Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION FOURTH QUARTER 1999

FDIC
ATLANTA
REGION

DIVISION OF
INSURANCE

JACK M.W. PHELPS,
REGIONAL MANAGER

SCOTT C. HUGHES,
REGIONAL ECONOMIST

PAMELA R. STALLINGS,
SENIOR FINANCIAL
ANALYST

In Focus This Quarter

◆ ***Economic Conditions and Emerging Risks in Banking*—This article provides an overview of economic conditions and banking industry trends, with a primary focus on potential risks to insured depository institutions.**

Indicators of Industry Performance*—The reported financial condition of insured banks and thrifts is strong. However, despite projected growth in earnings, bank and thrift stocks underperformed the broader market through October 1999. *See page 3.

Economic Conditions*—The economy remains generally strong, and the outlook calls for continued growth. Growth is likely to slow, however, in order to correct financial imbalances that have developed as a result of a rapid creation of household and commercial credit and borrowing from abroad. There is a threat that the adjustment process could be a volatile one. *See page 4.

Emerging Risks in Banking*—Rising indebtedness on the part of businesses and households raises concerns about future loan performance. Industry responses to intense competition have created greater credit, market, and operational risks. *See page 8.

Consumer Lending*—Banks and thrifts are becoming increasingly involved in subprime consumer lending, which has raised some supervisory concerns. *See page 8.

Commercial and Industrial Lending*—Signs of deterioration in corporate credit quality can be found in rising loss rates, slower profit growth, and rising corporate bond defaults. At the same time, banks are expanding their lending to heavily indebted companies in the syndicated loan market. *See page 11.

Commercial Real Estate and Construction Lending*—Loans for real estate construction and development are growing rapidly. Despite an uptick in commercial vacancy rates, loan losses remain low. *See page 12.

Agricultural Lending*—Low commodity prices are hurting farm operating incomes, but widespread effects on farm banks have yet to materialize. *See page 13.

Funding and Interest Rate Risk*—Lagging deposit growth has led to a greater reliance on more volatile, market-based funding, and some institutions are taking on greater interest rate risk to maintain loan growth. *See page 14.

By the Analysis Branch Staff

Regional Perspectives

◆ ***Atlanta Region economic conditions remain strong despite recent slowing in some rural areas*—The Atlanta Region's economic growth exceeds that of the nation, although job growth moderated during the first half of 1999. Favorable economic conditions are reflected in strong loan demand, expanded fee income, and a low level of expenses related to asset quality problems at the Region's insured commercial and savings banks. Recently, however, commercial credits at large and small banks have weakened as pressures continue on the economically critical agricultural, steel, mining, and textile industries. *See page 18.***

◆ ***Increased use of noncore funding by the Region's banks may require higher levels of asset-side liquidity*—Atlanta Region banks increasingly are relying on noncore funds to support asset growth. While the potential instability of these funds may require higher levels of asset-side liquidity, shrinking net interest margins are forcing some banks to sacrifice liquidity by extending loan and investment maturities in search of higher yields. However, active secondary markets for bank loans and asset-backed securities may help relieve liquidity pressures caused by increased noncore funding and longer-maturity assets. *See page 22.***

By the Atlanta Region Staff

The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation institutions and financial institution regulators. It is produced for the following eight geographic regions:

Atlanta Region (AL, FL, GA, NC, SC, VA, WV)
Boston Region (CT, MA, ME, NH, RI, VT)
Chicago Region (IL, IN, MI, OH, WI)
Dallas Region (CO, NM, OK, TX)
Kansas City Region (IA, KS, MN, MO, ND, NE, SD)
Memphis Region (AR, KY, LA, MS, TN)
New York Region (DC, DE, MD, NJ, NY, PA, PR, VI)
San Francisco Region (AK, AZ, CA, FJ, FM, GU, HI, ID, MT, NV, OR, UT, WA, WY)

Single copy subscriptions of the ***Regional Outlook*** can be obtained by sending the subscription form found on the back cover to the FDIC Public Information Center. Contact the Public Information Center for current pricing on bulk orders.

The ***Regional Outlook*** is available on-line by visiting the FDIC's website at www.fdic.gov. For more information or to provide comments or suggestions about the Atlanta Region's ***Regional Outlook,*** please call Jack Phelps at (404) 817-2590 or send an e-mail to *jphelps@fdic.gov.*

Chairman	Donna Tanoue
Director, Division of Insurance	Arthur J. Murton
Executive Editor	George E. French
Editors	Lynn A. Nejezchleb Maureen E. Sweeney Ronald L. Spieker
Publications Manager	Teresa J. Franks
Writer/Editor	Kim E. Lowry

Economic Conditions and Emerging Risks in Banking

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. Overall, conditions in the economy and banking industry are favorable at this time. However, signs point to vulnerability in the economy and in the banking industry that may make the years ahead much more challenging. Three broad themes emerge from this assessment:

- *Households' and businesses' debt levels are on the rise.* Spending by households and businesses is growing faster than cash income, resulting in rapidly increasing indebtedness. Consumer spending has been driven, in part, by large increases in the net worth associated with stock holdings and home equity. Businesses are restructuring and investing in new technologies to raise productivity and cut costs. Both consumer and business spending has been assisted by ready access to financing. Rising interest rates or slower economic growth could make debt service more difficult for borrowers.

- *Intense competition in banking is driving business strategies.* Competitive pressures have affected nearly every facet of the banking business. These pressures are evident in net interest margins, which have suffered from tighter loan pricing and higher funding costs. To maintain profits, some institutions are lending to less creditworthy borrowers, expanding into new or higher-yielding activities, creating more complex balance sheet structures, or cutting costs. These strategies may lead to greater credit, market, and operational risks.

- *The currently benign economic environment is vulnerable to rapid deterioration in the event of financial market instability.* During the 1990s, we have witnessed recurring, and perhaps more frequent, episodes of financial market turbulence. Recent episodes have arisen mainly overseas and have had little adverse effect on U.S. economic activity. However, the current economic expansion is closely tied to the ready availability of market-based financing for households and businesses and to wealth generated with the help of rising stock prices and falling interest rates. For this reason, the currently strong economic outlook may be subject to sudden deterioration in the event of market shocks that sharply raise interest rates or lower stock prices.

The analysis that follows explores these themes in more detail in the following sections: 1) indicators of industry performance, 2) economic conditions, and 3) emerging risks in banking.

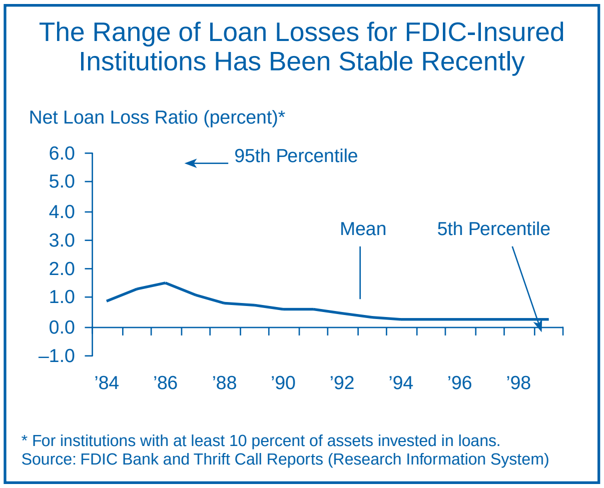
Indicators of Industry Performance

Industry Financial Performance Is Strong

According to reported financial information, the banking and thrift industries are performing well. As summarized in the ***FDIC Quarterly Banking Profile,*** second quarter 1999, both the commercial banking and thrift industries report near-record earnings, strong capital levels, and manageable volumes of problem assets and loan losses. Return on assets (ROA) for all insured institutions in the second quarter was 1.21 percent and return on equity (ROE) was 14.07 percent. ROA and ROE were down slightly from the first quarter despite improvement in the industry net interest margin (NIM) and a decline in provision expense. However, the majority of the decline in net earnings resulted from a $1.5 billion loss posted by one large bank.

The low overall level of net loan losses has been a key contributor to strong industry performance. Chart 1 (next page) shows that the average net loan loss ratio for the industry has been low and stable in recent years. Similarly, the range between the worst and best 5 percent of net loan loss ratios has narrowed considerably since the early 1990s. More than 95 percent of insured institutions reported a net loan loss ratio of less than 1 percent in 1998, continuing a five-year trend.

CHART 1



Bank Stocks Underperform Despite Projected Earnings Growth

Analysts expect continued earnings growth for banks and thrifts in 1999 and 2000. Median growth in earnings per share is projected to be 16.9 percent for publicly traded banks and 19.4 percent for publicly traded thrifts for 1999.[1] Ratings agencies also view the industry positively. The ratio of upgrades to downgrades for ratings issued by ***Moody's Investors Service*** improved in the second quarter, with nine companies receiving upgrades versus four receiving downgrades.

Nonetheless, bank and thrift stocks have underperformed the broader market in the first three quarters of 1999. The ***SNL Securities Bank Stock Index,*** which tracks more than 450 publicly traded commercial banks, declined 6.7 percent between January 1 and September 30, 1999. The ***SNL Securities Thrift Stock Index,*** which tracks the performance of about 350 publicly traded thrifts, fell 13.7 percent during the same period. By contrast, the ***Standard & Poor's (S&P) 500*** index gained 4.6 percent. Analysts cite rising interest rates, concerns about problems with corporate credit quality, and a decline in bank merger activity as reasons for the recent performance of bank and thrift stocks.

Economic Conditions

Overview

The U.S. economy has remained generally strong during 1999, the ninth year of the current economic expansion. If growth continues through February 2000—as most analysts expect—this expansion will become the longest in U.S. history. What is also remarkable about this business cycle expansion is the fact that the highest rates of growth have occurred during the past two years, 1997 and 1998. Even as growth has accelerated with unemployment declining to 4.2 percent, wage and price inflation has remained unusually subdued. While low inflation has helped prolong the expansion, it has imposed intense price competition on a wide range of industries. The currently positive economic outlook is subject to possible sudden deterioration in the event of financial market shocks that could raise financing costs, reduce the availability of financing, or destroy investor wealth.

Commodity Industries Have Faced Pricing Pressures

One disadvantage of low inflation during this expansion has been that firms in certain commodity industries have suffered from falling prices. Profit margins have declined in agriculture, mining, and some manufacturing sectors because of weak or negative revenue growth during 1997 and 1998.[2] Firms operating in these industries have aggressively cut costs to preserve profit margins. Nonetheless, profit growth has been flat or negative for a large proportion of ***S&P 500*** firms in the mining, textiles, chemicals, iron and steel, and oil and gas sectors since 1997. In response, some firms in these industries have chosen to consolidate through mergers. According to ***Mergerstat,*** the dollar volume of merger and acquisition transactions involving U.S. firms was a record $1.2 trillion in 1998, more than 80 percent above 1997 levels.

Business Investment Is Outpacing Cash Flow

Analysts recently have become concerned about increasing levels of debt on corporate balance sheets.

[1] Based on estimates as of November 4, 1999, for 98 commercial banks and 33 thrifts that have at least five analyst estimates.

[2] Richard A. Brown and Alan Deaton, "Falling Prices in Commodities and Manufacturing Pose Continuing Risks to Credit Quality," ***Regional Outlook,*** Third Quarter 1999 (http://www.fdic.gov/bank/analytical/regional/ro19993q/na/t3q1999.pdf).

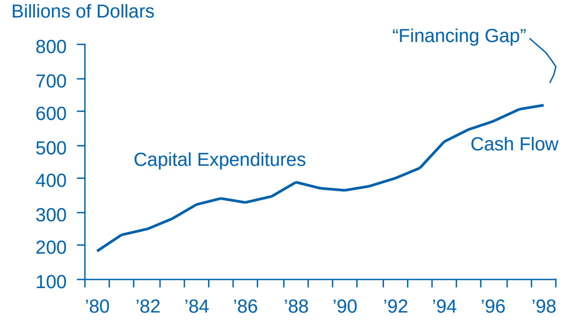
Chart 2 tracks the steady growth of fixed investment by U.S. corporations during the current expansion. It also shows, however, that growth in cash flow available to finance investment has slowed in recent years. This "financing gap" has grown steadily, reaching a record $86 billion in 1998.

As a result, corporations must finance an increasing portion of investment spending by issuing either net new equity or net new debt. In recent years, firms have overwhelmingly chosen debt financing. Net issuance of corporate debt was $219 billion in 1998, while corporations repurchased equity shares on net for the sixth straight year. Corporate borrowing has also continued at a brisk pace; domestic commercial and industrial (C&I) lending rose by 12.5 percent in the year ending June 1999.

A widening financing gap and increasing debt levels could pose future problems if there are adverse changes in the financial environment. For example, a sharp rise in interest rates would increase the debt burden of businesses, hurt their profitability, and impair their creditworthiness. Under such a scenario, firms might decide to curtail their capital expenditures, which would tend to reduce the rate of growth in the rest of the economy.

CHART 2

The Financing Gap Has Widened for Nonfinancial Corporations



Source: Federal Reserve Board (Haver Analytics)

Rapid growth in consumer spending also warrants attention. Despite the highest rates of real income growth in nine years, consumer spending has grown more quickly than disposable personal income. The divergence in growth has resulted in a falling personal savings rate, which reached a record low in 1999.[4] The recent decline in the personal savings rate continues a trend that has been under way for more than a decade (see Chart 3, next page).[5]

Analysts cannot fully explain the reasons for the falling savings rate, although the "wealth effect" associated with the accumulation of capital gains by households is believed to be a significant factor. Since 1995, the total value of equities, mutual funds, and pension funds owned by households has risen by $6.8 trillion, while the value of owner-occupied housing net of mortgage debt has increased by $812 billion. This accumulation of wealth apparently has emboldened consumers to spend, as evidenced by data that show aggregate spend-

Consumer Spending Continues to Grow

Strong growth in consumer spending continues to propel the economic expansion. Spending has accelerated in recent quarters, in contrast to previous expansions when the strongest growth in consumer spending occurred early in the recovery. One factor supporting the robust pace of spending is housing activity. Single-family housing starts rose to an annualized rate of more than 1.3 million units in fourth quarter 1998 and have remained near that level through third quarter 1999. Existing home sales also have maintained a record pace of 5.3 million units on an annualized basis during the second and third quarters. Low mortgage interest rates and real income gains have combined to push housing affordability to its highest level in many years.[3]

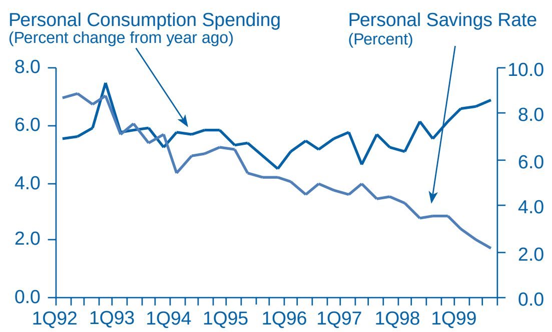
[3] The housing affordability index published by the ***National Association of Realtors*** equals 100 when the median family income qualifies for an 80 percent mortgage on a median-priced existing single-family home. The value of the index as of the third quarter of 1999 was 127.1.

[4] *Personal savings* is calculated as the difference between *disposable personal income* (DPI, or total income net of taxes) and *consumption expenditures.* The *personal savings rate* is equal to personal savings divided by DPI. It should be noted that capital gains, even when realized, are not included as income in this calculation, although taxes paid on capital gains are deducted from DPI. Consequently, large-scale realization of capital gains by households will tend to push down the personal savings rate.

[5] The ***Bureau of Economic Analysis,*** which tabulates the personal savings rate, has recently revised its methodology, leading to a large revision in the savings rate data. Earlier estimates reported the personal savings rate to be around negative 1 percent, suggesting that households were spending more than their disposable (after-tax) income. Revised estimates show that the savings rate for the third quarter of 1999 was 2.1 percent. Although higher than previously reported, the revised personal savings rate data continue to show a downward trend similar to earlier savings rate estimates.

CHART 3

Strong Consumer Spending Has Been Accompanied by a Falling Personal Savings Rate



Source: Bureau of Economic Analysis (Haver Analytics)

ing growth exceeding income growth. For the most part, when consumers have chosen to convert capital gains to spendable cash, they have done so by borrowing—often against the equity in their homes or their 401(k) accounts.

The increasing indebtedness of consumers could substantially raise the costs of debt service relative to income, especially if interest rates rise or income growth slows. Moreover, analysts express concerns about a reversal of the wealth effect if there is a significant and sustained decline in equity prices. Any resulting decline in consumer confidence could substantially slow the pace of consumer spending, leading to a reduced pace of economic growth.

The Growing Private Deficit Raises Concerns

Taken together, the sum of annual net borrowing by businesses and households has been referred to as the "private deficit." During the late 1990s, as the combined budget of federal, state, and local governments moved from deficit to surplus, the private deficit rose sharply; between 1996 and 1998, it nearly doubled from $550 billion to $1.02 trillion (see Chart 4).

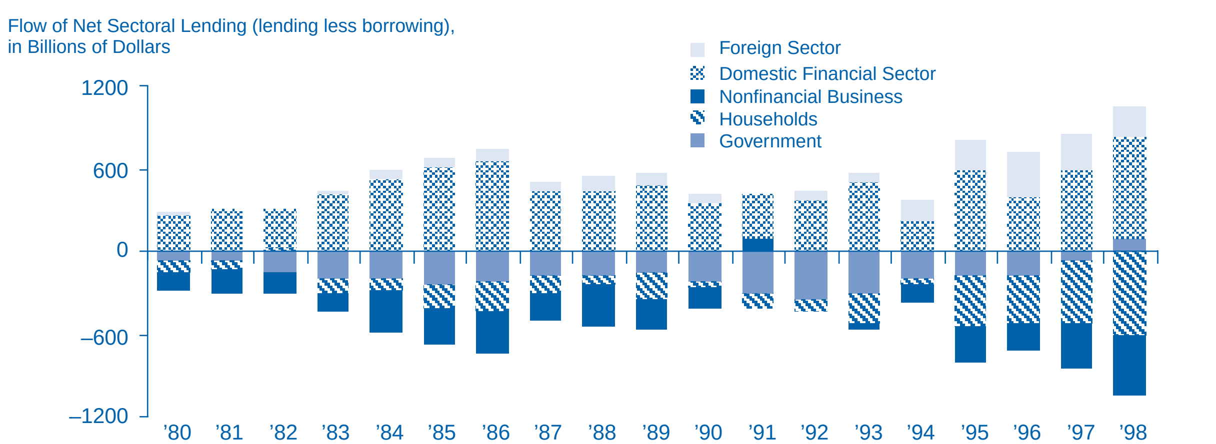
The private deficit was financed from three sources in 1998. One source was the $73 billion surplus in the government sector, the first surplus in 28 years. The largest portion of the 1998 private deficit was financed by the creation of credit by the domestic financial sector and by an inflow of foreign capital. The rapid creation of credit raises concerns about credit quality, an issue that is explored in more detail under *Emerging Risks in Banking,* below. Dependence on foreign capital raises questions about what might happen if the foreign sector becomes less willing to export capital to the United States.

Recovery Abroad Is Changing the Terms of Trade

During the past three years, the U.S. economy has experienced consistently strong growth with low inflation, while the economies of some of its major trading partners have grown more slowly or not at all. Japan was mired in its worst recession in decades, while a number of countries in Asia, Latin America, and Eastern Europe

CHART 4

Net Borrowing by Businesses and Households Represents a Growing "Private Deficit"



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

have experienced the harsh fallout resulting from financial market and exchange rate crises. The euro-zone economies, Germany and France in particular, have grown slowly following the imposition of tight fiscal and monetary policies in advance of the introduction of the euro on January 1, 1999.

The net effect of this disparity in growth rates has been a growing U.S. trade deficit. The deficit rose by 57 percent in 1998 to $164.3 billion, reflecting a small decline in exports and a 5 percent increase in imports. The adverse effects of the trade deficit on the U.S. economy have been felt primarily by the commodity industries—farming, mining, and basic manufacturing. In addition, the large trade deficit has resulted in the transfer of billions of dollars to foreign investors. During 1997 and 1998, many foreign investors used their excess dollars to purchase dollar-denominated stocks and bonds. This inflow of capital helped keep U.S. equity and bond prices high, while pushing up the value of the dollar.

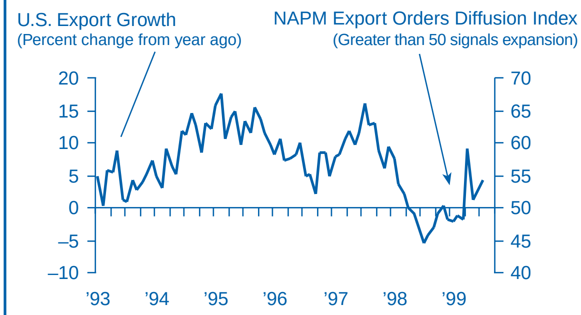
A global economic recovery during the first three quarters of 1999 has led to higher demand for investment capital outside the United States. The ***International Monetary Fund*** estimates that growth in the global economy will increase from 2.5 percent in 1998 to 3.0 percent in 1999 and 3.5 percent in 2000.[6] Foreign investors, in anticipation of stronger growth and greater investment opportunities abroad, have started to convert excess dollar holdings to other currencies, including the yen and euro. This change in investment strategy has put downward pressure on the value of the dollar. Between July and September 1999, the dollar lost approximately 10 percent of its value against the yen.

A falling dollar will likely contribute to a recovery of U.S. exports in coming months. The index of export orders compiled by the ***National Association of Purchasing Managers*** points to future growth in shipments abroad. The index has signaled growing export orders for nine months through October 1999. As Chart 5 shows, increasing export orders tend to lead the actual rise in exports by several months.

A lower dollar could also place upward pressure on U.S. inflation and interest rates. A steady decline in the dollar would make foreign goods more expensive, while higher export demand would raise manufacturing output at a time when U.S. labor markets are very tight. The prices of several important industrial commodities have

CHART 5

U.S. Exports Fell in 1998, but Rising Orders Point to Growth in 1999



Source: Bureau of the Census; National Association of Purchasing Managers (NAPM) (Haver Analytics)

risen in dollar terms during 1999, led by a doubling in the price of oil during the first nine months of 1999. Domestically, the producer price index has risen by approximately 4 percent since the beginning of the year following a two-year decline, reflecting an increase in oil and intermediate goods prices.

Interest rates have risen in step with renewed concerns about inflation. The constant maturity yield on 10-year Treasury bonds increased by approximately 140 basis points in the year ending October 1999, while the Federal Reserve instituted two 25-basis point increases in short-term rates during the summer of 1999.

The Economic Outlook Calls for Continued Growth

One scenario for the year ahead is that the U.S. economy will continue to grow at much the same rate as it has during the past few years. As discussed above, however, continued rapid growth would lead to even greater imbalances in the domestic economy and in the foreign sector. For this reason, most economists do not believe that rapid growth can continue indefinitely. Instead, analysts suggest two possible scenarios for the economy.

The ***Blue Chip Economic Indicators*** consensus outlook for the U.S. economy calls for a "soft landing." Gross domestic product is projected to grow at a rate of 3.8 percent in 1999 with somewhat slower growth of 2.8 percent in 2000.[7] Rising wage pressures, reflecting tight

[6] International Monetary Fund, ***World Economic Outlook,*** October 1999.

[7] *Blue Chip Economic Indicators,* Aspen Publishing, October 10, 1999.

labor markets across the nation, and economic recovery abroad are expected to increase the risks of higher U.S. inflation. Improving growth prospects in the global economy may also lead to a stabilization of commodity prices, reversing a trend of falling prices that has until recently contributed to lower U.S. inflation. In response to expectations of higher inflation, medium-term interest rates are also expected to rise modestly. Slower U.S. growth and faster expansion abroad would result in a rebalancing of global growth that should narrow the U.S. trade deficit and reduce downward pressure on the dollar.

Although the consensus forecast calls for continued expansion, an alternative scenario suggests the possibility of a steep decline in economic growth leading to a "hard landing." Sharply higher interest rates, in response to a weak dollar and an unexpected acceleration of U.S. inflation, could lead to declining capital investment and reduced consumer spending. Rising interest rates would increase the debt burden for households and businesses even as measures of indebtedness are rising. A significant and sustained decline in equity prices may occur if investors become pessimistic as the economy slows. The response of the world economy to a U.S. recession is difficult to assess. As the past several months have shown, growth in the U.S. economy has been an important factor in supporting growth abroad. If the U.S. economy were to enter a recession, overall global growth could also slow, depending on the extent to which recoveries in Europe, Asia, and Latin America offset any shortfall in U.S. growth.

Emerging Risks in Banking

Overview

Favorable economic conditions continue to support strong loan growth and healthy loan performance among insured institutions. Net loss rates remain low relative to the early 1990s for almost every major loan category except consumer loans. Loss rates in domestic commercial loans, previously at low levels, rose modestly during the first half of 1999. Agricultural loan loss rates appear likely to rise in the future due to the effects of weak commodity prices on farm incomes. Strong loan growth and low loan losses have helped banks achieve record and near-record high quarterly profits. However, rising indebtedness on the part of businesses and households raises concerns about future loan performance, particularly if economic conditions were to deteriorate or if interest rates were to rise.

Strategic responses to competitive pressures point to greater credit, market, and operational risks for the industry. Intense competition has pressured NIMs and has encouraged many lenders to seek higher returns by lending to less creditworthy borrowers. In order to maintain and grow profits, some insured institutions are expanding into activities such as subprime consumer lending, high loan-to-value mortgage lending, and lending with minimal or no documentation requirements. Rapid growth in syndicated lending to leveraged companies also indicates that large commercial lenders have increased their tolerance for risk. Competition has made funding with deposits more difficult. As a result, some institutions are relying increasingly on securitizations and more expensive, market-based sources of funds, which can alter an institution's liquidity position, interest rate risk profile, and operational needs. Institutions have also responded to competitive pressures by cutting costs or merging in an attempt to achieve greater efficiencies. In some cases, deep reductions in operating costs support profits at the expense of less effective operational controls.

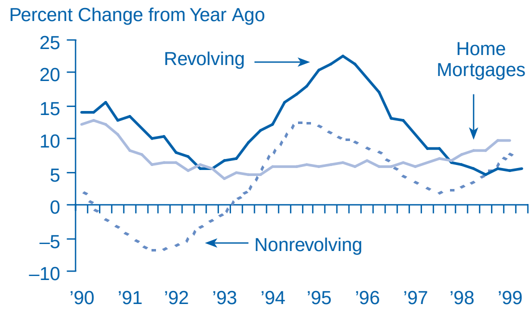
Consumer Lending

Household Borrowing Is on the Rise

Household borrowing is growing rapidly, consistent with high reported levels of consumer confidence and strong consumer spending. Mortgage debt, which grew by 10.4 percent in the second quarter from year-ago levels, is the fastest-growing segment of household debt (see Chart 6). Mortgage loan growth has been particularly strong, in part because of rising homeownership, the availability of more low-down-payment loans, and the use of mortgage loans to consolidate revolving debt balances. Nonrevolving debt grew by 7.3 percent in the year ending June 1999, largely because of strong sales of new cars. In contrast, credit card and other revolving debt increased by only 5.7 percent during the same period—a much slower rate of growth than during the mid-1990s.

CHART 6

Household Borrowing Is on the Rise, Led by Increases in Mortgage Debt



Source: Federal Reserve Board (Haver Analytics)

A Mortgage Refinancing Boom Has Helped Consumers Consolidate Debt

A key component of the recent shift by consumers from credit card debt to mortgage debt has been a surge in mortgage refinancing in 1998 and early 1999. The ***Mortgage Bankers Association's Refinancing Index*** peaked at over 4,300 in October 1998, compared with an average monthly index value of 527 during 1997.[8]

Many households have refinanced their mortgages to obtain cash to pay down credit card and other high-cost consumer debt, thereby lowering their monthly financial obligations. According to a ***Freddie Mac*** survey of 1998 refinancing transactions, more than 3 million homeowners, or 51 percent of all mortgage-refinance borrowers, generated net cash proceeds when they refinanced their loans.[9] On average, these borrowers cashed out 11 percent of the equity in their homes. On the basis of this survey, ***Bank One Corporation*** estimated that cash out refinancing added about $60 billion in cash flow to consumer pocketbooks last year. This extra cash flow could help explain recent quarterly declines in personal bankruptcy filings, mortgage delinquencies, and consumer credit charge-offs.[10] Rising interest rates appear to have ended this mortgage refinancing boom. The lower volume of mortgage refinancings raises questions about whether consumers again will increase their use of credit cards to finance purchases. If so, there may be negative consequences for future consumer debt service burdens and consumer credit quality.

Credit Card Lenders Face Declining Returns

After several years of rapid growth in the mid-1990s, the credit card industry has become characterized by overcapacity and declining margins. At the same time, the high level of mortgage refinancings and rising household incomes have reduced the dependence of consumers on credit card debt. Consequently, credit card lenders are struggling to maintain volume as consumers pay off their credit card balances more quickly.

Overcapacity and declining margins have led lenders to search aggressively for new ways to increase revenues. One method they have adopted is to charge new fees that are triggered by cardholder behavior. Lenders are now charging fees for inactive accounts, fees to close accounts, and even customer service fees. In addition, they are reducing grace periods, curtailing leniency periods, and imposing higher penalty interest rates. According to ***RAM Research,*** banks' income from credit card fees has grown 79 percent over the past two years, while card interest income rose only 10 percent.[11]

Shrinking margins have also prompted consolidation in the credit card industry. Today, the top five issuers control about 60 percent of the total managed assets in the credit card sector, up from just 35 percent in 1990.[12] Amid this changing competitive landscape, credit quality has improved. Credit card charge-off levels at insured commercial banks hit an all-time high of 5.5 percent in the third quarter of 1997 but have declined steadily to a level of 4.1 percent in the second quarter of 1999. This decline has been attributed to tighter underwriting standards, more aggressive collection efforts, and extra household cash flow generated through mortgage refinancings.

[8] Index is seasonally adjusted where the week of March 16, 1990 = 100.

[9] Survey cited in a study by the Joint Center for Housing Studies at Harvard University, "The State of the Nation's Housing: 1999."

[10] Tristan Mabry, "This Boom, Some Say, Is on the House," ***The Wall Street Journal,*** July 6, 1999.

[11] Miriam Kreinan Souccar, "Consumer Groups Up in Arms Over Card Penalties," ***American Banker,*** February 26, 1999.

[12] James C. Allen, "Tarnished Platinum," ***SNL Securities Bank Mergers & Acquisitions,*** June 1999.

Subprime Lenders Have Riskier Characteristics than the Industry

Subprime lending to consumers has grown dramatically in recent years. Subprime mortgage originations have grown from 5 percent of the total mortgage market in 1994 to 15 percent in 1997.[13] The percentage of originations fell somewhat in 1998 to 10 percent—not because the volume of subprime mortgage originations fell but because the volume of prime mortgage originations was at a record high. In fact, in terms of dollars, subprime originations grew by 20 percent from 1997 to 1998, to $150 billion. That figure is up significantly from the $35 billion in subprime originations in 1994. Estimates of the size of the subprime automobile loan market vary somewhere between $50 billion and $75 billion, but one source estimates that subprime automobile originations jumped from about 8 percent of all automobile loan originations in 1990 to over 18 percent in 1998.[14] Analysts also have indicated that the subprime credit card market is the fastest-growing segment of credit card lending today. According to ***RAM Research,*** subprime receivables are growing 45 percent annually, compared with 16 percent or less for other segments of credit card lending.[15]

Intense competitive pressure has contributed to the expansion of bank and thrift participation in subprime consumer lending. These loan programs offer higher margins than prime consumer lending products and have become an attractive alternative for banks and thrifts that have experienced shrinking margins in credit cards, mortgage lending, and other consumer product types. Moreover, the shakeout in the subprime specialty finance industry has provided new opportunities for insured depository institutions seeking to enter the subprime lending market. In 1999, several insured depository institutions acquired, or announced plans to acquire, a subprime specialty finance company. Bank and thrift involvement in subprime lending is expected to increase. In fact, some industry analysts predict that insured depository institutions with subprime affiliates will overtake finance companies as leaders in the subprime industry.

Subprime lending poses entirely new challenges in risk management for insured institutions. Not only are expected credit losses higher than for prime consumer lending, but a number of factors suggest that losses are also less predictable:

- *Subprime borrowers are more likely to default than prime borrowers and may be more vulnerable to economic shocks, such as a recession.* Borrowers' previous credit problems suggest that they have limited financial resources to withstand economic difficulties.

- *Credit-scoring and pricing models used to underwrite subprime loans are untested in a recession.* Analysts have noted that credit-scoring models are less effective in predicting the likelihood of default for subprime borrowers than they are for prime borrowers.

- *Operational risks are greater in subprime lending.* Because defaults occur sooner and more often than in prime lending, subprime portfolios require a greater investment in servicing and collections resources. Subprime lenders run a greater risk that these resources could become severely strained if the level of defaults is not correctly anticipated.

- *Liquidity risks are greater in subprime lending.* Some large-volume subprime lenders heavily depend on the ability to securitize and sell loans to the secondary market. But investor demand for paper backed by subprime loans may be volatile, as was demonstrated during the financial market turmoil of late 1998. A number of nonbank subprime lenders experienced a liquidity crunch as a result of that market turmoil, and several opted for—or were forced into—bankruptcy.[16]

- *Reputation, legal, and compliance risks also are important for subprime lenders.* Subprime lenders generally run a greater risk of violating, or being accused of violating, consumer protection laws or regulations. The public perception of subprime

[13] ***The Mortgage Market Statistical Annual for 1999,*** Inside Mortgage Finance Publications, 1999.

[14] Ron Feldman, ***An Introduction to Subprime Auto Lending for Examiners,*** Federal Reserve Bank of Minneapolis, April 1998, and data supplied by CNW Marketing and Research.

[15] Lisa Fickenscher, "Credit Card Issuers Panning for Gold Among Tarnished Credit Histories," *American Banker,* October 22, 1998.

[16] Dominic DiNapoli and Ron Greenspan, "The Next Industry Crisis Could Be Even Bigger," *American Banker,* June 15, 1999.

lenders could be tarnished if a recession were to result in substantially higher default rates.

The growing involvement by insured depository institutions in subprime lending has raised significant concerns for bank and thrift supervisors. To address those concerns, FDIC Chairman Donna Tanoue recently announced that the FDIC will propose to the other federal financial institution regulators that insured depository institutions with concentrations in subprime lending be held to higher minimum capital requirements than the current rules dictate.[17] The FDIC proposal includes a common supervisory definition of subprime lending and ties capital adequacy to the types and levels of risks that individual subprime lenders have in their portfolios. This proposal will be shared with other federal regulators to refine a final approach.

Commercial and Industrial Lending

Commercial and Industrial Loan Losses Have Been on the Rise

Insured institutions continue to accommodate the credit needs of business borrowers. Domestic C&I loans grew almost 12.5 percent during the year ending in June 1999 and accounted for 40 percent of all net new loans booked during that period.

Although commercial loan losses are low, there are signs that credit quality in C&I portfolios is deteriorating. Net domestic C&I charge-offs during the first half of 1999 more than doubled from 1998 levels, while noncurrent domestic C&I loans rose by 26 percent. Examiners also have reported increasing problems in commercial portfolios. The ***Office of the Comptroller of the Currency*** recently reported that the dollar volume of classified and special-mention Shared National Credits rose 70 percent during a recent annual review.[18]

Slower profit growth and rising corporate bond defaults also point toward somewhat weaker business credit quality. While corporate profits grew by an average of 15 percent per year between 1993 and 1996, economists polled by *Blue Chip Economic Indicators* project growth of 6.7 percent for all of 1999, followed by growth of only 3.5 percent in 2000.[19] ***Standard & Poor's*** reported that 55 rated issuers defaulted on $20.5 billion in debt during the first six months of 1999.[20] This pace of defaults is already nearly double levels experienced in the first half of 1998 and does not include more recent large defaults such as Iridium and Daewoo Group. Approximately 85 percent of the defaults that occurred during the first half of 1999 were among speculative-grade issuers. According to ***Moody's,*** junk bond defaults rose to 5.8 percent of issues outstanding during the 12 months ending in September 1999, the highest level since 1991.

Rising Losses May Be Attributable to Loose Underwriting

Analysts attribute the recent deterioration in commercial credit quality to weak underwriting standards in the corporate debt markets during 1997 and early 1998.[21] Bank underwriting was reported to be particularly accommodating at that time. The ***Federal Reserve Board*** reported in its May 1998 *Senior Loan Officer Opinion Survey on Bank Lending Practices* that domestic banks were "generally eager to make loans to businesses" and that during early 1998 "a large percentage cut their spreads on such loans." Subsequently, the November 1998 *Survey* reported a "broad tightening of business lending practices" associated with the financial market turmoil in progress at that time. However, regulators have continued to express concern about the assumptions underlying bank lending decisions. A Supervision and Regulation Letter sent by the ***Federal Reserve Board of Governors*** to its examiners in September 1999 noted the recent tightening of standards, but stated that "certain deeper issues remain," which relate mainly to overoptimistic assumptions about the future repayment capacity of business borrowers.[22]

[17] FDIC Chairman Donna Tanoue in a speech before America's Community Bankers, Orlando, Florida, November 2, 1999 (http://www.fdic.gov/news/news/speeches/chairman/sp02Nov99.html).

[18] "OCC Says Big Commercial Loans Suffering from Lax Underwriting," *American Banker,* October 6, 1999, p. 1. The shared national credit program is a cooperative interagency program to review large credits held at several institutions. Loans subject to review include commitments in excess of $20 million that are shared among three or more participating lenders.

[19] *Blue Chip Economic Indicators,* Aspen Publishing, October 10, 1999.

[20] "Defaults Soar in First Half 1999," *Standard & Poor's,* August 12, 1999.

[21] See, for example, "Under Boom Economy, Strain Over Debt," *The Wall Street Journal,* August 18, 1999, Section C, p. 1.

[22] SR 99-23, September 28, 1999. "Recent Trends in Bank Lending Standards for Commercial Loans" (http://www.federalreserve.gov/boarddocs/SRLETTERS/1999/SR9923.HTM).

Leveraged Lending Has Been the Predominant Type of Syndicated Lending

Banks appear to be taking on more risk in the syndicated loan market by expanding their lending to heavily indebted companies. During the first half of 1999, leveraged lending was the fastest-growing segment of syndicated commercial lending.[23] While overall syndicated loan volume was down slightly compared with the first half of 1998, syndicated lending to leveraged companies rose $7 billion, or 5 percent, on the strength of a record volume of "highly leveraged loans."[24] As shown in Chart 7, loans to leveraged companies are making up a growing proportion of syndicated loan originations.

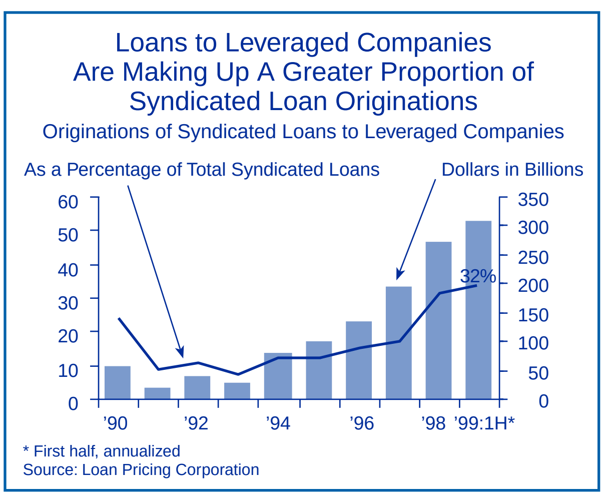
Factors driving growth in leveraged lending include a high volume of corporate mergers and acquisitions, increasing investor demand for higher-yielding loans, and a shift in preference for loans over bonds by high-yield issuers.[25] While bank syndicators pass a large volume of these loans along to nonbank investors, a substantial portion of these credits remains on bank balance sheets. ***Loan Pricing Corporation*** has reported that as much as 64 percent of the value of "highly leveraged" loans originated in the first half of 1999 was retained by banks.[26]

[23] Syndicated loans are credits extended to large or medium-sized corporate borrowers that are originated by a group, or syndicate, of lenders. One type of syndicated lending is leveraged lending, in which the borrower's debt-to-equity ratio is significantly higher than the industry average. Loan Pricing Corporation defines "leveraged loans" as those for which pricing exceeds 125 basis points over LIBOR.

[24] Loan Pricing Corporation defines "highly leveraged loans" as those for which pricing exceeds 225 basis points over LIBOR.

[25] According to ***Mergerstat,*** the value of mergers and acquisitions (M&A) was almost $400 billion during second-quarter 1999. According to ***Loan Pricing Corporation,*** syndicated loans originated in the second quarter to finance M&A activity totaled some $69 billion—a 43 percent increase over issuance in the first quarter.

CHART 7



Commercial Real Estate and Construction Lending

Construction Loan Volume Continues to Rise

Loans for real estate construction and development (C&D) represent one of the fastest-growing segments of bank balance sheets, increasing 24 percent during the year ending June 1999. Compared with construction activity in the mid-1990s, spending on new commercial construction has shifted somewhat away from the industrial and retail markets and toward office and hotel construction. Residential construction growth was also strong during the first half of 1999, with single-family completions increasing 17 percent from a year ago. In the midst of this growth in loan volume, loss rates and past-due ratios for construction and development loans remain very low by historical standards, as indicated in Chart 8.

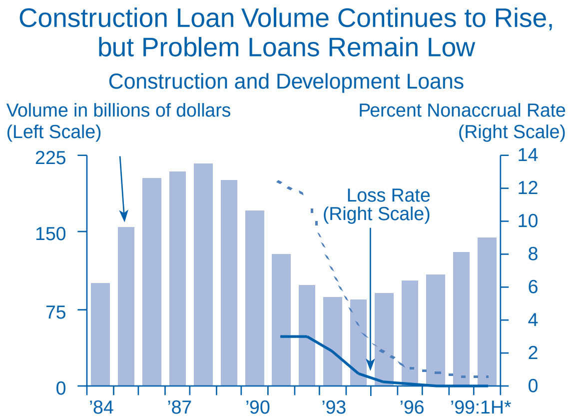
Office Vacancy Rates Are Rising in Many Top Markets

In previously published reports, Division of Insurance analysts identified nine metropolitan real estate markets where rapid development threatened to produce near-term oversupply conditions.[27] These cities were identified based on the pace of current construction activity, commercial space demand indicators, and independent market analysts' projections. Six of the metropolitan areas identified—Atlanta, Phoenix, Orlando, Portland, Dallas, and Nashville—subsequently experienced large increases in office vacancy rates during the first half of 1999. These areas have also experienced reduced employment growth and slowing net in-migration. Higher vacancy rates are often accompanied by slower

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

[27] Steven K. Burton, "Commercial Developments Still Hot in Many Major Markets, but Slower Growth May Be Ahead," *Regional Outlook,* First Quarter 1999 (http://www.fdic.gov/bank/analytical/regional/ro19991q/na/infocus2.html) and "Ranking the Risk of Overbuilding in Commercial Real Estate Markets," ***Bank Trends,*** FDIC Division of Insurance, October 1998 (http://www.fdic.gov/bank/analytical/bank/bt9807.html).

CHART 8



* First half
Source: FDIC Bank and Thrift Call Reports (Research Information System)

rental-rate growth, which may lead to lower real estate values. For example, Atlanta's vacancy rate rose 1.5 percentage points to 10.3 percent, while growth in rental rates slowed noticeably from the pace of the previous three years.[28]

Surveys Suggest Tighter Standards in Commercial Real Estate Lending

Evaluations of bank loan underwriting suggest a recent tightening of lending standards for commercial real estate loans. The August 1999 ***Federal Reserve Board*** *Senior Loan Officer Opinion Survey* reported a net tightening of commercial real estate underwriting standards, continuing a trend begun in late 1998. The ***FDIC's*** March 1999 *Report on Underwriting Practices* also found fewer instances of risky lending practices with respect to commercial real estate and construction lending than in prior reports. The FDIC's September *Report* showed no significant changes in lending standards.

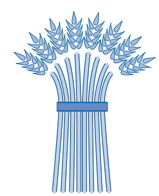
The FDIC also recently published the findings of a targeted evaluation of the underwriting practices of banks operating in three of the fastest-growing metropolitan areas in the country—Atlanta, Dallas, and Las Vegas.[29] Results indicated that competition was generally driving pricing margins down to very low levels, particularly compared with the 1980s. In some instances, lenders have responded to competitive pressures by making structural concessions on loan-to-value, cash equity, and recourse terms, particularly for large borrowers. However, underwriting standards generally have not been as aggressive as practices observed in the 1980s.

Agricultural Lending

Low Commodity Prices Stress the Agriculture Industry

Low prices for wheat, corn, hogs, cotton, and oilseeds are creating financial difficulties for farmers in the nation's midsection. Several consecutive years of high worldwide production have resulted in large inventories of grains and oilseeds, which have depressed prices. Prices not only have fallen from mid-1990s levels, but are also low by historical standards. The ***United States Department of Agriculture (USDA)*** forecasts for 2000 show little likelihood of improvement in prices.[30]

The financial outlook for significant portions of the farm sector has deteriorated. The USDA projects that farm income from operations will decline by around 15 percent in 1999 from year-ago levels. However, total net farm income is projected to decline less than 1 percent. A projected $16.6 billion in government payments is expected to make up most of the difference between operating income and total net income.[31] Legislation passed in October 1998 provides for $8.7 billion in emergency aid to affected farmers.



Farm Banks Continue to Perform Well Overall

Despite the difficulties created by low farm prices, the overall financial condition of the 2,250 FDIC-insured farm banks continues to be strong.[32] Farm banks reported an annualized ROA of 1.21 percent and an equity capital-to-assets ratio of 10.5 percent at mid-year

[28] Vacancy rates and rental growth rates were obtained from ***REIS Reports.***

[29] Steven K. Burton, "Recent Trends in Construction Lending Practices," *Bank Trends,* FDIC Division of Insurance, July 1999 (http://www.fdic.gov/bank/analytical/bank/bt9901.pdf).

[30] "World Agricultural Supply and Demand Estimates," USDA, October 10, 1999.

[31] "Potential Impacts of an Agricultural Aid Package," ***Agricultural Outlook,*** USDA, September 1999.

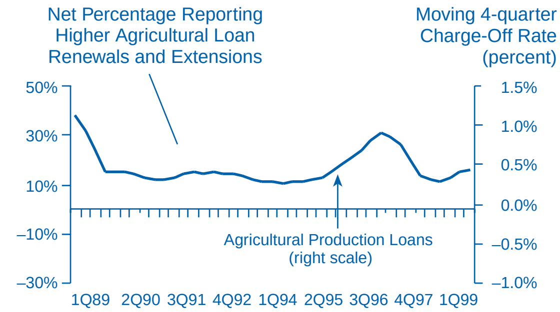
[32] Farm banks are defined by the FDIC as those with over 25 percent of their loans in agricultural production or secured by agricultural real estate.

1999.[33] Loan loss reserves, which stood at 1.58 percent of total loans in June, remain high compared to historical levels. Loan performance at farm banks also appears to be strong at this time. Total past-due loans made up just 2.66 percent of total loans at farm banks in June, a level that is only 9 basis points higher than a year ago. Moreover, this increase in past-due loans is attributable entirely to nonagricultural loans; the level of past-due farm loans has not risen over the past 12 months. At the same time, higher-than-average nonperforming loan levels have been reported by farm banks in the upper Midwest and the South.

There are reasons to believe, however, that it will take time for financial distress among farm producers to significantly affect loan performance at farm banks. One such reason is the increasing use of carryover debt to restructure and extend operating loans that cannot be fully retired by borrowers during the current crop year. The most recent *Survey of Agricultural Credit Conditions* conducted by the ***Federal Reserve Bank of Kansas City*** indicated an increase in the use of agricultural carryover debt by Tenth District banks.[34] An increase in carryover debt was also noted in the ***FDIC's*** March 1999 *Report on Underwriting Practices,* which indicated that almost one-third of FDIC-supervised farm banks experienced at least a "moderate" increase in agricultural carryover debt during the preceding six-month period.[35] Although the use of carryover debt is not an uncommon practice in agricultural lending, it can be a leading indicator of declining loan performance. Chart 9 shows that increases in carryover debt by Tenth District farm banks in 1995 preceded increased loan losses during 1996.

CHART 9

Rising Levels of Carryover Debt Suggest Future Increases in Loan Losses at Farm Banks



Source: Federal Reserve Bank of Kansas City; FDIC Bank and Thrift Call Reports (Research Information System)

Funding and Interest Rate Risk

Lagging Deposit Growth Has Led to Greater Reliance on Market-Based Funding

For most of the 1990s, banking industry asset growth has outstripped growth in deposits, creating greater reliance on more expensive and less stable market-based sources of funding. The trend in the loan-to-deposit ratio for commercial banks, which reached a record high of almost 90 percent at June 30, 1999, reflects this shift. Deposit growth has not kept pace with asset growth, in part because of a low rate of personal savings by households and competition for depositor funds from higher-yielding investment alternatives and nonbanks. Lagging deposit growth is particularly important for community banks because these institutions traditionally rely more heavily on deposits to fund assets than do larger banks.[36] Greater dependence on market-based funding can alter the liquidity and interest rate risk positions of institutions and may require heightened attention to, and expertise regarding, asset-liability policies and procedures.

Growth in Securitization Affects Underwriting and the Structure of Bank Balance Sheets

Banks, and nonbanks in particular, continue to employ the securitization market to fund lending activities.

[33] Twenty-three percent of insured farm banks have adopted a Subchapter S designation since 1997, when banks were first allowed to take advantage of the favorable tax treatment available under this section of the Internal Revenue Service code. Because of the effects of this tax treatment on reported profitability, farm bank ROA levels may not be comparable with ratios from prior periods.

[34] *Survey of Agricultural Credit Conditions,* Federal Reserve Bank of Kansas City, June 29, 1999 (http://www.kc.frb.org/PUBLICAT/RED/PDF/2q99AgCrPress.pdf). The Tenth District comprises significant agricultural areas in Colorado, Kansas, Nebraska, Oklahoma, Wyoming, northern New Mexico, and western Missouri.

[35] John M. Anderlik and Jeffrey W. Walser, "Agricultural Sector Under Stress: The 1980s and Today," *Kansas City Regional Outlook,* Third Quarter 1999 (http://www.fdic.gov/bank/analytical/regional/ro19993q/kc/k3q1999.pdf).

[36] Allen Puwalski and Brian Kenner, "Shifting Funding Trends Pose Challenges for Community Banks," *Regional Outlook,* Third Quarter 1999 (http://www.fdic.gov/bank/analytical/regional/ro19993q/na/t3q1999.pdf).

Issuance of asset-backed securities and commercial mortgage-backed securities (CMBS) totaled $223 billion through the first six months of 1999, and is on pace for another record year. Including participation through credit card companies and CMBS conduit programs, bank-related issuance amounted to about 25 percent of total issuance in 1998, a decline from 1997 levels. Although insured institutions are not dominant players, growth in the securitization market can influence loan underwriting practices and the structure of bank balance sheets.

The securitization market competes to originate loans that could be made by insured institutions. This competition may tend to erode underwriting standards if securitizers ease terms to maintain sufficient volume to support lending pipelines. Recent trends indicate that this competition has intensified. For example, market observers note that the subordination levels in the CMBS market have been declining, which allows securitizers to increase lending volume for a given level of capital.[37]

When banks do securitize, it is not always clear how much risk is transferred. The issue of credit risk transference by commonly used securitization structures continues to receive attention from the markets and rating agencies. For example, many analysts agree that revolving structures, such as those used to securitize credit cards, eliminate only the most catastrophic credit risks for issuers.[38] In addition, assets created by gain-on-sale accounting rules when loans are securitized can be volatile and can lead to unstable earnings and capital if not properly controlled and administered.

[37] Securitizations are often structured in tranches such that a subordinated security bears the credit risk for a senior piece. The relative size of the subordinated piece affects not only funding costs for the issuer, but also the amount of effective leverage achievable through securitization.

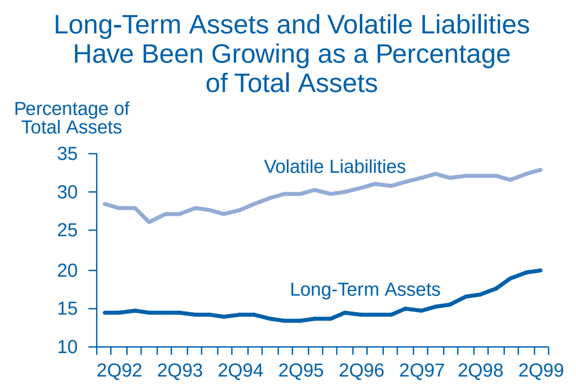
[38] A common feature of a revolving securitization structure is the provision for an "early amortization." When a triggering event occurs, such as a negative three-month average excess spread, all available cash flows are used to pay off bondholder principal. This event causes receivables related to the deteriorating accounts to remain on the balance sheet of the issuer. Unless the deterioration in account credit quality is very rapid and severe, the bondholders will be repaid completely, and the credit risk will be borne by the issuer.

Banks and Thrifts Appear Increasingly Vulnerable to Rising Interest Rates

Potentially volatile liabilities and long-term assets have been growing as a percentage of banking assets. Consistent with reduced deposit funding by insured institutions, more market-based and potentially volatile liabilities have been supporting an increasing proportion of banking assets in recent years (see Chart 10).[39] At the same time, the lengthening maturity of insured institution mortgage portfolios has increased the percentage of total bank assets with maturities or repricing frequencies of greater than five years. This trend in mortgage portfolios is primarily responsible for the thrift industry's increasing interest rate sensitivity. According to the ***Office of Thrift Supervision's*** *Quarterly Review of Interest Rate Risk,* interest rate sensitivity for the median thrift rose in the second quarter of 1999 for the third consecutive quarter.

[39] Volatile liabilities include borrowings, federal funds purchased, repurchase agreements, jumbo certificates of deposit, foreign deposits, and trading liabilities.

CHART 10



Note: Long-term assets have a maturity or repricing frequency of greater than five years.
Source: FDIC Bank and Thrift Call Reports (Research Information System)

Operational Risks

Insured banks and thrifts face numerous business- and process-oriented operational risks on a daily basis. At the same time, recent industry developments and bank failures have highlighted the importance of maintaining strong operations. The ***Basle Committee on Banking Supervision*** reported in late 1998 that "awareness of operational risk among bank boards and senior management is increasing."[40]

The competitive environment and shareholder expectations have led many insured institutions to search for greater efficiency by cutting costs. In some cases, deep cuts in overhead expenses may weaken the effectiveness of operating and monitoring systems as well as internal controls. Anecdotal evidence from banking regulators suggests that internal control and recordkeeping weaknesses are on the rise. Moreover, industry consolidation and new business activities are creating bigger, more complex, and more decentralized operating environments, especially for the largest institutions. These issues are important since operational weaknesses may leave institutions more vulnerable to adverse economic conditions, insider abuse, or fraud.

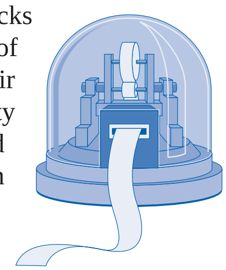
Implications

This article has summarized the generally favorable current condition of the U.S. economy and banking industry. The economy is in the ninth year of a remarkable economic expansion that has been conducive to a high level of financial performance on the part of the banking industry. There are, nonetheless, areas of vulnerability that could contribute to a less favorable economic environment and less robust financial performance for insured institutions in the future.

One issue raised by this report is rising indebtedness on the part of households and businesses, which represents a growing private deficit. Rising interest rates could increase the debt service burden for consumers and businesses, making them more vulnerable to a slowing economy. An increasing private deficit is problematic also because the two major sources of financing—foreign capital inflows and domestic credit creation—have the potential to create problems for the economy and for lenders. Dependence on foreign capital makes U.S. inflation and interest rates highly subject to changes in the decisions of foreign investors and the value of the dollar. The rapid pace of credit creation by the financial sector threatens to impair credit quality. The intuition that loose underwriting standards can lead to credit quality problems is supported by recent signs of rising credit losses in a strong economy.

The second issue that cuts across this report is the effect that competition is having on banking strategies and exposures to credit, market, and operational risks. There has been an increase in lending to less creditworthy borrowers, including subprime consumer borrowers and leveraged corporate borrowers. There is also evidence that institutions are pursuing asset-liability structures with higher levels of interest rate risk to maintain loan growth and meet funding needs. Finally, some of the innovations banks have used to counter competitive pressures may introduce new risks associated with complex accounting valuations, weakening internal controls, and the need for more intensive loan servicing.

The third issue is the increasing potential for financial market instability, which leaves the economy and the banking system vulnerable to sudden shocks. Events from fall 1998 showed some of the more damaging aspects of these crises, as market-based financing went from abundance to scarcity virtually overnight. The financial imbalances associated with the rapid creation of credit and borrowing from abroad not only create the need for the economy to slow down eventually, but also threaten to make that adjustment process a volatile one. Financial market shocks could quickly alter the confidence of consumers and businesses and their access to financing. Such instability could end the current expansion and expose underlying weaknesses in bank risk-management practices.



[40] "Operational Risk Management," Basle Committee on Banking Supervision, September 1998 (http://www.bis.org/publ/bcbs42.pdf).

This article was prepared and coordinated by the 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
Steven K. Burton, Senior Banking Analyst
Steven E. Cunningham, Chief, Financial Institutions Section
Alan Deaton, Economic Analyst
Diane Ellis, Senior Financial Analyst
Brian Kenner, Financial Analyst
Allen Puwalski, Senior Financial Analyst
Arlinda Sothoron, Senior Financial Analyst
Jack Taylor, Senior Financial Analyst

Regional Perspectives

- **Economic conditions in the Atlanta Region remain strong despite recent slowing in some rural areas with declines in the mining, manufacturing, and agricultural sectors. Growth remains very strong in metropolitan areas, where tight labor markets could become a constraining factor.**

- **The performance of insured institutions reflects the Region's strong economy. Favorable growth and earnings among metropolitan institutions has resulted in heavy *de novo* activity in high-growth markets, while some rural institutions have seen asset quality weaken because of pressures in the agriculture, textiles and apparel, steel, and coal industries.**

- **Increased noncore funding by banks in the Region may require higher levels of asset-side liquidity to ensure that loan demand and deposit withdrawals can be satisfied quickly and with minimal financial impact given a less stable funding base.**

Region's Economic and Banking Conditions

The Atlanta Region's economy continues to expand at a pace above the national average, although job growth has moderated during the first half of 1999. Following the prolonged expansion, labor markets generally have tightened throughout the Region, particularly in metropolitan areas. In some areas, jobless rates remain near 25-year lows and below 2 percent. (In some rural areas, however, unemployment rates have begun to rise.) Factors driving the economic expansion include continued corporate relocation and population in-migration, which have fueled growth in demand for local goods and services. Inflows of new types of high-tech manufacturing, such as automobile production, have helped offset persistent declines among the Region's traditional producers (such as textiles and apparel) and are shifting the industrial mix of the Region. Business expansion, in-migration, plentiful jobs, and strong income growth, combined with historically low interest rates, also have fostered strong gains in commercial and residential construction activity.

Benefiting from the strong economy, commercial and savings banks in the Atlanta Region continue to perform well. Strong cyclical loan demand, expansion of fee income business lines, and low asset-quality-related expenses have allowed the Region's insured institutions to maintain healthy returns despite declining net interest margins (NIMs). Low interest rates and a lack of pricing power in some competitive urban markets have led to further NIM compression at both large and small banks over the past four quarters. Larger institutions continue to reduce their dependence on the interest margin, however, by emphasizing fee income products and services. Thus far, fee income production has been limited at small banks. Large banks also enjoy scale efficiencies on the expense side, as overhead costs generally are lower than at small institutions. In addition to a greater reliance on spread income, small bank aggregate returns are being constrained by a growing number of *de novos* that have not yet reached sustainable profitability. *De novo* activity has been concentrated mostly in high-growth metropolitan markets, particularly in **Florida, Georgia,** and **North Carolina.**

Asset quality indicators remain strong in the Region, with past-due loans measuring less than 2 percent of total loans. Commercial and consumer portfolios have weakened over the past couple of quarters, however. Severely delinquent loans (90 days or more), while still under 1 percent for the Region, are at their highest level in nine quarters because of increases in commercial and consumer delinquencies at some of the Region's largest banks. Meanwhile, the highest overall delinquencies are at the smallest banks (assets under $100 million), many of which serve rural communities affected by weakness in the agriculture, textiles and apparel, coal, and steel industries.

Division between Urban and Rural Markets Persists

Despite eight years of economic expansion, growth in the Atlanta Region has not been uniform as urban and rural areas have experienced differing levels and types of growth. The following discussion revisits this issue, first highlighted in the Atlanta ***Regional Outlook,*** third quarter 1997, which analyzes how divergent growth can lead to different types of risk. Economic gains in the Region have been concentrated in urban areas with direct access to interstate highways, ports, and major airports. These areas, which include **Atlanta, Charlotte, Northern Virginia, Orlando,** and **Raleigh,** have experienced the lowest levels of unemployment, the highest rates of in-migration and corporate expansion and relocation, and strong real estate construction activity. High rates of growth can have downside risk, however.

Strong Growth Continues in Urban Markets

One consequence of the strong growth has been rising labor shortages, particularly among less skilled workers. Anecdotal evidence suggests that wage growth may be rising in some areas, although actual statistical evidence still remains sparse. (Labor costs did rise by 4.5 percent in the second quarter, the largest increase in five years, as productivity slowed.) Total compensation (which can include starting and retention bonuses, better medical coverage, tuition reimbursement, and other types of employee benefits) may be rising as employers try to attract scarce labor. For example, one enterprising sporting goods retailer in the Atlanta metropolitan area offers employees free ski trips to Colorado to test the company's equipment. Between 1995 and 1998, total compensation growth has trended upward. Inability to pass on these higher costs in highly competitive markets could affect businesses' profit margins.

Construction activity has been a primary driver of the Region's above-average economic performance in recent years. However, as many of the Region's rapidly growing metropolitan markets have experienced residential and commercial construction booms, a number of insured institutions have developed concentrated credit exposures to this potentially volatile sector. When the previous expansion ended in the late 1980s and real estate markets weakened, institutions with excessive construction and development (C&D) lending concentrations performed poorly as a group during the downturn that followed. Although capital, reserves, and management might be stronger than a decade ago, some institutions in rapid-growth markets report exposures that are well above the U.S. average and, in some cases, even above 1980s levels. The Region's highest aggregate concentration is in the metropolitan Atlanta area, where C&D financing accounts for about 12 percent of total assets at banks under $1 billion (nearly three times the national average). Other high-growth markets where C&D lending exposure is above average and increasing include Charlotte and Raleigh, North Carolina; **Naples,** Orlando, and **Ft. Walton Beach,** Florida; **Huntsville, Alabama;** and **Norfolk-Virginia Beach, Virginia.**

Much of the commercial real estate development in the Orlando area is related to tourism, an industry whose expansion is highly correlated with national income growth and overseas economic conditions. Theme park and hotel investment in Orlando has been exceptionally heavy in recent years and planned construction activity remains high. Some analysts are concerned that Orlando's tourist industry may become oversaturated, especially in light of recent declines in visitorship from outside Florida.

Because of the importance of construction activity, the Atlanta Region's economy may have a higher interest rate exposure. Both short- and long-term interest rates have risen over the past few months. The Federal Reserve raised its target Federal Funds rate by 25 basis points in July and again in August, from 4.75 to 5.25 percent. Meanwhile, market investors, reacting to signs of potential inflation, pushed the 30-year Treasury yield up 96 basis points from January through the first week of September. While the steeper yield curve may relieve some pressure on NIMs for new business, the increase may squeeze margins further at banks with large fixed-rate loan portfolios funded by short-term or repriceable liabilities. Moreover, higher rates could adversely affect credit quality by slowing the economy and raising consumer and business debt service requirements. This economic effect may be even greater in the Atlanta Region than in other parts of the country, as the Southeast economy is largely driven by cyclical industries such as real estate C&D and, increasingly, transportation and related production. Eventually, Southeast home sales and, consequently, housing construction may be affected adversely by rising mortgage rates, which have risen 100 basis points to 7.85 percent (30-year; fixed) through early September 1999 from the start of the year.

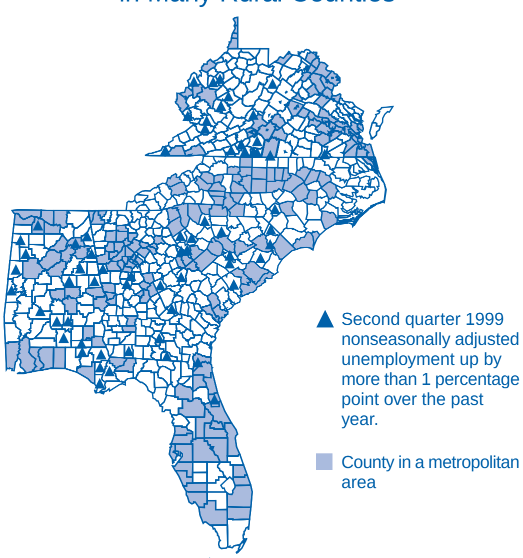
Rising Rural Unemployment Rates

While most urban areas have seen strong growth in recent years, gains in rural areas have not been as pronounced. In fact, unemployment rates have crept up in many rural areas throughout the Atlanta Region over the past year (see Map 1), challenging the commonly held belief that all areas of the Region are experiencing economic gains. Of the Region's more than 400 rural counties, 22 percent saw jobless rates that were up 1 percentage point or more in the second quarter of 1999 from one year earlier. Continued textile and apparel job losses are partially responsible for this upward trend with the loss of thousands of jobs over the past year, particularly in Georgia, Alabama, and the Carolinas. Further, coal mining layoffs have occurred in **West Virginia,** Virginia, and Alabama, partly because of growing dependence on fuel oil, competitive issues, and environmental controversy. Pulp and timber industries are seeing job cuts in portions of Alabama and in the western Florida panhandle. Agriculture commodity prices have been declining since 1996, and widespread drought has further exacerbated conditions in the Atlanta Region.

Textile and apparel job losses continue to mount throughout the Region. Job losses in North Carolina and **South Carolina** have been particularly severe as companies pursue cheap labor offshore. Small rural communities have been especially hard-hit; displaced workers have limited opportunities because there is less diversification of industries than in larger, more urban areas. North Carolina has lost over 4,100 textile jobs since January as employers reduce production costs through enhanced technological innovations and movement to areas where labor costs are cheaper. Apparel jobs also are dwindling as employers battle heightened competition from countries with weakened economies. Likewise, South Carolina has felt the effects of the declining textile and apparel industries. About 10 percent of all apparel jobs have been eliminated over the past year.

Map 1

Unemployment Rates Have Risen in Many Rural Counties



Source: Bureau of Labor Statistics (Haver Analytics), U.S. Census Bureau

Job losses in the mining industry have claimed hundreds of jobs in Alabama, Virginia, and West Virginia. The industry declines result from the increasingly mechanized nature of coal mining, competition from other fuel, and rising environmental concerns as well as depletion of resources, according to Rex Bowman, ***Richmond Times-Dispatch.*** Jobless rates in **Marion, Lamar, Fayette,** and **Pickens counties** in Alabama have risen by more than 1 percent over the past year, partially as a result of a downturn in coal mining. One **Tampa**-based coal mining operation eliminated about 377 jobs in **Adger,** Alabama, in March, and the company is trying to dispose of three additional coal mines in **Tuscaloosa County,** which, if closed, could idle an additional 1,650 workers. In Virginia, about 190 coal mines are currently in operation employing about 6,235 miners, down from 410 mining operations employing 10,696 miners in 1988, according to the ***U.S. Department of Energy.*** Coal mining is one of the largest employers in West Virginia and is among its highest-paying industries. According to the ***West Virginia Mining & Reclamation Association,*** every coal mining job supports eight other jobs in the state's economy. Coal mining jobs in the state totaled over 29,000 at the beginning of the decade, but that number had fallen to about 18,000 by 1998. Unemployment rates in the state rose by over 1 percent in 15 counties within the state, with coal mining losses considered among the predominant causes.

Increasing economic stress in rural areas can adversely affect credit quality as struggling businesses and displaced workers encounter difficulties servicing their debt. Financial institutions with geographic diversity may be in a better position to weather economic slowdowns scattered across a wide area. In contrast, smaller financial institutions may be more at risk to local economic volatility. Already, small banks in Alabama and West Virginia, both beset by declining manufacturing sectors, report the highest loan delinquencies in the Atlanta Region.

Some Agricultural Borrowers Struggle with Price Declines

Agricultural losses continue to mount as farmers face the second consecutive year of moderate to severe drought conditions and the third consecutive year of declining agriculture commodity prices (see Atlanta ***Regional Outlook,*** third quarter 1999, for a more detailed discussion of price pressures). Economic effects are likely to be most severe in areas that depend heavily on agriculture for income and employment. Such effects may be direct or indirect (ripple) and may pose heightened exposure to area banks if losses continue for the long term. Also, losses may continue even after the industry begins to improve.

Many farmers, particularly those with outstanding loans, began 1999 in a weakened financial state as a result of severe drought conditions in 1998, when federal disaster relief was required for 157 Georgia counties, 29 North Carolina counties, 17 Alabama counties, and 13 South Carolina counties. Already, federal disaster relief funds have been approved for farmers who qualify in both North and South Carolina as of August 1999, with Virginia, West Virginia, Georgia, and Alabama expected to seek government assistance during the coming months. A Georgia state climatologist announced that Georgia suffered one of the worst August droughts ever. Corn, cotton, and soybean crops have been particularly hard-hit by prolonged drought conditions, with losses expected to meet or exceed those suffered last year as a result of insufficient rainfall. The ***Associated Press*** reported an estimated $100 million in crop damage in West Virginia as of August 1999, with other states also reporting substantial losses. Early in the season, Alabama received sufficient rain to produce normal corn yields; however, late crops such as soybeans are expected to suffer damage in excess of 50 percent. Depleted hay reserves are a growing concern throughout the Region; these reserves normally are used during the winter months, but have been partially consumed to sustain livestock. Farmers also are concerned that parched pasturelands will result in higher costs of alternate feed sources throughout the winter months. Some farmers increasingly are selling cattle at extremely reduced prices to limit their losses.

In North Carolina, heavy rains from Hurricane Dennis offered little assistance to drought-stricken areas. While the storm brought total annual rainfall levels in the state close to average, the ground could not absorb such large volumes of water at once, causing temporary flooding and clogged drainage systems in some areas. Hurricane Floyd created catastrophic conditions for the eastern sections of the state, with measured rainfall reaching 24 inches or more in some areas. Many portions of the state that needed substantial rainfall to salvage crops and pastureland have now suffered total losses from disastrous flooding. In the western section of the state, forecasters estimate that significant rainfall over several months would be needed to end the drought.

Some farmers have diversified their operations and increased their planted acreage. However, larger operations may increase the level of capital at risk. Farm lenders in Georgia, for example, relate that most farmers were able to repay operating loans in 1998, but many were unable to repay long-term debt, according to the ***University of Georgia College of Agricultural and Environmental Sciences.*** Potential risk to insured financial institutions will depend on the duration and severity of the drought. Credit quality, particularly among leveraged farmers, could deteriorate as pressures on the agriculture sector continue to build. Persistent low commodity prices and uncertainty about future federal programs may pose additional risks to banks in farm areas. In the Atlanta Region, agricultural credit risk is concentrated most heavily in Georgia, home to 28 of the Region's 40 agricultural banks, with total assets of $1.6 billion. For this group, agricultural loan losses have not reached significant levels thus far, although delinquencies are up sharply from a year ago at some banks. Also, examiners report an increase in carryover debt, as several farmers were not able to repay last year's production loans. This increase might only delay inevitable losses if current conditions persist.

Growth in the Atlanta Region continues to exceed the national average as in-migration of both new residents and businesses fuels the economy; however, many urban and rural areas are experiencing disparate economic performance, which could affect asset quality in different ways. Urban areas have seen prolonged growth that, in some instances, has caused new types of problems such as tight labor markets and, indirectly, rising costs of doing business. High levels of in-migration and corporate relocation also have contributed to issues such as urban sprawl. In contrast, several rural areas have seen rising jobless rates over the past year as key traditional industries experience continued and, in some cases, accelerated erosion of their workforce. Also, agricultural losses continue to mount as drought conditions and low commodity prices persist. In either case, financial institutions should be aware that situations such as these could compromise borrowers' ability to service debt.

Increases in Noncore Funding Heighten Asset-Side Liquidity Management

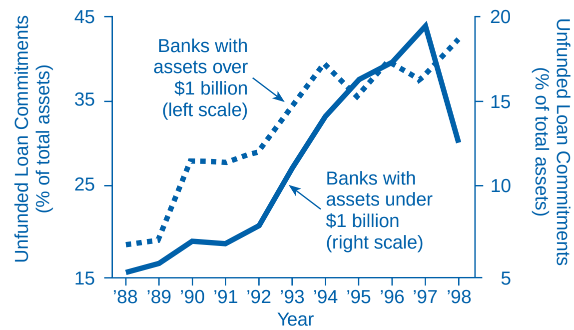
Atlanta Region banks are becoming increasingly reliant on potentially volatile (noncore) funding. This reliance may require greater management of asset-side liquidity going forward. Core deposit growth has not kept pace with loan demand during the current economic expansion. That disparity has contributed to increased dependence on noncore deposits[1] and borrowings by the Region's banks. These funding sources traditionally have been more rate-sensitive, and therefore more volatile, than core deposits.[2] In addition, borrowings often contain embedded options that give the creditor the right to reprice the funds if rates rise or to reduce credit if asset quality problems develop. Borrowing agreements also may require banks to pledge loans or investments as collateral, which makes it more difficult to sell these agreements. The increase in noncore funding, discussed in ***Regional Outlook,*** third quarter 1999, raises the question of whether liquidity needs, particularly on the asset side, have increased at the Region's banks.

Off-Balance-Sheet Commitments Have Grown

In addition to loan bookings outpacing deposit growth during this economic expansion, the level of unfunded loan commitments is significantly higher now than in the late 1980s. As Chart 1 shows, unfunded commitments totaled 42 percent of assets at large[3] banks at year-end 1998, up from only 19 percent ten years earlier. Similarly, community bank unfunded commitments increased more than threefold from 1988 to 1997 before declining in 1998. Absent strong core deposit growth or high borrowing capacity, some banks might need to rely on asset liquidity, such as loan or investment sales, to ensure that an increasing volume of loan commitments can be funded.

CHART 1

Unfunded Loan Commitments Have Grown Significantly This Decade at Atlanta Region Commercial Banks



Source: Bank Call Reports

Asset Allocations Must Balance Liquidity and Interest Rate Spread Objectives

Because nondeposit alternatives such as Federal Home Loan Bank borrowings, subordinated debt, and federal funds purchases consistently have had higher interest costs than core deposits (see ***"Shifting Funding Trends Pose Challenges for Community Banks," Regional Outlook,*** third quarter 1999), banks with high levels of noncore funding, on average, report lower NIMs than core-funded banks do. Increased noncore funding could lead some banks to sacrifice liquidity, extend asset maturities, or assume higher credit risk to bolster yields; however, that strategy can conflict with the need to maintain a minimum level of short-term, high-quality liquid assets. Moreover, a more volatile funding base, along with higher levels of off-balance-sheet commitments, may call for even higher levels of asset-side liquidity than banks have maintained in the past.

Allocations among broad asset categories such as cash, securities, and loans have not changed substantially at Atlanta Region banks, but the mix within the loan and investment portfolios has. Over the past ten years, cash balances have declined somewhat at both large and small banks, with the offset being a slight increase in investment holdings at large banks and a slightly larger loan portfolio at community banks. As discussed below, some liquidity has been traded for higher yields in the investment portfolio, while a shift in customer demand has led to longer maturities (and possibly less

[1] Noncore deposits include time deposits over $100,000, foreign-office deposits, and brokered deposits.

[2] Core deposits include demand, NOW, savings, and money market deposit accounts, as well as nonbrokered time deposits under $100,000.

[3] Large banks include commercial banks headquartered in the Atlanta Region with assets over $1 billion, excluding credit card specialty banks and banks open less than three years. Community banks include commercial banks with assets less than $1 billion, excluding credit card banks and banks open less than three years.

liquidity) in the loan portfolio. However, evolving secondary markets may have increased loan liquidity for some institutions.

Atlanta Region banks have noticeably shifted out of U.S. Treasury securities into agency- and mortgage-backed securities (MBS) during this decade. This transition has implications for liquidity, interest rate risk, and cash flow. Treasury securities, normally considered the most liquid of all investments, have declined from 28 percent to 12 percent of total investments at the Region's community banks over the past ten years. Large banks have seen a similar reduction in Treasury holdings. As Chart 2 shows, the bulk of the migration has been into agencies, including agency-issued MBS. Agency securities comprised two-thirds of total investments at large and small banks in the Region as of year-end 1998, up sharply from a decade earlier. MBS holdings alone doubled from 13 percent to 26 percent of community bank investments from 1988 to 1998, while nearly tripling, from 27 percent to 63 percent, at large banks. MBS typically have longer maturities than Treasury and agency bonds held by banks, thus introducing interest rate sensitivity that could depress values (impair liquidity) in a rising rate environment. Rate sensitivities also make the timing of MBS cash flows less predictable because of prepayment and extension risks. As MBS holdings increased in 1998, the share of total investments maturing in over five years also increased at banks in the Region. Meanwhile, securities maturing in less than one year declined as a share of Atlanta Region bank investments in 1998.

Banks most likely have shifted from Treasuries to agencies and MBS in search of higher yields. The spread between an option-free ten-year Federal Home Loan Bank bond and a ten-year Treasury has averaged about 56 basis points over the past 18 months, while the spread between a generic 7.0 percent coupon agency MBS and the ten-year Treasury has averaged about 155 basis points. And although not quite as liquid as Treasuries, agencies and MBS have a modest liquidity trade-off. If average daily trading volume[4] as a percentage of average securities outstanding is used as an indicator of market liquidity, approximately 6.7 percent of the Treasury market turned over daily in 1998, versus about 4.1 percent for agency bonds and 3.7 percent for agency MBS. In addition, the sheer size of these markets—Treasury ($3.2 trillion), agency ($1.4 trillion), and agency MBS ($2.2 trillion)—provides some indication that all are liquid instruments. That liquidity is limited somewhat by pledgings, however. More than one-third of community bank investments and more than one-half of large bank investments were pledged as collateral against bank liabilities as of year-end 1998.

The composition of the typical loan portfolio at an Atlanta Region bank might appear less liquid now than a decade ago, as residential mortgages have increased relative to consumer and commercial and industrial loans (see Chart 3). Consumer loans, which typically have shorter maturities, and commercial loans, which generally "self-liquidate" over a company's production cycle, might be viewed as more liquid in terms of a payback period than mortgages, which can have stated maturities of 15 to 30 years.[5] As pointed out in the

[4] Average daily trading volume by Primary Dealers with brokers and Primary Dealers with customers.

[5] Declining mortgage interest rates in recent years have fueled record refinance activity that has substantially shortened the average life of a residential mortgage; however, rates have been trending higher throughout most of 1999, and prepayments have slowed as a result.

CHART 2

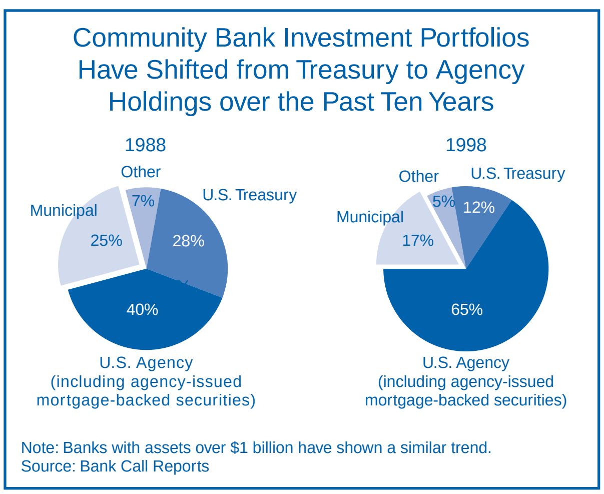
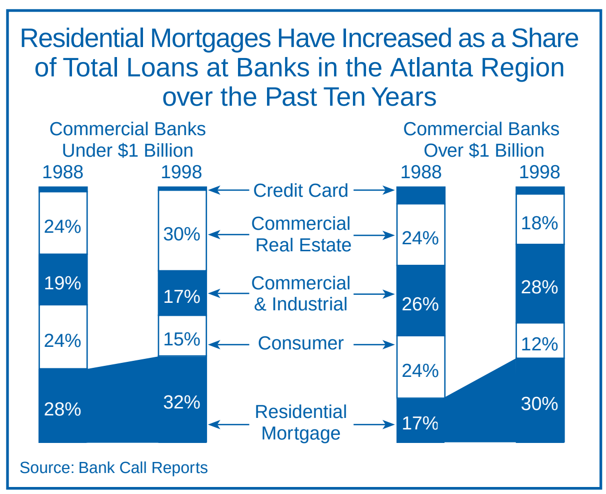


CHART 3



Federal Reserve Bank of New York's August 1999 "Current Issues in Economics and Finance: Are Banks Still Important for Financing Large Businesses?," commercial borrowers increasingly are turning to the capital markets (issuing bonds and commercial paper) rather than insured institutions to meet funding needs. That trend, along with the strong housing demand created by a good economy and low interest rates, has contributed to the increase in residential mortgage lending shown in Chart 3.[6]

The increase in longer term lending may not necessarily reduce loan portfolio liquidity. Investor appetite for asset-backed securities (ABS[7]) and MBS[8] has created a highly liquid market for loans to be securitized[9] and sold, provided they are underwritten to secondary market standards. As shown in Chart 4, total national ABS and MBS issuance has risen sharply over the past five years. Moreover, securitization has created a market for nearly all types of bank loans, including mortgage, auto, equipment, credit card, and home equity products, to be sold. Given the growth of the secondary market in this decade and the fact that an increasing number of banks reportedly are involved either in securitization or in selling loans to larger issuers, bank loan portfolios arguably may be more liquid now than in the 1980s regardless of an extension in maturities. Assessing loan liquidity is difficult, however, as marketability is driven largely by individual bank underwriting standards, production volume, and market access. It is also difficult to discern loan sales and securitization activity from Call Reports, although anecdotal evidence suggests that some of the Atlanta Region's large banks are actively involved. Community bank participation reportedly is more limited.

The ability to sell or securitize loans can be a viable asset-side funding tool for some institutions; however, banks that actively sell loans must be aware of interest rate and market risks that can limit their liquidity. Rising interest rates, for example, can depress the value of fixed-rate loans, thus reducing the lender's ability to sell them without suffering a principal loss.[10] Securitization strategies also are vulnerable to widening credit spreads or risk premiums. For example, in fall 1998, investor concerns about the Asian and Russian financial crises led to a sudden and dramatic widening of spreads that severely reduced secondary-market liquidity. ***The Bond Market Association*** reported that ABS issuance in the third quarter of 1998 fell nearly $10 billion, or 16.4 percent, from the second-quarter level "as investors flocked to the U.S. Treasury market in search of quality and liquidity." That brief liquidity crunch contributed to the financial deterioration of several nonbank finance companies, including Criimi Mae, Southern Pacific Funding Corp., and United Companies Financial Corp., in the second half of 1998. Companies that combined active loan sales with high borrowings were hit particularly hard, as the inability to sell loans corresponded with a reduction in borrowing capacity, thus straining liquidity on both sides of the balance sheet. Insured institutions should be less affected by similar circumstances because the quality of their

[6] The acquisition of thrifts by commercial banks also has contributed to higher levels of mortgage lending being reported by commercial banks compared with the 1980s.

[7] Asset-backed securities include securitized home equity, auto, credit card, student, and manufactured housing loans.

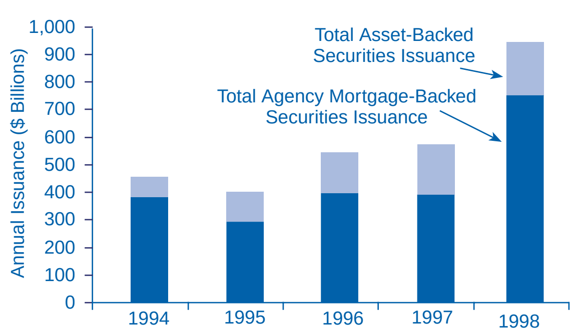
[8] Data include only mortgage-backed securities issued by the Government National Mortgage Association, Federal National Mortgage Association, and Federal Home Loan Mortgage Company.

[9] Securitization refers to the process of pooling loans together into bond-like structures that are then sold to investors in the public securities market.

[10] Secondary market demand for asset-backed securities can strengthen as rates rise, increasing loan liquidity as investors anticipate higher returns as refinance activity slows.

CHART 4

Annual Loan Securitizations Have Increased Steadily over the Past Few Years, Reaching a Record $925 Billion in 1998



Source: The Bond Market Association

loans is much stronger, as is their ability to portfolio loans if demand weakens. Nonetheless, last year's market turmoil may have highlighted the risks of overreliance on loan sales and noncore funding as primary sources of liquidity.

Liquidity Management Will Become More Complex as Asset and Liability Structures Evolve

Changing balance sheet structures continue to introduce new and complex interest rate and market sensitivities into the difficult task of asset/liability management. Sources of liquidity have expanded on both sides of the balance sheet, but potential liquidity pressures also may have increased on both sides as funding has become less permanent and off-balance sheet commitments are at or near ten-year highs. Moreover, strategies that rely on nontraditional funding sources such as borrowings and loan sales have developed largely in the 1990s and are not "recession tested." As always, the challenge for bank managers going forward is to maintain an asset allocation that provides sufficient liquidity for a given funding strategy, while also earning an acceptable return.

Atlanta Region Staff

Short-term liquidity issues...

Bankers continue to plan for the liquidity needs that could arise from the approaching year 2000 date change. On the liability side, some industry observers expect a net deposit outflow as consumers build "emergency" cash positions near year-end. Others contend that deposits will flow into U.S. banks in a global "flight to quality." On the asset side, loan funding requirements could increase if businesses and consumers draw down credit lines to bolster their liquidity positions.

To ensure liquidity in the banking system, the ***Federal Reserve Board*** has announced a number of initiatives, including making additional currency available and accepting a wider range of securities as collateral for bank borrowings. Further, federal regulatory agencies report that more than 99 percent of the nation's insured institutions have made satisfactory progress toward Y2K compliance. Reflecting confidence in banks' preparedness, William T. Clifford, president and CEO of ***Gartner Group, Inc.***, a Connecticut-based consulting firm, recently stated that "America's banking and securities industries have played a leading role in Y2K preparedness. There is no reason for consumers to withdraw large sums of money from banking, retirement, and investment accounts."

Subscription Form

To obtain a subscription to the FDIC ***Regional Outlook***, please print or type the following information:

Institution Name ______________________________

Contact Person ______________________________

Telephone ______________________________

Street Address ______________________________

City, State, Zip Code ______________________________

Please fax or mail this order form to:

FDIC Public Information Center
801 17th Street, N.W., Room 100
Washington, D.C. 20434
Fax Number (202) 416-2076

Please indicate below each Region's issue you wish to receive:

Atlanta	______	Dallas	______	New York	______	National	______
Boston	______	Kansas City	______	San Francisco	______	All	______
Chicago	______	Memphis	______				

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429-9990

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE, $300

BULK RATE MAIL
Postage & Fees Paid
FDIC
Permit No. G-36