Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION — SECOND QUARTER 1999

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DANIEL FRYE, REGIONAL MANAGER

NORMAN WILLIAMS, REGIONAL ECONOMIST

CAMERON TABOR, SENIOR FINANCIAL ANALYST

ANDREA N. VINCEQUERE, ECONOMIC 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.**

- ***Economic Developments*—Low interest rates, dormant inflation, and rising stock markets have all contributed to a generally positive near-term outlook for the U.S. economy.** *See page 3.*
- ***Trends Affecting Banking Lines of Business*—Although credit conditions appear strong, risks exist in the major banking lines of business.** *See page 7.*

  ***Consumer Lending*—Continued high consumer loan loss rates raise questions about how lenders will fare under less favorable economic circumstances.** *See page 8.*

  ***Commercial Lending*—Corporate loan growth accelerated in 1998 even as the corporate sector showed signs of stress.** *See page 9.*

  ***Commercial Real Estate and Construction Lending*—Selected metropolitan markets are experiencing rapid commercial development despite declining indicators of demand.** *See page 10.*

  ***Agricultural Lending*—Falling commodity prices threaten U.S. farm operators.** *See page 11.*

  ***Funding and Interest Rate Risk*—Intense competition and the changing term structure of interest rates have presented challenges for banks and thrifts.** *See page 12.*
- ***Indicators of Industry Performance*—Weaknesses appear to be developing for banks with certain types of exposures, and the dispersion in performance among insured institutions is increasing.** *See page 13.*

By the Analysis Branch Staff

Regional Perspectives

◆ ***Regional Economic and Banking Conditions*—Most indicators showed another year of steady economic growth during 1998, with only the manufacturing sector demonstrating some signs of weakness…During the first quarter of 1999, nonfarm payroll growth decelerated, while manufacturing payrolls declined from levels of a year ago…Strong asset quality continued to bolster insured institutions' earnings in 1998; however, weaker margins arising from a prolonged refinancing wave are taking a toll on overall profitability.** *See page 16.*

◆ ***Insured Institutions Are Taking on More Risk as Narrowing Margins Squeeze Earnings*—In 1998, strong performance by credit card banks, coupled with gains in many insured institutions' securities portfolios, effectively masked a weakening earnings posture for the industry…Weaker earnings are arising primarily from increased loan loss provisions at larger institutions and a weaker net interest margin that is negatively affecting a wide range of institutions…Institutions affiliated with publicly traded companies are adopting higher risk profiles in response to weaker earnings growth and lagging stock price performance.** *See page 20.*

By the Boston Region Staff

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Economic Conditions and Emerging Risks in Banking

Periodically, the Division of Insurance assesses conditions in the economy and across the banking industry in an effort to evaluate the types of risks that could adversely affect the performance of insured depository institutions. The analysis that follows describes the salient aspects of this assessment by focusing on three areas: 1) developments and conditions in the U.S. and global economies; 2) trends affecting particular banking lines of business; and 3) selected indicators of bank performance.

In brief, the U.S. economy continues to provide a favorable environment for the banking industry. The industry as a whole has exhibited strong loan growth and minimal credit losses. Nevertheless, there are areas of concern, including subprime and high loan-to-value consumer lending, higher levels of leveraged commercial lending, localized overbuilding of commercial real estate, and the potential for credit quality problems among agricultural banks. Although it is uncertain when, or even if, these concerns will ultimately affect overall industry performance, the potential for stress among insured institutions is being monitored.

Economic Developments

Conditions Have Improved Markedly since Late 1998

The U.S. economy is now in its eighth year of expansion, the longest peacetime expansion during the post-World War II era. Although analysts raised concerns about the durability of the expansion amid the late-1998 financial market turmoil, the economic outlook since that time has improved for a number of reasons: 1) the 75 basis point reduction in short-term U.S. interest rates between September and November helped to support consumer spending and business investment; 2) following several quarters of decline, U.S. exports rose unexpectedly during the fourth quarter; 3) inflation remained dormant even though U.S. labor markets were extremely tight; and 4) equity valuations for large-cap stocks rebounded and erased most of the losses incurred during August and September.

Consumer Spending and Business Investment Are Key to Economic Strength

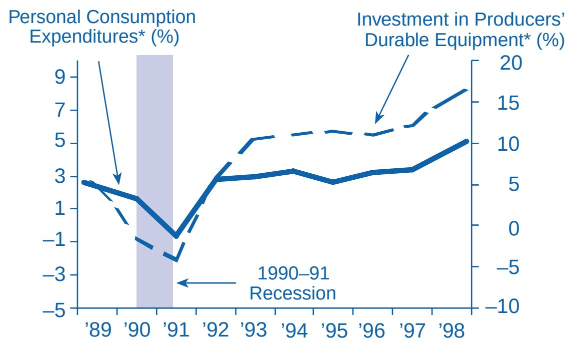
Most of the standard indicators of health for the U.S. economy currently register values associated with the best macroeconomic conditions in our history. Growth in real gross domestic product (GDP) was 3.9 percent for all of 1998—the third consecutive year in which growth exceeded 3.5 percent. The U.S. economy added over 3.1 million jobs during 1998, while unemployment averaged just 4.5 percent, the lowest annual figure since 1969. Despite this robust economic activity, inflation was also the lowest in a generation. Consumer prices rose by just 1.6 percent in 1998, extending a seven-year streak during which prices have risen by less than 3 percent per year. At the same time, strong gains in the productivity of U.S. workers helped real hourly earnings rise by 2.7 percent—the best performance since 1972—while unit labor costs of businesses rose by only 1.9 percent.

Growth in business investment spending, which typically peaks in the early years of an economic expansion, has actually accelerated during the current expansion (Chart 1, next page). A number of factors appear to be responsible for this investment boom. One is the need for producers to invest in new technologies in order to cut costs and remain competitive. Also, rising stock prices, low interest rates, and low yield spreads during the past few years have helped keep the cost of capital relatively low. The result has been an economic expansion in which approximately 20 percent of net growth in real GDP has come from investment in producers' durable equipment, versus approximately 10 percent during the long expansions of the 1960s, 1970s, and 1980s. Bank commercial and industrial lending has expanded at an average annual rate of 10.6 percent over the past five years, largely on the strength of business investment spending.

The underlying factors that drive consumer spending are strong. Low unemployment and rising real incomes have boosted the ***Conference Board's*** consumer confi-

CHART 1

Low Interest Rates and High Stock Prices Fuel Consumption and Investment



* Annual Inflation-Adjusted Rate of Change
Source: Bureau of Economic Analysis

dence index to its highest values since the late 1960s. Increases in new home construction reflect these favorable conditions. Almost 1.5 million new homes were completed during 1998—the highest level in ten years—while a record 4.8 million existing homes were sold (Chart 2). U.S. automobile sales reached 15.5 million in 1998, their best performance since 1986. Low interest rates also enabled a record number of homeowners to reduce their monthly interest expenses by refinancing their mortgages during 1998.[1]

Although real disposable personal income grew by more than 3 percent during 1998, personal savings was essentially zero during the fourth quarter. This was the lowest rate of personal savings recorded in the United States since the Great Depression. The decline in personal savings has prompted much discussion of its causes and potential implications for the economy and for consumer credit quality. Most analysts have argued for the importance of a "wealth effect" from rising stock values on consumer spending.[2] They note that although consumers are saving little out of current income, household wealth continues to grow rapidly, driving consumer spending higher. The willingness of American consumers to spend has been a prime factor in prolonging the economic expansion for the United States and in supporting the economies of countries around the world that depend on exports to the United States. This high degree of reliance on the U.S. consumer has led analysts to voice concerns that the wealth effect might reverse itself, leading to a sharp drop in consumer spending if there is a sustained stock market decline.

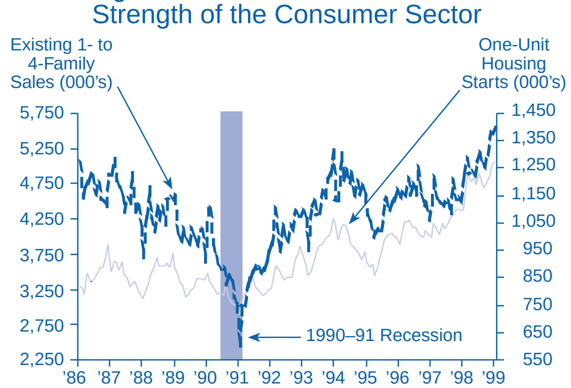
Conditions Vary across Industry Sectors

While overall conditions in the U.S. economy are good, certain sectors have been undergoing significant strain because of low commodity prices and weak foreign demand.

Commodity price weakness extends across a wide range of items, from agricultural goods to industrial commodities to basic manufactured goods (Chart 3). Among agricultural commodities, grain prices have fallen substantially from their record-high levels of just three years ago, while prices for hogs and soybeans have also been under severe pressure. Industrial commodity prices have fallen sharply, with steel prices down by nearly 30 percent since January 1997. Certain manufactured goods show a similar pattern. The price of the industrial chemical benzene has fallen by 40 percent since January 1997, while the price of computer memory chips fell by more than 80 percent during that time. Oil prices decreased by nearly 50 percent between January 1997 and February 1999. Since mid-March, however, oil prices have increased as a result of agreements among oil producers to limit output. Analysts are uncer-

CHART 2

Housing Starts and Home Sales Reflect the Strength of the Consumer Sector

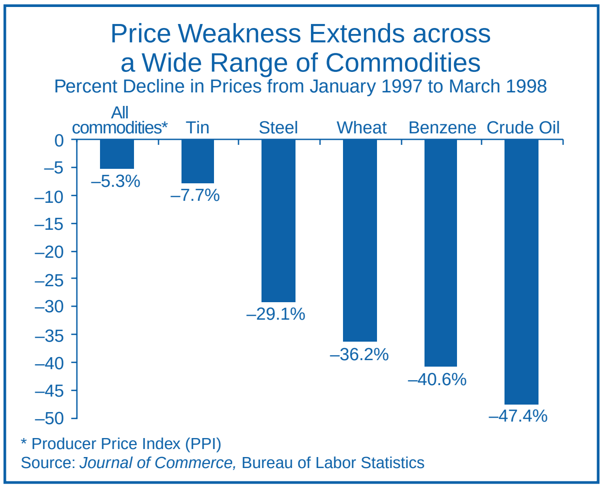


Sources: U.S. Census Bureau; National Association of Realtors

[1] The Refinancing Index of the ***Mortgage Bankers Association*** posted an all-time high of 4,389 in the second week of October 1998. The index is scaled to a level of 100 as of the third week of March 1990.

[2] Personal savings is measured as the difference between disposable personal income (personal income less tax payments) and total consumption outlays. Increasing household wealth may reduce personal savings either through a reduction in disposable income or through increased consumption outlays. Tax payments resulting from capital gains will reduce measured disposable personal income. Increasing household wealth may lead to higher consumption outlays by means of the wealth effect.

CHART 3



tain how long any reductions in output will be maintained or how much oil prices may increase during the next several months.

Three trends in the global economy appear to be responsible for weak commodity prices. First, sustained low inflation has taken root both in developed nations and in many emerging economies. Low inflation has eliminated much of the speculative demand for commodities that was evident during the 1970s. Low inflation has also made it difficult for manufacturing firms to raise prices, while at the same time encouraging the implementation of new technologies to cut costs. Second, large-scale investment in plant and equipment during the 1990s in both developed and emerging countries has added vast amounts of new global manufacturing capacity, making industrial overcapacity a source of price weakness in a number of industries. Third, successive currency crises and the resulting recessions that have taken place in Asia, Eastern Europe, and Latin America have reduced global demand for commodity goods. Moreover, U.S. firms find that their products are less price competitive abroad because of the relative strength of the dollar.

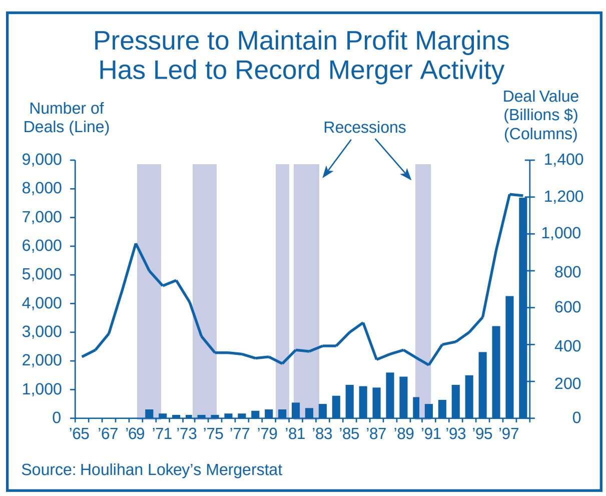
One reason the overall U.S. economy has proven so resilient in the face of weakness in the manufacturing sector is that firms have been able to restructure to cut costs and improve their market positions. Global overcapacity in industries such as oil and autos has been a driving force behind the record number and dollar value of merger deals announced during 1998. Mega-mergers involving Exxon-Mobil and Daimler Benz-Chrysler helped push the dollar volume of mergers announced in 1998 to almost $1.2 trillion—nearly double the level announced in 1997 and far greater than any year during the “merger mania” of the 1980s (Chart 4).

U.S. Foreign Trade Reflects Recent Turmoil in the Global Economy

The U.S. economy increasingly relies on exports to fuel its overall growth. Between 1994 and 1997, export growth contributed about 1 percentage point each year to total net growth in real GDP. However, with the onset of the Asian economic crisis in 1997, the export sector stalled and became a drag on overall U.S. economic activity. During the first three quarters of 1998, exports decreased at an annualized rate of 4.4 percent, led by declines in capital goods, industrial material and supplies, and food and agricultural products. Weakness in exports was not limited to Asia; in fact, Canada, Mexico, and South America were also weak markets for U.S. goods and services during most of 1998. Declining goods exports and rising imports combined to push the U.S. balance of trade to a record deficit of $169 billion during 1998—a 50 percent increase from the year before. The trade deficit continued to increase in early 1999. Data for January show an imbalance of nearly $17 billion, the largest monthly deficit ever recorded.

Despite the weakness in foreign demand that was observed during much of last year, U.S. exports rose sharply at the end of 1998. Total exports jumped by 19.7 percent during the fourth quarter, contributing 2.0 percent of the total 6.0 percent growth in GDP during the

CHART 4



quarter. This unexpected increase in U.S. exports involved nearly every region of the world except Eastern Europe. Export shipments increased across most product types, with the greatest increase in activity observed in capital goods.

The Outlook for the Global Economy Remains Uncertain

Developments during the past six months have resulted in an improved outlook for the global economy, but some key uncertainties remain. While the global financial system is more stable today than it was six months ago, some of the world's most important economies either remain in recession or are experiencing slower growth. In this environment, the potential remains for shocks to arise in the global economy that could adversely affect the performance of the U.S. economy and the credit quality of insured depository institutions.

Canada. The Canadian economy is healthier than at any time during the past several years. Canada's economy is expected to track overall growth in the United States, in part because U.S. demand for goods and services is the principal support for Canadian exports. Canada's relatively high dependence on weak commodity industries, such as metals, grains, and livestock, poses risks for producers and for local economies closely tied to these commodities.

Mexico. Mexican GDP growth was 4.6 percent in 1998, reflecting relatively strong employment and wage gains, high levels of foreign direct investment, and robust non-oil export growth. Looking ahead, inflation remains a concern. At the end of 1998, the inflation rate was 18.7 percent, up from a low of 15 percent in the middle of the year. The ***Blue Chip Economic Indicators*** consensus forecast calls for real GDP growth of 2.9 percent during 1999, down from 4.6 percent in 1998.

Western Europe. Europe's problems are similar to those of the United States in that they stem from declining growth in manufacturing exports. Despite a 175 basis point cut in short-term interest rates in the U.K. since October 1998, the Bank of England forecasts economic growth of less than 1.0 percent in 1999. In Germany, manufacturing activity has also decreased, owing to weakness in export markets. German GDP shrank by 0.4 percent during the fourth quarter of 1998, while unemployment remains above 10 percent. In response to signs of growing weakness in Germany and other major economies in the 11-member "Euro-zone," the European Central Bank cut short-term interest rates by 50 basis points to 2.5 percent on April 8, 1999.

Eastern Europe. Much of Eastern Europe is faced with slow growth or recession following the devaluation of the ruble and the default on Russian government debt in August 1998. The Russian economy shows few signs of recovery amid high inflation and halting progress in economic reform. Poland and Hungary, Eastern Europe's engines of growth before the Russian crisis, are facing rising current account deficits and a slowdown in export growth.

Asian Pacific Rim. The Japanese economy remains mired in a long-running recession that has resulted in a greater number of bankruptcies (up 17 percent in 1998), falling domestic demand, and pessimism among consumers and businesses alike. Japanese GDP fell by 2.8 percent during 1998, and analysts call for a drop of 0.8 percent in 1999.

There are signs that the worst phase of the Asian economic crisis may have passed.[3] In the Philippines, South Korea, Hong Kong, and Thailand, current accounts have moved from deficit to surplus as devalued currencies continue to depress imports. Foreign capital is returning to the region, as evidenced by the 27 percent increase in foreign direct investment in Korea during 1998. However, weak consumer spending remains a problem for the entire region, which ships fully 40 percent of all exports to other Asian Pacific Rim nations.

In China, which has been relatively immune to the worst of the region's economic crisis, slower growth is also forcing economic restructuring. With annual economic growth below the targeted 8 percent mark, economic planners have been forced to reduce production and close plants in the oil, steel, glass, and cement industries. Meanwhile, the government is trying to stimulate demand by investing in public infrastructure and by urging banks to increase lending to the private sector.

[3] See "The Asian Economic Crisis: Implications for the U.S. Economy," *Regional Outlook,* Third Quarter 1998. Also available at http://www.fdic.gov/publish/regout/ro19983q/ny/infocus1.html.

Latin America. With the apparent stabilization of the Asian economies, attention has now focused on emerging problems in Latin America. The 50 percent devaluation of the Brazilian *real* versus the dollar that began in January 1999 has depressed economic activity and renewed fears of inflation. Consensus estimates place Brazilian economic growth at negative 3.5 percent for 1999, while short-term interest rates are likely to remain high (currently about 42 percent) to prevent further capital flows out of the country.

Risks Remain despite a Positive U.S. Economic Outlook

Robust economic growth, low inflation, and stable interest rates appear to be the most likely economic scenario for the remainder of 1999, according to the consensus forecast of the ***Blue Chip Economic Indicators.*** If this outlook actually comes to pass, we can expect that the vast majority of insured institutions will continue to enjoy moderate loan growth and generally favorable indicators of financial performance and condition.

Despite this positive outlook, the risk remains that the expansion could be derailed by one of three types of shocks. The first would be a resurgence of inflation resulting from demand-induced shortages of labor or other key economic resources. Although inflation has been consistently low in recent years, investors remain on the lookout for any signs of higher prices. While it is not certain that a recession would result, it is worth noting that rising short-term interest rates in response to increasing inflation have preceded every recession during the past 40 years.

The second type of shock that could end the expansion is a sustained period of deflation. Concern about deflation arises from the low prices many commodity producers are receiving and the effects of foreign currency devaluations on U.S. import prices. Although these trends have helped to keep U.S. inflation and interest rates low, at some point they could impose a heavier burden on U.S. businesses by shrinking revenues and profit margins, mirroring what has already occurred in some commodity-based industries.[4]

The third type of shock is financial market instability. Consumer confidence, which has reflected recent increases in stock market wealth, could tumble in the event of a severe and prolonged decline in the stock market. Business investment has also depended on the support of strong and stable financial markets that offer firms access to capital on favorable terms and facilitate restructuring in troubled industries. A recession accompanied by financial market instability could pose a particular threat to bank loan performance because it would likely produce a disorderly shakeout of troubled firms marked by a rise in bankruptcies and loan defaults.

[4] See "How Will the Expansion End?" *Regional Outlook,* Second Quarter 1998. Also available at http://www.fdic.gov/publish/regout/ro19982q/sf/infocus2.html.

Trends Affecting Banking Lines of Business

Overview

Trends in bank and thrift lines of business align closely with those of the economy. Most insured institutions have prospered during this economic expansion, as shown by the industry's continuing earnings growth, strong capital levels, and improving or stable loan performance across most major loan categories. Likewise, today's strong economy depends to a great extent on the continuing availability of consumer and business credit from banks and thrifts. Even during the closing months of 1998, when capital market funding sources became quite volatile, credit continued to flow from insured institutions. During that turbulent period, insured institutions may have acted as a stabilizing force for businesses, consumers, and farmers by continuing to provide credit, albeit at higher prices and with stricter underwriting terms in some cases.

Although credit conditions appear strong, a number of insured institutions' loan portfolios are shifting toward a riskier mix of credits. Underlying reasons for these shifts vary, but likely explanations include opportunities to earn higher yields and confidence about the overall economic outlook. The following paragraphs discuss credit risk trends and highlight possible areas of concern in the major lending lines of business at insured institutions. The influence of recent interest rate changes and competitive factors on asset/liability and credit risk management is also explored.

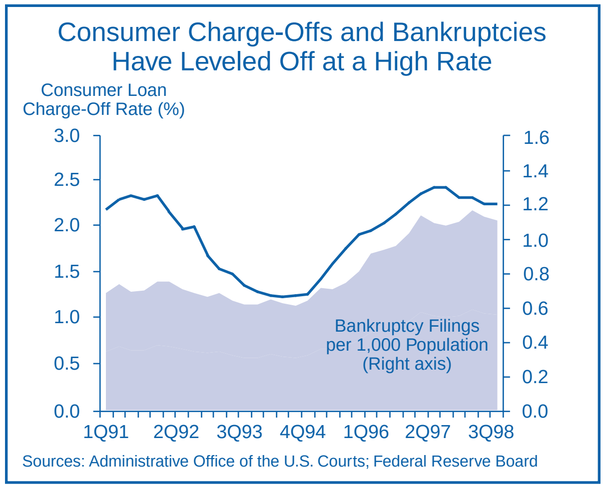
Consumer Lending

Debt Growth Sustains Consumer Spending but Could Contribute to Financial Strains under Less Favorable Economic Conditions

Much of the strength and stability of the overall U.S. economy owes itself to the continuing growth in consumer spending. While higher personal incomes and consumer confidence are important contributing factors, lower interest rates and expanding avenues of credit access have also played key roles in supporting consumer spending. With mortgage debt leading the way, consumer loan growth rates accelerated in 1998. The key factor driving mortgage loan growth was lower interest rates, which encouraged many consumers to purchase homes, refinance existing mortgages, and consolidate their personal debts through home equity loans. As a result, the growth in home mortgage credit during 1998 reached a post-recession high of 10 percent. Other consumer loan types, such as auto and credit card debt, grew at slower but accelerating rates of 8 percent and 5 percent, respectively.

Nonmortgage consumer loan loss rates remain above previous recession levels despite the apparent strength of the consumer sector. Chart 5 shows that nonmortgage consumer loss rates have declined slightly from their peak in the fourth quarter of 1997, but remain above the rates experienced during the prior recession. The chart also shows that consumer credit loss rate trends are closely related to the rise in personal bankruptcy filings, which reached an all-time high of 1.4 million in 1998.[5] The good news for consumer lenders is that the growth rate in personal bankruptcies has slowed. However, this leveling off does not mean that consumer credit quality concerns have abated. The overriding concern is how personal bankruptcies and consumer credit losses, already at high levels, would be affected by less favorable economic conditions. Another concern is whether current consumer spending patterns will be supported by a new round of credit card growth. Since revolving credit card balances typically carry higher interest rates than home equity loans, this "reloading" of credit card debt would further strain the financial flexibility of consumers.

CHART 5



High Loan-to-Value Mortgage Products and Subprime Lending Transform Consumer Lending

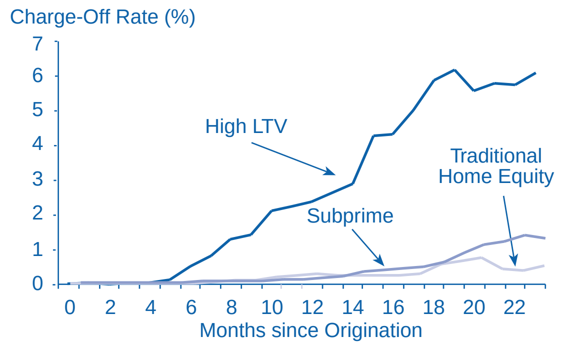
Consumer lending practices have changed significantly since the last recession. Because of intense competition and declining net interest margins, consumer lenders are reaching out to borrowers further down the credit quality spectrum and relaxing traditional collateral requirements. Bank supervisors have indicated that a growing number of insured institutions are involved in some form of subprime lending. Subprime loans, designed for borrowers with blemished or limited credit histories, can take a variety of forms, including home equity, automobile, and credit card loans. As compensation for increased risk, subprime loans carry higher interest rates than prime-rate loans and often require substantial collateral margins.

Insured institutions are also embracing another relatively new consumer loan product: high loan-to-value (LTV) loans. High LTV loans, where the combined amount of senior and junior liens against a home exceeds its value, are usually made to borrowers with "clean" or unblemished credit histories. However, the lack of collateral protection results in much higher loss experience when a borrower defaults. As Chart 6 shows, high LTV loans have had a higher loss rate experience (adjusted for seasoning) than either traditional home equity loans or subprime loans. Moreover, the delinquency rates on recent-vintage home equity loan pools

[5] Reasons for the rise in personal bankruptcy rates are further explored in a series of ***Bank Trends*** articles published by the FDIC. See, for example, "A Time Series Model of the U.S. Personal Bankruptcy Rate, 1970-1996," February 1998, and "The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-Offs, and Personal Bankruptcy Filings," March 1998. Both reports can be accessed at www.fdic.gov/publish/bktrnds/index.html.

CHART 6

High LTV Mortgages* Have a Higher Loss Experience than Other Mortgage Types



* Includes home improvement loans
Source: Moody's Investor Services

have deteriorated as high LTV loans have proliferated.[6] At the same time, recent regulatory surveys of credit underwriting practices show easing standards on home equity loans.[7] The loss experience of these higher risk consumer products during less favorable economic circumstances is unknown and continues to be a concern.

Commercial Lending

Commercial Loan Performance Remains Strong but Corporate Financial Strains Are Developing

Continued strength in the corporate sector is reflected in the level of corporate bankruptcy filings, which have declined since the middle of 1997 to just under 10,000 in the fourth quarter of 1998. Bank losses on commercial credits remain low but did register a modest increase during the fourth quarter (see Chart 7). In addition to strong economic fundamentals in high tech, construction, finance, service-related, and other sectors, U.S. businesses have benefited from significantly lower interest rates and an abundant supply of credit. Credit access provided by banks was particularly important to U.S. businesses in the latter part of 1998. During this period, sharply higher interest rate spreads on corporate bonds[8] and commercial paper led many companies to tap cheaper funding sources, including existing unused credit and commercial paper lines held by commercial banks. As a result, commercial banks experienced a 15 percent (annualized) rate of growth in fourth quarter 1998, the highest rate of commercial loan growth in 16 years.

Although commercial loan loss rates are low, financial strains are becoming apparent among certain U.S. business sectors. Bank lending to U.S. businesses has grown at a faster pace than GDP during each of the past eight quarters. Moreover, growth in bank commercial lending through 1998 has come at a time when total after-tax U.S. corporate profits have begun to decline.[9] Deteriorating profits are especially prevalent in sectors with exposure to weak commodity prices and slower export growth. For many businesses, lower profits have resulted in a reduced capacity to service outstanding debt obligations. For instance, a recent ***Bank of America Corporation*** study reported that amendments to syndicated loans in the latter half of 1998 were driven increasingly by borrowers seeking relief from financial performance-related covenants.[10] Financial strains are

[6] "Moody's Home Equity Index Update." *Moody's Investor Services*, October 2, 1998, p. 3.

[7] For example, the ***Office of the Comptroller of the Currency's*** "1998 Survey of Credit Underwriting Practices" indicated that 33 percent of the banks offering home equity loans eased standards, compared with only 7 percent that tightened standards. The report is available at http://www.occ.treas.gov/cusurvey/scup98.pdf.

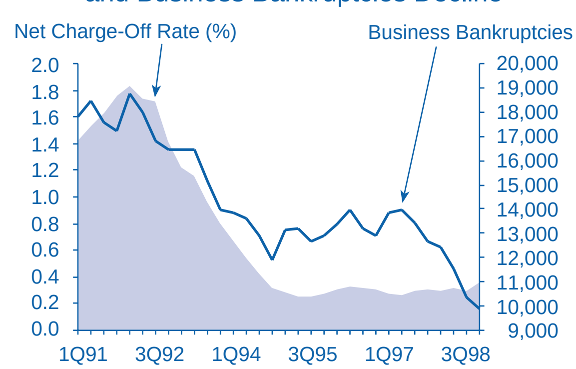
[8] ***The Merrill Lynch U.S. Investment Grade Corporate Bond Master Index*** indicates that corporate bond spreads over ten-year Treasury rates rose 58 percent, an increase of 63 basis points, from the end of July 1998 to the end of October 1998.

[9] See the ***Bureau of Economic Analysis Corporate Profit Index.***

[10] "Covenants Provide Loan Repricing Opportunity." *Bank of America Report*, January 25, 1999.

CHART 7

Domestic Commercial Loan Losses Remain Low and Business Bankruptcies Decline



Sources: U.S. Courts; Bank Call Reports

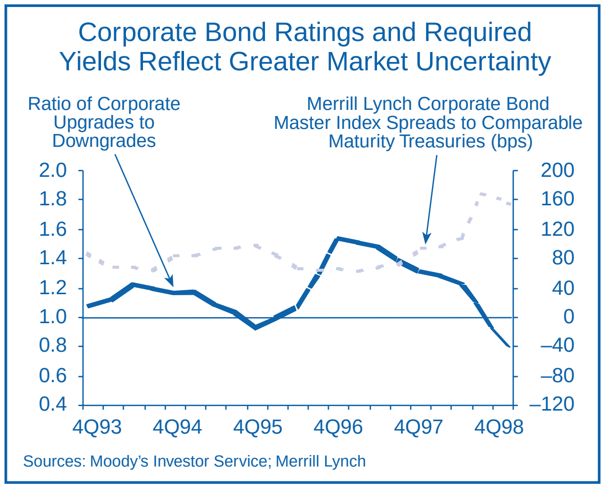
also reflected in the level of corporate bond defaults, which ***Standard and Poor's*** reported at 48 ($10.8 billion in affected debt) in 1998, up 182 percent from 1997 levels (up 150 percent in dollar volume terms).[11]

As Debt Markets Become More Cautious, Syndicated Lending Shifts toward Higher Risk Borrowers

Although the longer-term trend has been toward more aggressive corporate lending strategies, many insured institutions responded to the financial market turmoil in late 1998 with a heightened sense of caution. Recent surveys of underwriting practices conducted by the federal banking agencies show that many banks tightened standards in late 1998 across many product lines.[12] However, tighter lending terms do not appear to have quelled either loan demand or loan production substantially.

Syndicated lending trends suggest an increase in corporate lending risks.[13] Despite the flight to quality that occurred in the latter part of 1998, syndicated loans to leveraged companies jumped 41 percent to $273 billion during 1998. Over the same period, nonleveraged loans declined 35 percent to $599 billion. Although corporate merger activity accounts for much of the increase in leveraged lending volume in 1998, some lenders appear to be taking advantage of the higher yields available in this market relative to yields on lower risk credits. The apparent shift toward a higher risk mix of total syndicated credit outstanding is occurring at the same time that corporate bond defaults for speculative grade issues are trending upward.[14] Moreover, trends in corporate bond spreads and rating agency actions on corporate bond debt suggest a bond market that is becoming increasingly cautious about the outlook for U.S. businesses (see Chart 8).

CHART 8



Commercial Real Estate and Construction Lending

Construction Loan Growth Accelerates as Overbuilding Pressures Increase in Certain Markets

In 1998, the value of private commercial construction rose 4.0 percent over 1997 levels, reflecting a moderate slowdown in growth compared with a compounded average annual growth rate of 8.4 percent since 1992. In contrast, the pace of residential development has accelerated. The value of private residential construction rose 11.5 percent in 1998, compared with an annual average growth rate of 8.0 percent since 1992. Construction loans at insured institutions grew 20 percent in 1998, the highest growth rate since 1986.[15]

Although market fundamentals are strong throughout most major U.S. markets, some metropolitan areas appear to be vulnerable to an oversupply of commercial space. The ***Regional Outlook***, First Quarter 1999, highlighted nine markets that may be susceptible to commercial overbuilding on the basis of the following factors: 1) the rapid pace of current construction activity in those markets; 2) high vacancy rates relative to construction in progress in some cases; 3) projections of rising vacancy rates by market analysts; and 4) various recent shifts in demand indicators. Data through June 1998 indicate that construction activity in these markets

[11] "Corporate Defaults Rise Sharply in 1998," ***Standard & Poor's***, March 5, 1998.

[12] See ***Federal Reserve Board*** Senior Loan Officer Opinion Surveys for November 1998 and January 1999, http://www.bog.frb.fed.us/boarddocs/snloansurvey/.

[13] Syndicated loans are credit facilities made to medium and large corporate borrowers by a group or syndicate of lenders. Analysts often segment this market into "leveraged" lending (loans to heavily indebted companies) and nonleveraged lending.

[14] ***Moody's Investor Services*** reports that trailing 12-month default rates for speculative-grade issuers rose from 2.02 percent at the end of 1997 to 3.31 percent at year-end 1998. These default rates compare to an all-corporate trailing default rate of 0.68 percent in 1997 and 1.27 percent in 1998.

[15] Construction loan growth captures growth in both residential and nonresidential development.

has not yet abated to reflect moderating demand levels.[16] Overbuilding concerns may be tempered to the extent that tighter commercial real estate lending standards slow the pace of development.[17]

Loan Underwriting Study Reveals Sounder Practices Compared with the 1980s, but Intense Competition Forces Some Concessions on Pricing and Structure

Beginning in August 1998, FDIC analysts set out to investigate construction loan underwriting practices in banks servicing various rapidly growing markets. The study identified several differences between today's lending practices and those prevalent during the last cycle. Most importantly, today's lenders are making credit decisions on the basis of improved appraisals, increased attention to project cash flows and project feasibility, and better market information on competing projects. However, intense competition has forced an across-the-board reduction in loan pricing margins even compared with margins at the height of the 1980s building boom.

The study also identified some instances of aggressive loan structures, including pricing at extremely thin margins, waiving or limiting personal guarantees, waiving cash equity requirements, and lending on thin collateral margins. Borrowers who secured the most aggressive loan terms were typically larger developers, who presumably have the resources and financial flexibility to weather adverse conditions. Nevertheless, waiving personal guarantees and eliminating a borrower's financial exposure to project risks are practices often cited in conjunction with the heavy construction loan losses experienced during the previous real estate downturn. Finally, the study found that many real estate investment trusts and large corporate developers have been able to obtain long-term unsecured financing for development purposes. The lack of collateral protection could make these loans particularly vulnerable to declining commercial real estate prices.[18]

[16] The nine markets are Atlanta, Charlotte, Dallas, Las Vegas, Nashville, Orlando, Phoenix, Portland, and Salt Lake City. "Commercial Development Still Hot in Some Markets but Slower Development May Be Ahead." *Regional Outlook,* First Quarter 1999, www.fdic.gov/publish/regout/ro19991q/na/index.html.

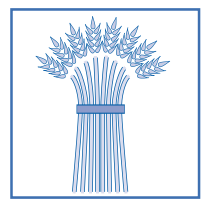
[17] Consistent with commercial and industrial underwriting trends, commercial real estate lenders reacted to market volatility in late 1998 by tightening loan terms and raising pricing margins. See, for example, the Federal Reserve Board Senior Loan Officer Opinion Survey for November 1998 and January 1999.

Agricultural Lending

Farm Banks Threatened by Falling Commodity Prices

Farm banks generally performed well in 1998, reporting a modest increase in nonperforming loans from 1.09 percent at year-end 1997 to 1.13 percent as of year-end 1998. Although delinquent loans rose only slightly in the aggregate, farm banks in some localized areas such as northeast North Dakota and northwest Minnesota experienced sharply higher problem loan levels and reduced profits in the aftermath of three consecutive years of low prices, bad weather, and crop disease-related problems. Moreover, recent surveys by the federal banking agencies, which show rising levels of farm carryover debt at farm banks, suggest that nonperforming loan data may understate borrower difficulties.

During 1998, the outlook for significant portions of the farm sector deteriorated following a dramatic fall in prices for several major farm commodities. Prices for wheat, corn, soybeans, and hogs fell to ten-year lows and were below the economic breakeven cost of production for many producers. For areas heavily dependent on these commodities, the ***U.S. Department of Agriculture*** (USDA) projects that producers will experience substantial declines in net cash income from 1999 through 2003.[19] In 1999, the USDA projects farm income to fall 7.1 percent, to $44.6 billion, from last year's level of $48 billion.



Although current conditions have the potential to cause stress for substantial numbers of farm banks in certain regions, some significant differences exist between today's circumstances and those that led to the farm

[18] Loan covenants may mitigate some of the risks of lending without collateral protection. Common covenants include maximum leverage ratios, minimum equity requirements, and limits on encumbered assets through recourse or cross-collateralization to third parties.

[19] A substantial portion of the ***USDA's*** projected decline in the net cash income for U.S. farmers over the next five years is attributable to reductions in government payments to farmers.

bank crisis of the mid-1980s. Current favorable factors include 1) lower debt-to-equity for farm producers; 2) substantially lower interest rates; 3) moderately appreciating farmland prices relative to the more rapid appreciation (and subsequent price corrections that followed) in the 1970s and 1980s; and 4) better underwriting practices by farm lenders. Nevertheless, if weak exports of farm products and low commodity prices continue for the remainder of this year, the condition of farmers could deteriorate significantly, increasing financial stress at insured farm banks.

Funding and Interest Rate Risk

Deposit Funding Becomes More Difficult to Obtain

Competitive pressures in the banking industry are not restricted to lending. Insured institutions are also finding it difficult to attract deposits in today's marketplace, largely because of the existence of higher yielding investment products. For example, the ***Investment Company Institute*** reports that net inflows into mutual funds have exceeded net increases in deposit accounts in all but three quarters since mid-1991. The fourth quarter of 1998 marked the sixteenth consecutive quarter that mutual fund inflows outstripped deposit increases. As deposits have become more difficult to attract, loan portfolios have expanded in line with the overall growth in the economy. As a result, institutions have turned increasingly to other borrowings for funding. These trends are captured in Chart 9, which shows that the ratio of bank and thrift loans to deposits reached a record 88 percent in December 1998. Small community banks and thrifts (institutions with less than $1 billion in assets) are most affected by deposit trends, since they tend to rely more heavily on deposit funding than larger institutions with greater access to the capital markets.

Interest Rate Changes Pose Asset/Liability Management Challenges

Interest margin pressures are posing challenges for insured institutions. In addition to the effect of competitive pressures, changes in interest rates have had a substantial influence on institutions' net interest margins. The flattening of the yield curve in 1998, for example, appears to have contributed to a decline in margins to their lowest levels since 1991 for both large and small insured institutions (see Chart 10). For insured institutions with more traditional asset/liability structures (longer-term asset holdings funded with shorter-term deposits and borrowings), a flatter yield curve results in lower spreads between asset yields and interest costs.

The decline in long-term interest rates during 1998 also led to a record volume of mortgage refinance activity, as indicated by the ***Mortgage Bankers Association's Refinancing Index.***[20] Among many mortgage lenders, the most immediate impact from this refinancing activity was the revaluation of servicing assets and lower servicing fee income. Some mortgage lenders also saw a significant increase in overhead as they expanded staff to accommodate higher loan application volumes. A

[20] This index hit its peak in mid-October and has since declined in line with a modest upward movement in fixed mortgage rates.

CHART 9

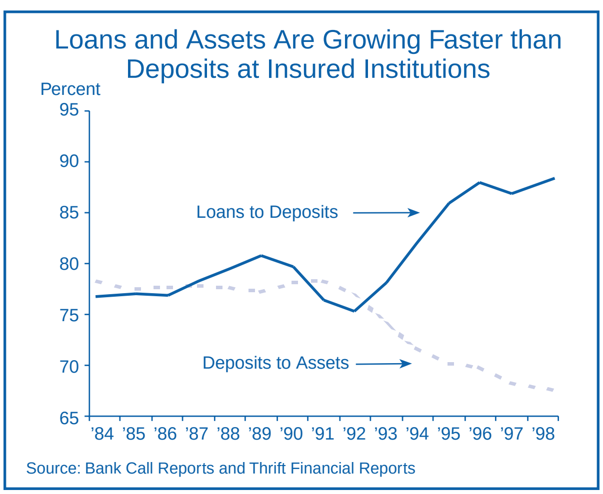
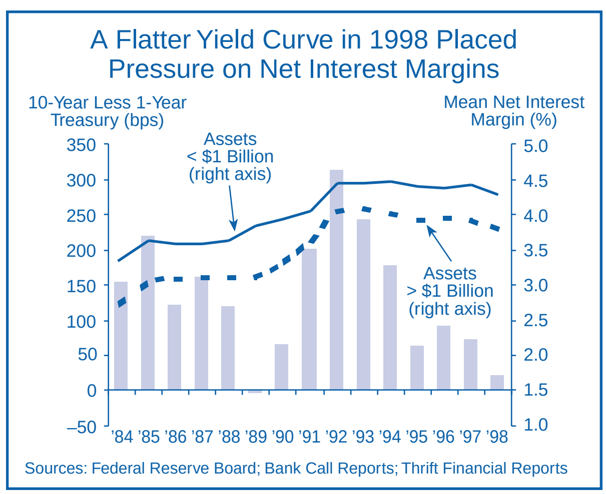


CHART 10



longer-lasting impact involves the shift in borrower preferences toward fixed-rate mortgages. According to ***Freddie Mac,*** approximately 65 percent of adjustable-rate mortgages refinanced in 1998 were replaced with 30-year fixed-rate mortgages. Another 30 percent were refinanced into 15- and 20-year fixed-rate mortgages. As a result of this activity, mortgage lenders may tend to have a higher proportion of assets held in longer-term mortgage loans, leading to further margin pressures should interest rates rise.

As discussed in previous sections, many insured institutions appear to be turning toward higher risk consumer and corporate lending strategies. Such strategic shifts may be at least partially in response to pressures on net interest margins. The search for higher yield spreads may also explain the continuing growth in nondeposit funding sources, which often take the form of complex obligations with embedded options that can reduce funding costs at the expense of additional interest rate risk.

Indicators of Industry Performance

Market Signals for the Banking Industry Are Mixed

Diminished concerns over the near-term economic outlook and reduced financial market volatility resulted in a sharp turnaround in investor attitudes toward banks in the fourth quarter of 1998. During the quarter, the ***SNL Bank Stock Index***[21] rose 21 percent, recovering all of the value it lost during the turmoil of the third quarter. The index has continued to rise in 1999.

Although equity indicators have been generally positive, ratings actions in 1998 for the long-term debt of U.S. banks and finance companies reflect developing problems for certain industry segments. In sharp contrast to the previous six years, when upgrades far exceeded downgrades, ***Moody's*** downgraded as many bank and finance company debt ratings as it upgraded during 1998. In the fourth quarter of 1998, Moody's downgraded the long-term debt ratings of 27 bank and finance companies and upgraded only 15—the highest quarterly ratio of downgrades to upgrades since 1992. Downgrades during 1998 were centered in finance companies specializing in nonportfolio subprime lending and bank holding companies with exposure to emerging markets.

Bank Performance Remains Strong but Earnings Variability Is Increasing

Recent stable industry profitability in the aggregate has masked an increasing range of profit variability for individual commercial banks. Over the past six years, the annual aggregate return on average assets (ROA) for commercial banks has shown little fluctuation, ranging from a low of 1.15 percent in 1994 to a high of 1.24 percent in 1997.[22] However, the variability in commercial bank profitability, as measured by the distribution of the industry's ROA excluding the top and bottom 5 percent, has widened since 1994 (see Chart 11). For example, ROA for the worst 5 percent of the industry was negative 0.29 percent or less in 1998, reflecting a steady decline from 0.2 percent in 1995. Similarly, ROA for the most profitable 5 percent of commercial banks was above 2.16 percent, up from 1.94 percent in 1994.

Reasons for the increasing variability of commercial bank ROA can be further analyzed by segregating institutions along predominant product or business lines. Chart 12 (next page) details the distribution of 1998

[21] This index tracks the market capitalization of approximately 520 banking companies.

[22] *FDIC Quarterly Banking Profile,* Fourth Quarter 1998, www2.fdic.gov/qbp.

CHART 11

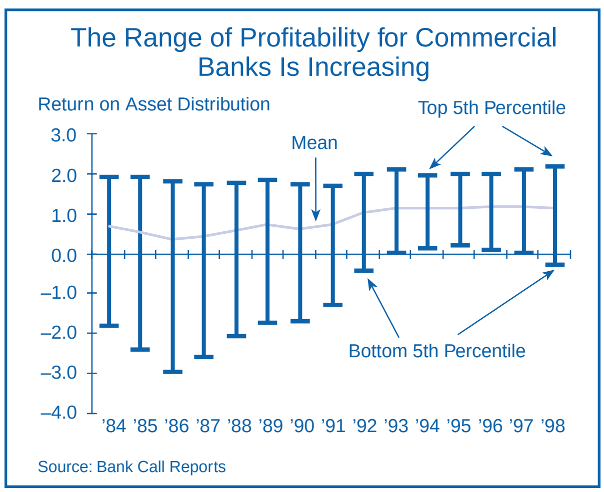
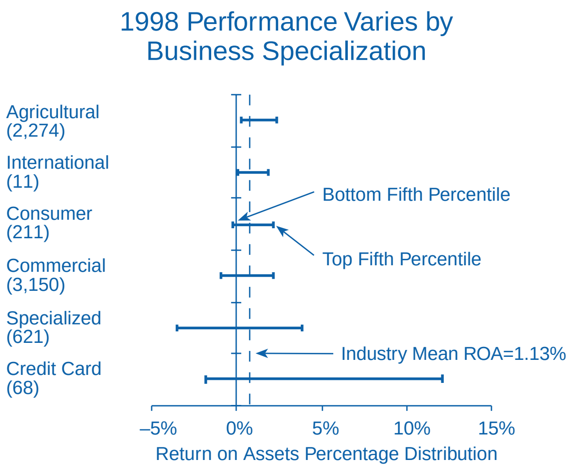


CHART 12



Note: Group institution count is in parentheses.
Source: Bank Call Reports (Research Information System)

ROA for six selected groups of banks segregated by line of business concentrations. This chart reveals that bank performance varies considerably by business specialty. For example, the distribution of ROA of credit card lenders[23] differs significantly from that of other bank groups, including other consumer lenders.[24] Small specialized banks[25] and commercial lenders[26] followed credit card lenders as the groups with the greatest variability in profitability in 1998. Moreover, 75 percent of the least profitable commercial banks were members of small specialized or commercial groups. New banks have also influenced the dispersion of bank ROA. Banks chartered in 1997 and 1998 make up more than 60 percent of the industry's worst performers. However, earnings variability widened in 1998 even when newer institutions are excluded from the analysis.

[23] Banks with at least 50 percent of managed loans in managed credit card receivables and at least 50 percent of managed loans in total managed assets.
[24] Banks with consumer loans and single-family mortgages in excess of 50 percent of assets that do not meet separate credit card or mortgage lending concentration thresholds.
[25] Banks with total assets less than $1 billion, and less than 40 percent of assets held in loans, that do not fall in other business specialties. Members of this group include *de novo* banks and more seasoned banks with low loan activity, such as trust companies.
[26] Banks with 25 percent or more of assets in commercial and commercial real estate loans.

Far fewer commercial banks posted losses in 1998 than during the period from 1984 to 1992. Still, the number of unprofitable institutions appears to be rising despite generally favorable economic conditions. These concerns are mitigated somewhat, since today's worst-performing institutions are generally much better capitalized and are burdened with fewer problem assets than their counterparts during the 1980s.

Summary

Most indicators of U.S. economic health remain robust in spite of the difficulties posed by low commodity prices and falling exports during 1998. The consensus forecast of leading economic analysts calls for continued growth in the U.S. economy for the rest of 1999. At the same time, a number of threats to this favorable outlook exist, including the possibility of higher inflation and higher interest rates stemming from strong economic growth. Other scenarios involve a very different threat—namely, price deflation brought on by global overcapacity and a decline in U.S. exports. Shocks that might arise in the foreign sector or in the financial markets, as experienced during 1998, remain a significant concern during 1999. Consumer spending and business investment seem particularly vulnerable to such shocks at this stage of the expansion.

Favorable economic conditions are reflected in the overall performance of the banking industry. Still, a number of indicators suggest that the risk profile of some insured institutions is increasing. Responding to significant competitive pressures, and perhaps emboldened by the long duration of the current expansion, many institutions are expanding their involvement in higher-risk consumer loan products, such as subprime and high LTV loans and higher-risk leveraged commercial loans. The overall shift toward higher-risk credits is occurring despite signs of financial strain on the part of many consumers (in the form of record personal bankruptcies) and businesses (in the form of declining profits and increasing bond default rates). Credit-related concerns also extend to commercial real estate, where some markets are exhibiting rapid commercial real estate development at the same time that demand indicators are trending downward. Finally, sustained weak commodity prices are placing strains on farmers and could eventually lead to higher agricultural loan delinquencies.

Bank and thrift net interest margins are being pressured by a flatter yield curve and heightened competition. Community institutions, which rely most heavily on interest income, are particularly vulnerable to tighter margins. The major concern in this area is that insured institutions will combat falling margins by entering into riskier funding and lending strategies.

Market indicators and reported financial data reflect favorable industry performance as well as new sources of risk. Investor attitudes toward banking companies have improved since late 1998 because of an improved near-term economic outlook and a reduction in financial market volatility. However, a recent increase in ratings downgrades of bank and finance company long-term debt suggests growing concern over bank exposures to such areas as subprime lending and emerging markets. Despite relatively strong aggregate industry performance, profit variability among individual commercial banks has increased because of new chartering activity and pressures in consumer and commercial lending. As a result, for the first time since 1992, the worst performing 5 percent of all commercial banks were unprofitable last year.

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
Steve Burton, Senior Banking Analyst
Steven E. Cunningham, Chief, Financial Institutions Section
Alan Deaton, Economic Analyst
Diane Ellis, Senior Financial Analyst
Jim Heil, Economic Analyst
Brian Kenner, Financial Analyst
Allen Puwalski, Senior Financial Analyst

Regional Perspectives

- **The New England economy extended its expansion for another year in 1998, with most indicators showing gains from 1997.**

- **Manufacturing employment was the Region's one weak area during 1998, and some deceleration in overall job growth was seen during the first quarter of 1999.**

- **Strong asset quality continues to bolster earnings; however, weaker margins arising from a prolonged refinancing wave are taking a toll on overall profitability.**

- **Institutions affiliated with publicly traded companies are adopting higher risk profiles in response to weaker earnings growth and poor stock price performance.**

Regional Economic and Banking Conditions

Economic Overview of 1998

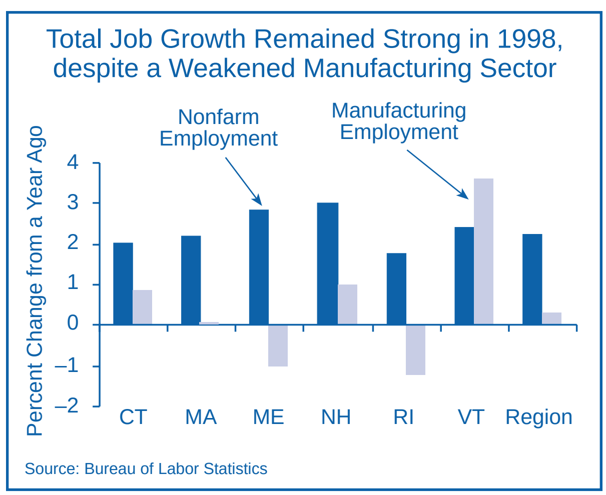
The Boston Region experienced another year of solid expansion in 1998. Manufacturing was the only sector to show some weakness, although many of the Region's states saw a net gain in factory jobs last year. The Region's growth seemed likely to continue at a steady pace in the early months of 1999, as ongoing global weakness was offset by a very strong national economy.

Employment

Nonfarm employment rose by 2.3 percent in the Region during 1998, about the same pace as in 1997. All the New England states contributed to the overall employment advance (see Chart 1). Job growth in **Massachusetts** moderated slightly from the previous year, while **Connecticut** had its sixth straight year of progressively stronger job growth. Both **Maine** and **New Hampshire** had employment gains that exceeded the 2.6 percent national rate during 1998, although New Hampshire was the only state in the Region whose growth in 1998 fell below its trend for this expansion. **Vermont**'s advance was its strongest in three years and was broadly based; **Rhode Island**'s gain was about the same as the previous year. During the first quarter of 1999, job growth decelerated modestly. New England nonfarm payrolls rose by 1.8 percent from a year earlier, with job growth decelerating most in the Region's large states. The pattern of larger percentage gains posted by the northern New England states during 1998 persisted through the first quarter of 1999.

As noted in last quarter's ***Regional Perspectives,*** manufacturing is the economic sector that has been most affected by slackening global demand and a weakened trade picture. Nationally, factory payrolls rose by only 0.3 percent last year, after rising 0.9 percent in 1997. They also decelerated in New England, from a gain of 0.5 percent in 1997 to 0.3 percent in 1998. Only two of the Region's states, Maine and Rhode Island, experienced actual net declines in factory sector payrolls last year. Both have been witnessing a flight of manufacturing jobs for several years as a result of various structural factors, which have been discussed in previous articles. Vermont's strong 3.6 percent surge (about 1,700 factory jobs) came after two years of gains under

CHART 1



2 percent and was spread across several industries. Massachusetts' factory employment was unchanged in 1998. Connecticut's manufacturing sector, after losing jobs steadily between 1987 and 1996, added another year of positive growth: Connecticut factory payrolls rose 0.5 percent in 1997 and 0.9 percent in 1998. Despite the average increase for all of 1998, factory payrolls in the Region declined in the fourth quarter compared with the previous year. This trend was seen in all New England states except Vermont and persisted during the first quarter of 1999.

Unemployment

The labor market tightened further in 1998, as can be expected in a Region where job gains have been outpacing labor force growth for many years. The Region's unemployment rate declined to an average of 3.5 percent last year—its lowest since 1988, just before the last recession. By way of comparison, the national unemployment rate averaged 4.5 percent in 1998, down from 4.9 percent in 1997. The big story in 1998 was the dramatic plunge in Connecticut's unemployment rate, from 5.1 percent in 1997 to well under 4 percent last year. This drop put the state's unemployment rate below the national average for the first time since 1995. Maine's unemployment rate also dropped below the national average, from 5.4 percent in 1997 to 4.4 percent last year. Rhode Island was the only state in the Region with an average unemployment rate above the nation's in 1998—a condition that has existed in that state for eight of the past ten years.

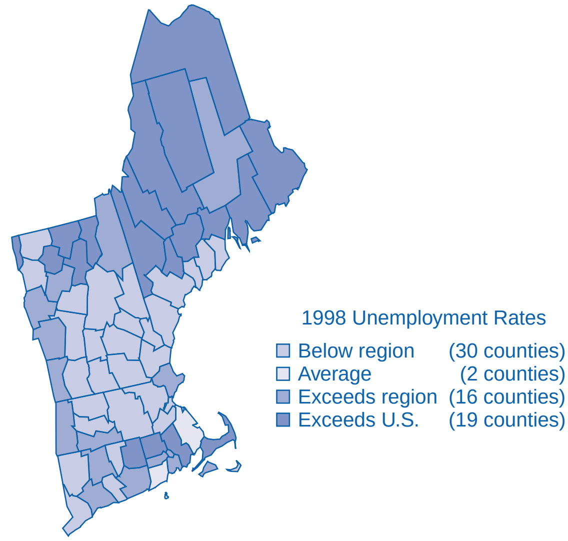
Unemployment fell steadily during 1998 for all the Region's states, and year-end unemployment rates were far below those recorded in January and the annual averages reported above. This trend persisted in the early months of 1999; by March, seasonally adjusted state unemployment rates in the Region had fallen to between 2.8 and 3.1 percent, except for Maine, where the rate was 3.4 percent. Map 1 shows that despite the overall tightness in the labor market, some areas of higher unemployment remain. They are clustered in rural areas or those with large concentrations of basic manufacturing industries (such as Bristol County, Massachusetts) and reflect persistent economic difficulties (as in Vermont's Northeast Kingdom and rural Maine) in addition to cyclical factors.

Income

At the time of this writing, personal income information was available for only the first three quarters of 1998. Based on that information and state population estimates by the ***New England Economic Project,*** the Region's income per capita rose 4.5 percent from the same period in 1997. If this rate persisted during the fourth quarter, then income will have grown in 1998 by its slowest pace in four years. Income growth eased in all of the Region's states except Vermont, where a 4.5 percent advance handily exceeded the previous year's 3.8 percent gain in per capita income. The acceleration in Vermont's per capita income was consistent with the state's strength in nonfarm employment during 1998. Despite the apparent slowing of income growth last year, the Region's advance still outpaced the national average of 4.2 percent. This made 1998 the fifth straight year in which the Region either matched or exceeded the national pace.

MAP 1

Some Pockets of Higher Unemployment Persist in the Region



Source: Bureau of Labor Statistics

Existing Home Sales and Prices

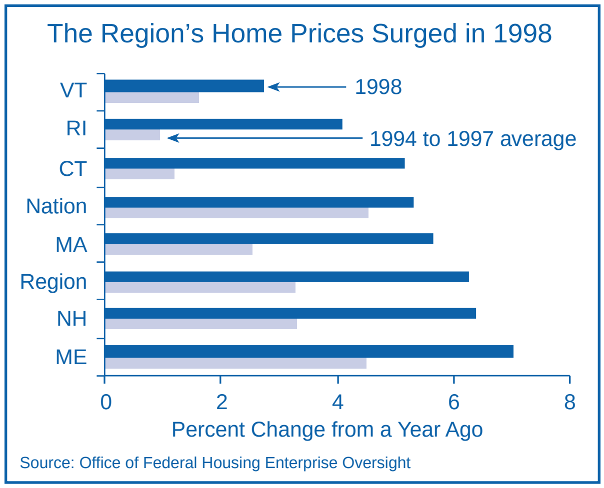
The recent history of existing home sales in New England is spotty because of missing data for some states in some years. However, data on home sales in 1998 were available for all states (for the first time in four years). Home sales last year, as reported by the ***National Association of Realtors,*** tallied 230,000 across the Region, up from 170,000 in 1994—a compound annual average growth rate of 8 percent per year, versus a national pace of 5 percent (see Table 1, next page). Nationally, sales volume increased at a record pace in 1998, advancing 14 percent from 1997. Only two states in this Region exceeded that pace: Sales shot up 16 percent in Maine

Table 1

Existing Home Sales Posted Solid Gains in 1998		
	Percentage Change	
	1997–1998	1994–1998*
Nation	14	5
Region	N/A	8
Connecticut	10	5
Maine	16	7
Massachusetts	6	10
New Hampshire	N/A	14
Rhode Island	15	9
Vermont	4	–6

* Compound annual rate
Source: National Association of Realtors

Chart 2



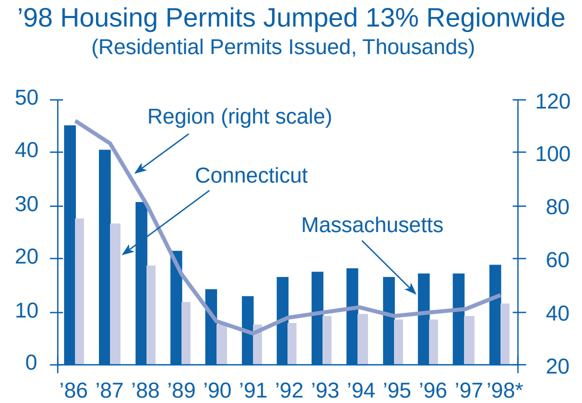
and 15 percent in Rhode Island last year. Favorable interest rates, continued job and income growth, a strong stock market and rising household wealth, and affordable pricing contributed to the home sales increases for these states and for the Region as a whole. Home sales rose by 6 percent last year in Massachusetts and by 10 percent in Connecticut. (Limited inventory in some areas of Massachusetts likely restrained growth in its home sales last year.) Sales increased 4 percent in Vermont, after falling for four consecutive years. Also, second and vacation home sales likely benefited from buoyant consumer confidence and the strong stock market. Although data for the intervening years are incomplete, home sales in New Hampshire rose at an average annual pace of 14 percent between 1994 and 1998, the strongest increase in the Region and far outpacing the national trend.

Limited inventory (primarily in very active markets, such as Boston) coupled with strong demand caused average home prices to rise 6 percent last year across the Region, compared with a national increase of 5 percent. The home price index produced by the ***Office of Federal Housing Enterprise Oversight*** offers a fairly good measure of true home price appreciation. After nine years of lagging the national pace, New England home prices rose at a faster pace than the nation's for the first time since 1988. The price growth gap was a far cry from the heady 1980s, however, when New England home prices were rising between 18 and 22 percent per year, compared with a national pace of 5 to 9 percent. Chart 2 shows the changes in price for the nation, Region, and six states during 1998 and the average pace for the previous four years. Clearly, the pace of price gains last year broke away from the trend for this expansion. The most dramatic acceleration in appreciation rates during 1998 occurred in Rhode Island and Connecticut. These states have lagged the rest of the Region during this expansion, and their housing markets have remained affordable throughout the current expansion. In Connecticut, the strength in home prices and sales may have been a major impetus behind a surge in new residential building permits.

Residential Building Permits

Strong demand for homes inspired developers to take out more permits in 1998. Across the Region, residential building permit issuance rose by 13 percent, compared with a gain of 11 percent for the nation. Last year's gain was the strongest since 1992, the first year of the expansion. Nevertheless, permit volume was only 40 percent of the 1986 volume, when residential construction activity last peaked in the Region. Each of the New England states saw an increase in permit issuance last year. The weakest gains were in Rhode Island, where permits increased by only 2 percent after two years of somewhat sturdier advances, and in New Hampshire, where permits increased by 4 percent after 10 to 11 percent gains in the previous two years. The pace of 1998 advances was quite disparate in the Region's largest markets. Massachusetts builders took out 9 percent more permits in 1998 than in 1997, while in Connecticut, permit issuance surged by 23 percent, setting a record for this decade (see Chart 3). Still, the volume of permits issued for each state was less than half the peak volume of the mid-1980s. Maine's permit issuance jumped 25 percent (the state's largest one-year gain during the 1990s), and Vermont permit issuance climbed 19 percent (after three years of declining volume).

CHART 3



* Preliminary
Source: U.S. Bureau of the Census

Banking Overview of 1998

Profits Continue to Be Supported by Strong Asset Quality

The Boston Region's insured institutions reported another strong year in 1998, posting an aggregate return on assets (ROA) of 1.27 percent. This measure of profitability remained well above the national average (1.16 percent) and, on a merger-adjusted basis, was in line with the year-earlier period (1.29 percent). Earnings continue to benefit from strong asset quality. The ratio of past-due loans to total loans has reached a historical low of 1.80 percent for the Region's insured institutions, 1.70 percent if credit card institutions are excluded. Restructured loans and other real estate owned have also retreated to levels not seen since the mid-1980s.

Aggregate loan losses remain subdued, and consumer loan losses remain elevated but stable. The only other sector exhibiting credit quality weakness in 1998 was commercial and industrial (C&I) loans. Net charge-offs rose 20 basis points, to 0.45 percent of average C&I loans. The increase was not followed by a commensurate increase in C&I delinquencies and was limited to the larger institutions in the Region, suggesting that the losses resulted from exposures to sectors hurt by weak international and capital markets in the second half of the year. Many of those losses were well publicized and included several finance companies involved in subprime consumer lending. For institutions with limited exposure beyond the Region, C&I losses remained low.

Asset Growth Continues to Outstrip That of Core Deposits

Core deposit growth remains lackluster for the Region's insured institutions, up 3.5 percent on a merger-adjusted basis in 1998, compared with an increase of 5.2 percent for the nation as a whole. The Region's larger institutions (assets greater than $1 billion) are lagging smaller institutions; however, their core deposit growth rate (1.3 percent) is dampened somewhat by branch sales. Bank efforts to drive away unprofitable accounts may also be contributing to the lower rate of core deposit growth.

While the aggregate core deposit growth rate in 1998 was the highest since the mid-1980s, it is well below the rate of asset expansion (10.4 percent) and remains a long-term concern. As a result, the trend of increased reliance on noncore funding continues. Noncore funding grew 22 percent in 1998, following a 19 percent growth rate the prior year. Core deposits now support just 52 percent of the Region's total assets, falling from a high of 71 percent of assets at year-end 1992. Clearly, the inability to grow core deposits has long-term liquidity implications. This factor is weighing heavily on net interest margins, as incremental asset growth is being supported largely by funds that are effectively priced at national market rates of interest. This trend will continue to hamper the industry's ability to manage margins.

Pace of Consolidation Remains Steady

Merger and acquisition (M&A) activity remained steady in the Region. During 1998, the number of insured institutions declined by 18, to 434. The attrition rate has approximated 4 percent for the past four years, with the exception of 1997, when a large number of reorganizations resulting from the implementation of interstate branching pushed the level to 6 percent. M&A activity in early 1999 appeared to be tracking with recent experience; however, the recently announced acquisition of BankBoston by Fleet would dwarf previous merger activity in the Region on the basis of sheer size. If approved, the merger will affect the competitive landscape profoundly by bringing together the two largest competitors in the Region. Smaller institutions have demonstrated an ability to compete effectively with larger institutions in the past, and the planned branch divestitures and reorganization of the combined companies will create additional opportunities for other institutions, both existing and new. The concentration of market share will demand strong management to compete with the combined entity.

Five de novo institutions began operations in 1998, the highest level of new bank activity in the Region since 1991. Four of them are headquartered in Connecticut, which produced nearly half of the Region's new banks between 1984 and 1989 (39 charters) but had only five new bank formations between 1990 and 1997. Bank chartering activity generally rises in sync with local economic conditions, and the recent activity in Connecticut reflects the improvement and growing confidence in the state's economy. Overall activity in the Region, however, remains subdued compared with the pace of the late 1980s. In the five years ending in 1989, 75 institutions opened for business, including 24 in 1987 alone. The pace of chartering activity in the Region today appears to reflect a more realistic assessment of the prospects for economic growth than was the case in the 1980s.

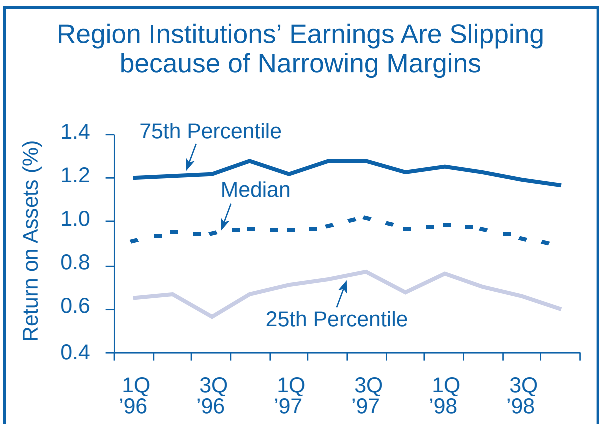
Insured Institutions Are Taking on More Risk as Narrowing Margins Squeeze Earnings

Aggregate Data Are Masking a Weakening Earnings Posture

In 1998, aggregate ROA at both the national and regional levels fell only 2 basis points from the year-earlier period; however, strong performance by credit card banks, primarily the result of a surge in noninterest income, effectively masked weakening earnings for the industry. The 1998 aggregate results were also bolstered by a greater reliance on securities gains. Excluding these two factors, the ratio of net operating income to average assets fell 5 basis points for the Region and 9 basis points for the nation, to 1.13 percent and 1.02 percent, respectively. The weakening earnings posture results primarily from increased loan loss provisions at larger institutions and a weaker net interest margin that is affecting a wide range of institutions. Chart 4 sets forth the quarterly trend in the median ROA for the Region's insured institutions as well as the level of performance for both the 25th and 75th percentiles. As the chart shows, the earnings engine appears to be losing some steam.

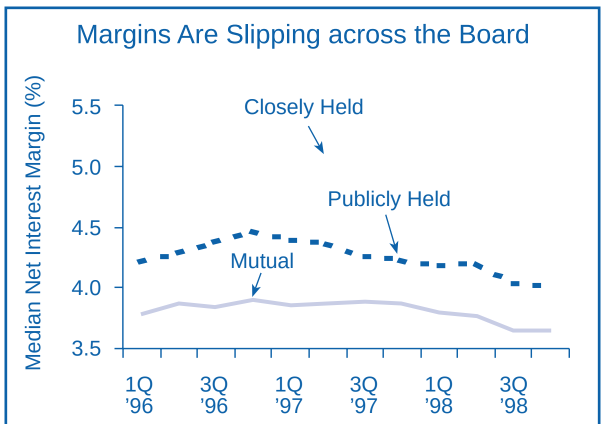
Net interest margins (NIM) have come under pressure as a result of the general flattening of the yield curve that began following the last Fed tightening in March 1997. Chart 5 shows the trend in the median NIM for the Region's insured institutions on the basis of ownership structure. Publicly traded banks and thrifts, as well as subsidiaries of publicly traded holding companies (public companies), had the sharpest decline in NIM in recent quarters. Publicly held institutions saw a 47-basis-point drop in median NIM, while closely held banks saw their median NIM fall 43 basis points. The median NIM fell only 25 basis points for mutually owned institutions (mutuals). The severity of the declines for the publicly held and closely held institutions relative to mutuals can be attributed largely to the

CHART 4



Source: Bank and Thrift Call Reports

CHART 5



Source: Bank and Thrift Call Reports

types of institutions in these categories. Table 2 breaks down the Region's insured institutions by ownership structure and groups them on the basis of asset composition. As the table shows, stock-owned institutions have higher concentrations of commercial lending specialists and a lower level of residential lending specialists.

The elevated refinancing activity of the past 18 months appears to have been felt more acutely by institutions with higher concentrations of commercial and commercial real estate loans (commercial structures). These types of loans were not as actively refinanced as residential loans during the refinancing waves of the early 1990s because short-term rates remained well below long-term rates and there was no advantage to locking in a longer-term rate. During the latter half of 1998, however, a significant flattening of the yield curve created an extremely attractive opportunity for customers with floating-rate commercial structures, particularly those based on the prime rate, to lock in lower fixed rates. This shift of the yield curve also took place at a time when competition for commercial structures was intensifying. The end result was that asset yields fell more rapidly than the cost of funds.

Ownership Structure Drives Strategies to Cope with Margin Squeeze

The compression in margin is particularly problematic for public companies that are pressured by shareholders to maintain high returns on equity and earnings-per-share growth. Returns on equity are falling, and revenue growth is slowing because of declining net interest margins. Through 1997, institutions were able to bolster earnings through improved asset quality (low loan loss provisions and higher levels of earning assets) and cost containment, while they expanded noninterest income sources. Noninterest revenues continue to rise, but the incremental gains related to asset quality improvement and cost savings are diminishing. In fact, 1998 was the first year since 1991 that the provision for loan losses for the Region's insured institutions actually exceeded the level of net charge-offs. Not surprisingly, bank and thrift stocks did not perform well in 1998. The ***SNL Securities Bank Index*** for all publicly traded banks rose 5.9 percent in 1998, compared with a 26.7 percent rise in the S&P 500. SNL's asset size indices for all asset size categories below $10 billion actually fell an average of 5.0 percent. Publicly traded thrifts performed even more

Table 2

Mutually Owned Institutions Are Highly Concentrated in Low-Risk Residential Lending

Group	Publicly Held	Share of Total %	Closely Held	Share of Total %	Mutually Owned	Share of Total %	Total	Share of Total %
International	2	2	—	—	—	—	2	0
Agriculture	—	—	1	1	—	—	1	0
Credit Card	3	3	—	—	—	—	3	1
Commercial	47	42	40	48	22	9	109	25
Residential	33	29	10	12	154	65	197	45
Consumer	3	3	4	5	9	4	16	4
Small Specialist	6	5	8	10	10	4	24	6
Other > $1B	10	9			1	0	31	7
Other < $1B7	8	7	20	24	43	18	51	12
Total	112	100	83	100	239	100	434	100

Institutions are grouped in the order presented below. When an institution first meets the definition of a grouping, it is not tested further to meet subsequent grouping definitions.
International—Assets greater than $10 billion and foreign assets greater than 25 percent of assets.
Agriculture—Agriculture loans greater than or equal to 25 percent of total loans.
Credit Card—Total managed loans greater than 50 percent of managed assets and managed credit card loans greater than 50 percent of total managed loans.
Commercial—The sum of commercial and industrial, multifamily, and commercial real estate loans is greater than 25 percent of assets.
Residential—The sum of 1- to 4-family loans and mortgage-backed securities is greater than 50 percent of assets.
Consumer—The sum of 1- to 4-family loans and consumer loans is greater than 50 percent of assets.
Small Specialist—Assets less than $1 billion and total loans are less than 40 percent of assets.
Other > $1B—Assets greater than $1 billion and no other criteria met.
Other < $1B—Assets less than $1 billion and no other criteria met.
Source: Bank and Thrift Call Reports

poorly, as indicated by the ***SNL Thrift Index,*** which registered a 13.3 percent decline for the year. Similar equity price performance persisted in early 1999.

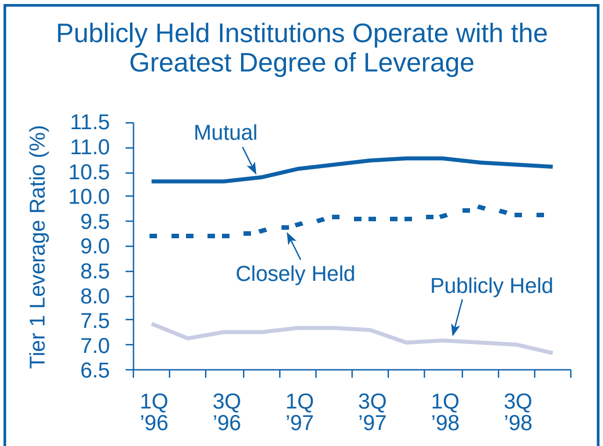
In addition to pressure from shareholders to improve the market value of the firm, executive compensation has become tied increasingly to the creation of shareholder wealth. Share price appreciation is a large consideration when year-end bonuses are calculated, and stock options in many instances can represent the lion's share of total executive compensation. Furthermore, it appears that the internal and external pressures related to building shareholder value are resulting in an increasingly higher risk profile for public companies in the Region compared with closely held and mutually owned institutions.

The most obvious difference in the risk profile of public entities is the degree of leverage employed in these companies. As Chart 6 shows, the aggregate Tier 1 leverage ratio for these companies has hovered in the 7 percent range, falling to 6.86 percent in fourth quarter 1998, well below the levels maintained by nonpublic institutions. Although these levels of capital are higher than the 5 to 6 percent levels seen in the mid- to late 1980s, certain regulatory changes that have become effective since then support the case that higher capital levels should be maintained.

The prompt corrective action rules that arose from the enactment of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) can result in the appointment of a receiver for insured institutions that become "critically undercapitalized" (tangible equity-to-asset ratio less than 2 percent). Before FDICIA, an institution typically had to be insolvent before such action could be taken. A second, and perhaps more significant, change is the elimination of a large portion of the benefits derived from tax loss carrybacks. Before 1994, banks were allowed to carry back losses from bad debts for ten years and recapture taxes paid in those periods. The carryback period has been reduced to just two years. Paid taxes used to represent a significant source of "hidden capital" that insured institutions could draw upon to offset losses. The reduction in the carryback provision has reduced this capital cushion; in a worst-case scenario, the loss of this hidden capital must ultimately be absorbed by the deposit insurance funds. Recent tax changes allowing certain institutions to become Subchapter S Corporations (S Corps) have had a similar effect, although losses in these institutions will flow straight through to capital without the benefit of any tax cushion. This is not a major issue within the Region, as only three institutions had converted to S Corp status as of December 1998. This is a larger issue nationally, as approximately 10 percent of all insured institutions are now S Corps.

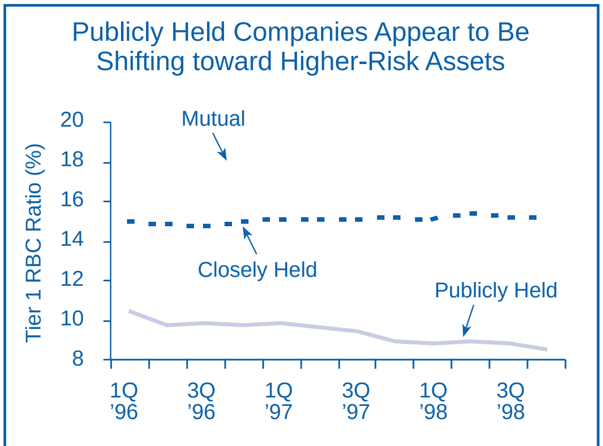
Chart 7 shows the recent trend in the Tier 1 risk-based capital (RBC) ratio for each of the three ownership forms. The difference between public companies and the other ownership forms is significantly larger than that in the Tier 1 leverage ratio, suggesting that these institutions maintain a higher-risk asset mix than closely held banks and mutuals. Additionally, while the Tier 1 leverage ratio has hovered around 7 percent for the public companies, the Tier 1 RBC ratio has fallen approximately 200 basis points, indicating that the asset mix of these institutions is steadily taking on a higher risk profile.

CHART 6



Source: Bank and Thrift Call Reports, Merger Adjusted

CHART 7



Source: Bank and Thrift Call Reports, Merger Adjusted

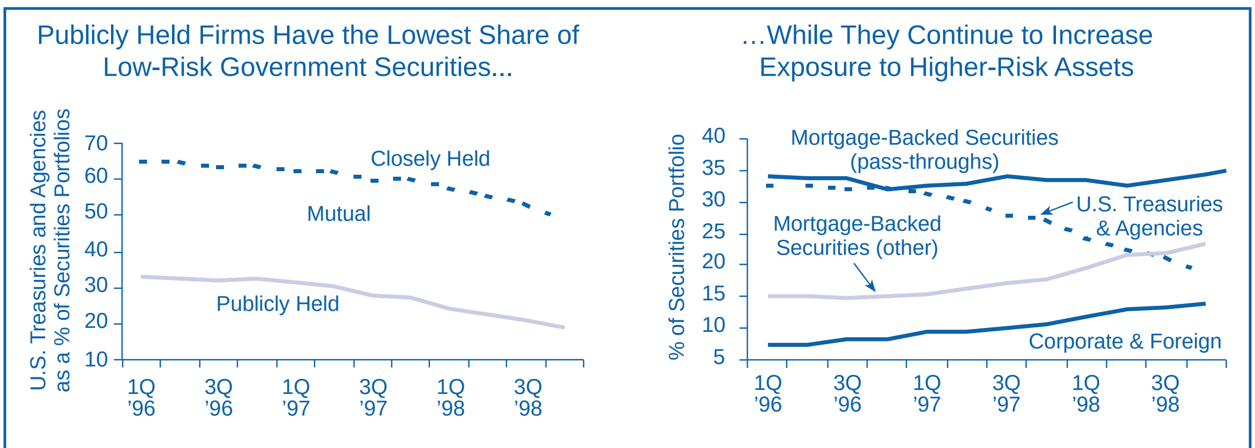
Chart 8 shows the changes in the securities portfolios of public companies over the past 12 quarters. There has been a clear shift of funds away from U.S. government and agency securities into corporate and foreign investments and mortgage derivatives. The shift in portfolio mix has prevented a steeper decline in margins but has introduced greater risk, in both credit and interest rate, to the balance sheet. There has also been a steady shift in the loan portfolio, away from real estate loans (primarily residential) and into the C&I and consumer sectors, both of which have been growing rapidly over the past two years. The combination of high operating leverage and strong growth in C&I loans is leading to a significant concentration in that sector relative to Tier 1 capital (see Chart 9).

Summary

It is clear that a greater level of risk is embedded in the balance sheets of publicly owned insured institutions. That risk is increasing, owing in part to efforts to mitigate earnings weakness as institutions strive to meet the profit expectations of shareholders. The pressure for profit growth will remain, particularly if bank and thrift stocks continue to languish in comparison with other stock groups. Management's challenge will be to respond to the pressure in a prudent manner without compromising safety and soundness.

Boston Region Staff

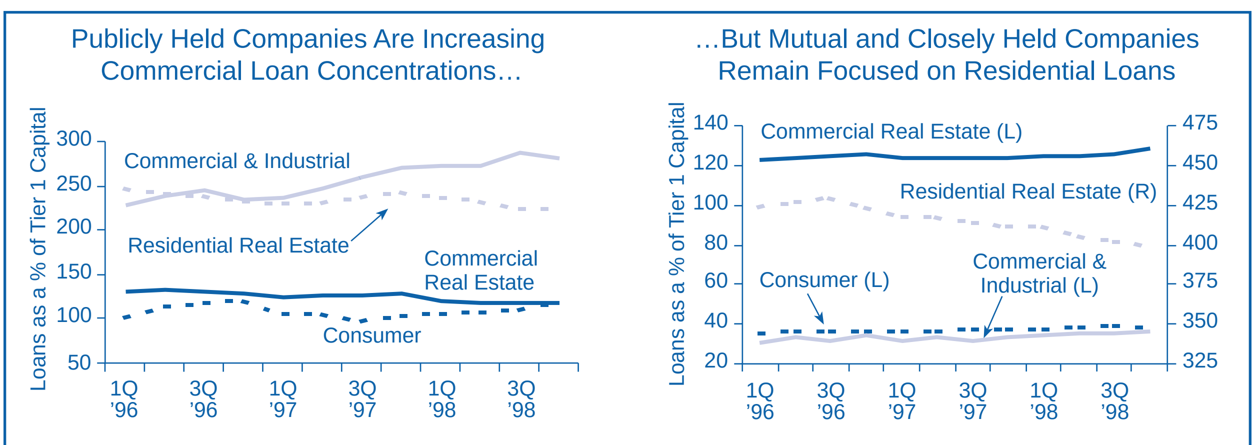
CHART 8



Source: Bank and Thrift Call Reports, Merger Adjusted

Source: Bank and Thrift Call Reports, Merger Adjusted (Publicly Held Only)

CHART 9



Source: Bank and Thrift Call Reports, Merger Adjusted (Publicly Held)

Source: Bank and Thrift Call Reports, Merger Adjusted (Closely Held and Mutuals)

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