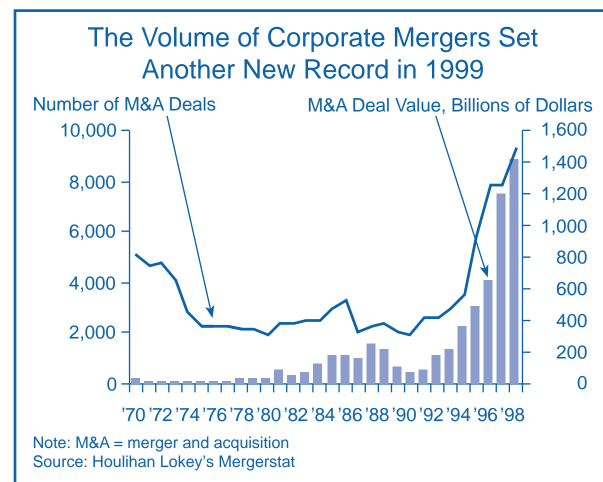
CHART 2



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

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

CHART 3



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

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

The Role of the Capital Markets

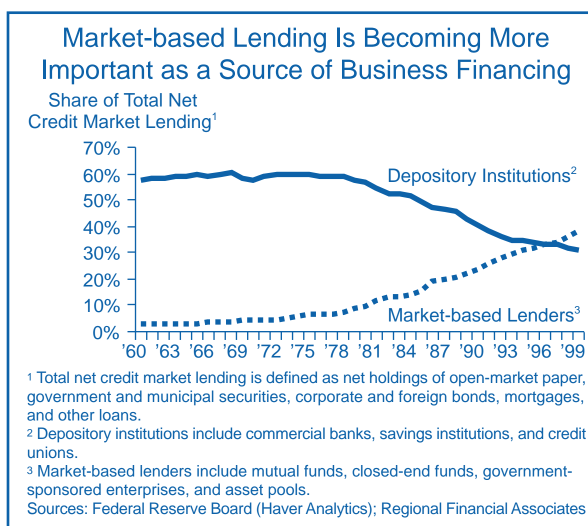
A critical factor in heightened business investment and restructuring during this expansion has been the remarkably favorable conditions in the financial markets. Financial capital has generally been readily available to business borrowers, usually on favorable terms. One factor that has held down the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

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

Banks have been active participants in nearly every facet of this financing activity. Syndicated loan origination volumes rose by 17 percent in 1999 to just over $1 trillion, despite relatively high credit costs and facility fees, factors that helped keep total volume below 1997's record $1.1 trillion in issuance. Syndicated loans to leveraged companies also rose 17 percent in 1999 to a record $320 billion. More impressive still was the growth in high-yield transactions, which rose nearly 50 percent in 1999 to $190 billion. It is difficult to determine precisely how much syndicated loan exposure resides on the books of insured institutions or, more important, how much high-yield exposure is retained by commercial banks. ***Loan Pricing Corporation*** estimates that 64 percent of high-yield volume in the first half of 1999 was retained by banks.[13] Insured commercial banks are the dominant originators of syndicated loans, with a 79 percent market share of investment-grade originations and a 56 percent market share of non-investment-grade originations in 1999. Commercial banks have also expanded their presence in the venture capital market. For some of the largest banks, profits from venture capital operations account for a large portion of total earnings. Chase Manhattan reported venture capital investment earnings of $2.3 billion in 1999, accounting for 22 percent of total net income.[14]

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

CHART 4



1 Total net credit market lending is defined as net holdings of open-market paper, government and municipal securities, corporate and foreign bonds, mortgages, and other loans.
2 Depository institutions include commercial banks, savings institutions, and credit unions.
3 Market-based lenders include mutual funds, closed-end funds, government-sponsored enterprises, and asset pools.
Sources: Federal Reserve Board (Haver Analytics); Regional Financial Associates

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

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

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

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

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

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

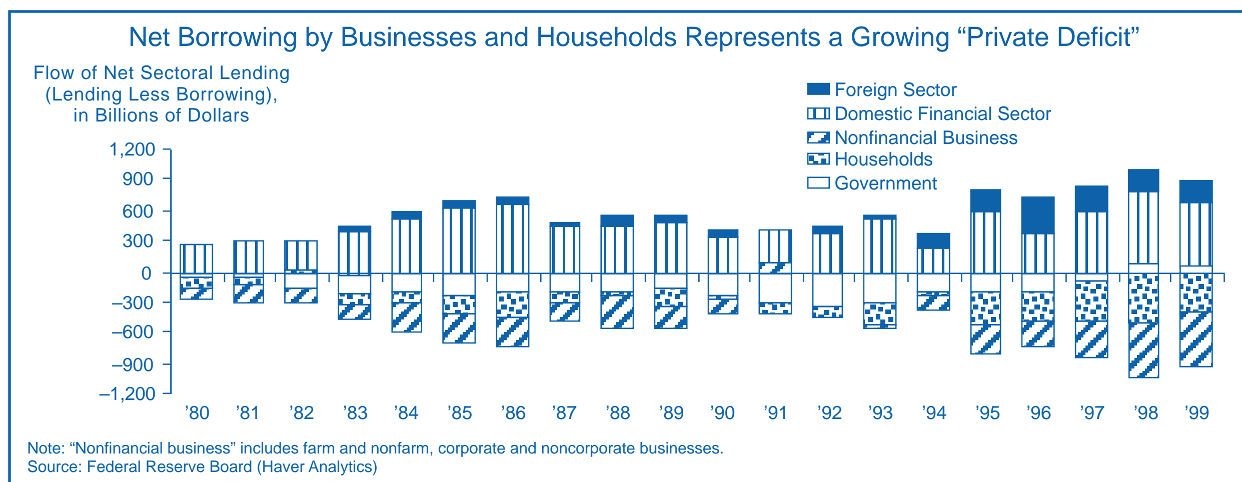
Financial Imbalances

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

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

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

CHART 5



Note: "Nonfinancial business" includes farm and nonfarm, corporate and noncorporate businesses.
Source: Federal Reserve Board (Haver Analytics)

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

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

Recent Shocks to the U.S. Economy

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

Rising Energy Prices. After declining to a low of around $10 per barrel in December 1998, oil prices have risen dramatically over the past year and a half. The spot price per barrel of West Texas Intermediate crude peaked in March 2000 at just under $30 before declining slightly in April. The rapid increase in oil prices during 1999 was sparked by a cutback in output by oil-producing nations that was instituted just as global economic growth was recovering from the crisis of 1998. The OPEC nations and other major oil producers reached a new agreement in March 2000 that provides for a production increase of some 1.5 million barrels a day. But, because demand is rising and gasoline inventories remain lean, analysts do not look for a significant decline in gasoline prices in the near term.[15]

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

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

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

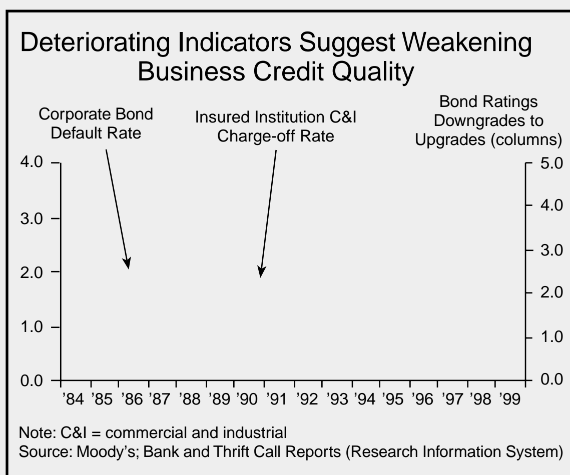
[15] Energy Information Agency (U.S. Department of Energy). April 2000. Short-Term Energy Outlook. http://www.eia.doe.gov/emeu/steo/pub/contents.html.
[16] March 11, 2000. Fueling Inflation? *The Economist.*
[17] See, for example, U.S. House of Representatives. February 17, 2000. Testimony of Chairman Alan Greenspan Before the Committee on Banking and Financial Services. http://www.federalreserve.gov/boarddocs/hh/2000/February/Testimony.htm.

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

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

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

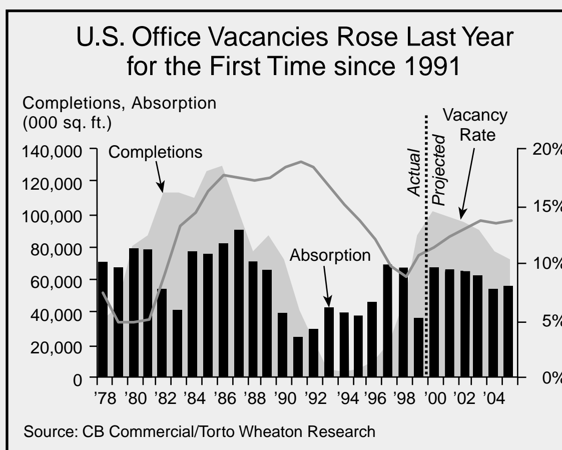
Chart 6



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

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

Chart 7



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

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

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

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

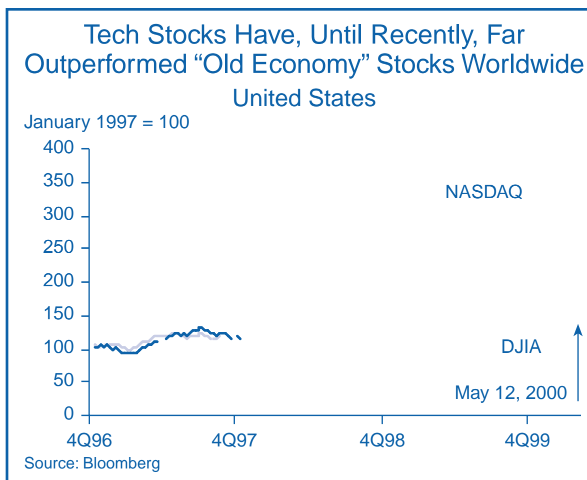
Higher energy costs and higher interest rates do not appear to have significantly slowed the pace of U.S. economic activity during the first quarter of 2000. The preliminary estimate of real gross domestic product growth during the quarter was 5.4 percent—a slowdown from the 7.3 percent rate of the fourth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

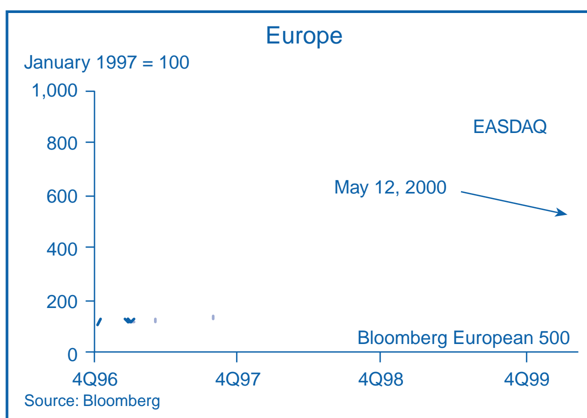
As for the business sector, higher costs for energy and debt service are most significantly affecting "Old Economy" firms that purchase commodity inputs and carry significant debt on their balance sheets. Airline companies in the S&P 500, for example, posted a year-over-year decline of 27 percent in net income from continuing operations during the first quarter of 2000.[21] Analysts have argued that New Economy firms, by contrast, are less vulnerable to recent economic shocks because they tend to carry little debt and consume relatively little energy.

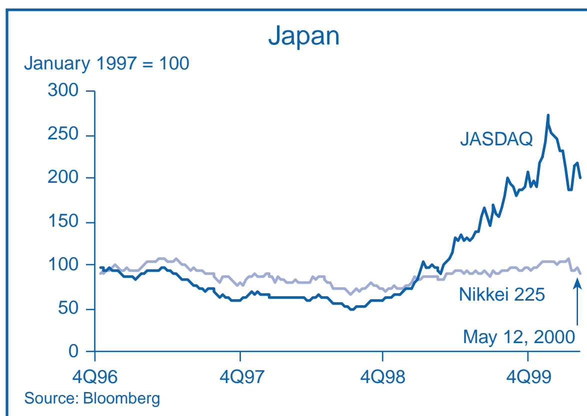
Equity Market Volatility. The notion that New Economy firms are less vulnerable to the effects of higher energy costs and higher interest rates may be one of the reasons that equity shares of firms in the technology sector began to dramatically outperform the broader market, beginning around the middle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

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

CHART 8







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

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

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

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

The Economic Outlook

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

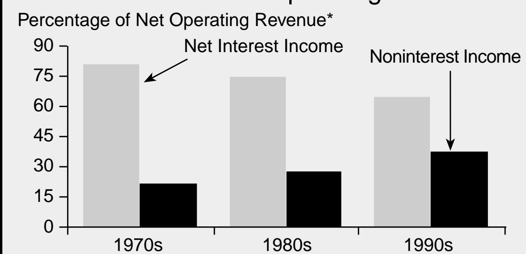
Clearly, risks are associated with the economic outlook. Recently, higher oil prices and higher interest rates have been the most visible signs of trouble for the economy. New Economy companies may be less vulnerable to these effects, but even these firms have experienced a sharp decrease in equity valuations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

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

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

Chart 9

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



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

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

Other Risks to Watch in Banking

Subprime Lending

- ***Subprime consumer loan portfolios contributed to the large losses associated with recent high-cost bank failures.*** During 1999, the FDIC reported the first annual loss for the Bank Insurance Fund since 1991. The loss was primarily the result of an uptick in unanticipated and high-cost bank failures. FDIC-insured institutions with at least 20 percent of Tier 1 capital in subprime loans accounted for 6 of the 13 bank failures that occurred between January 1998 and March 2000. Fraud and inappropriate accounting for residuals also played a role in some of these failures.[23]

- ***Subprime lending remains an area of concern.*** Insured depository institutions that engage in subprime lending represent a disproportionate share of problem institutions. Of the 79 banks and thrifts on the problem bank list as of year-end 1999, 21 percent were institutions with at least 20 percent of their Tier 1 capital in subprime loans.[24]

Agricultural Lending

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

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

[24] The problem bank list includes all insured depository institutions rated a composite "4" or "5."

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

- ***Some signs point to growing stress for agricultural institutions.*** Forty-two percent of FDIC-supervised banks active in agricultural lending showed a moderate or sharp increase in the level of carryover debt during third quarter 1999, compared with just 26 percent during third quarter 1998.[26] In addition, net loan loss rates for agricultural production loans increased in 1999 to the highest level since 1991. However, at 0.32 percent, the 1999 net loss rate is just one-tenth the rate experienced during the height of the agricultural crisis of the mid-1980s.[27]

Operational Risk

- ***Operational risks are becoming more prominent in the banking industry.*** Driven by consolidation and expansion into new product lines and markets, financial institutions are seeing an increase in operational complexity. Operational risk encompasses a host of factors not related to credit or market activities, including risks associated with processing transactions, legal liability, fraud, strategic missteps, and internal control weaknesses. Operational risks tend to be more pronounced when institutions engage in rapid growth, far-flung operations, and complex business processes.

- ***Greater attention is being paid to operational risks in the financial industry***. Recently, analysts have noted that the pressure to meet ambitious postmerger earnings predictions can result in cost-cutting measures that jeopardize the comprehensiveness and integrity of risk-management systems. In addition, the role that fraud has played in recent bank problems and failures reinforces the importance of adequate internal controls and audit procedures. The significance of operational risks to financial institutions has been noted in industry surveys and information-sharing efforts among financial firms.[28] NetRisk Inc., a Greenwich, Connecticut, consulting firm, recently estimated that operational losses among financial institutions have exceeded $40 billion over the past five years.

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

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

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

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

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

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

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

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

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

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