Regional Outlook

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FDIC
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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

◆ ***Economic and Banking Conditions***—**The Boston Region had a more marked deceleration in job growth than the nation did during the first eight months of 1999; manufacturing continued to shed jobs at a faster pace than the nation…Insured institutions performed well, but some measures of credit quality and profitability showed a modest decline.** ***See page 18.***

◆ ***Commercial Real Estate Trends***—**Commercial real estate office markets remained healthy in the Region with declining vacancy rates, while retail and industrial markets showed mixed results during the first half of 1999…Total construction starts fell in the Region, weighed down by declining office starts. Retail and industrial markets experienced increased activity.** ***See page 21.***

◆ ***Commercial and Small-Business Lending***—**Commercial lending has increased in the Region, but this could reflect greater loan demand more than an easing in underwriting standards or pricing…Small-business lending is growing faster than in previous years at the Region's small institutions. The Region's large institutions are increasingly using credit scoring.** ***See page 23.***

By the Boston Region Staff

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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.

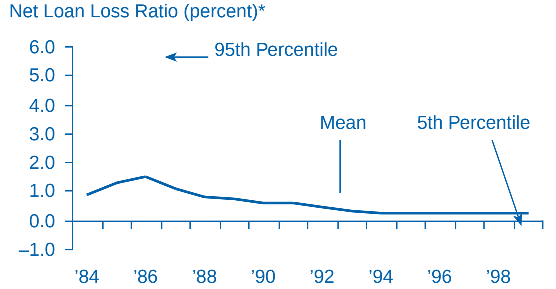
Indicators of Industry Performance

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



* For institutions with at least 10 percent of assets invested in loans.
Source: FDIC Bank and Thrift Call Reports (Research Information System)

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.

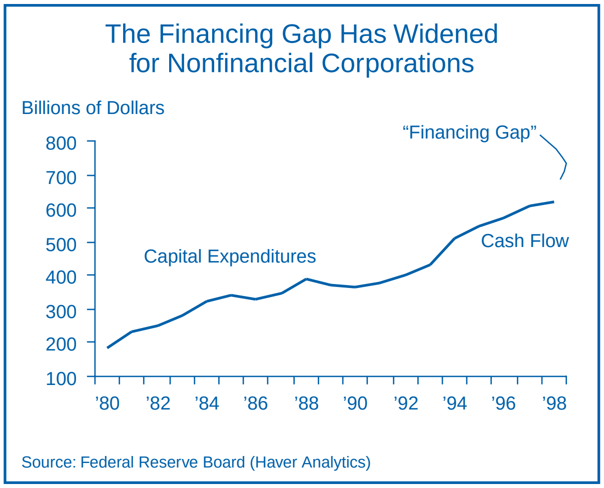
As a result, corporations must finance an increasing portion of investment spending by issuing either net new equity or net new debt. In recent years, firms have overwhelmingly chosen debt financing. Net issuance of corporate debt was $219 billion in 1998, while corporations repurchased equity shares 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.

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]

CHART 2



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]

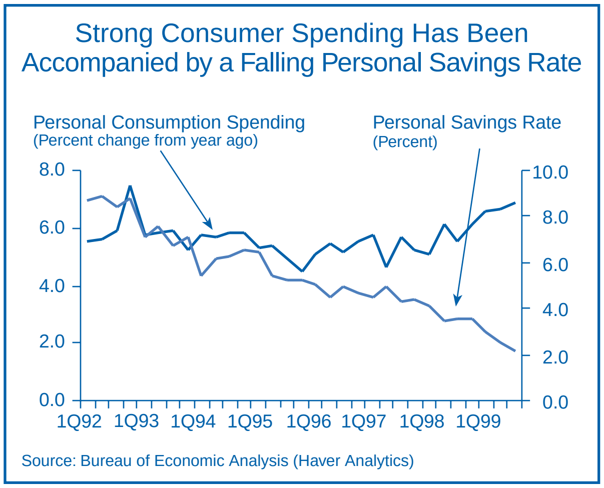
Analysts cannot fully explain the reasons for the falling savings rate, although the "wealth effect" associated with the accumulation of capital gains by households is believed to be a significant factor. Since 1995, the total value of equities, mutual funds, and pension funds owned by households has 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-

[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



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

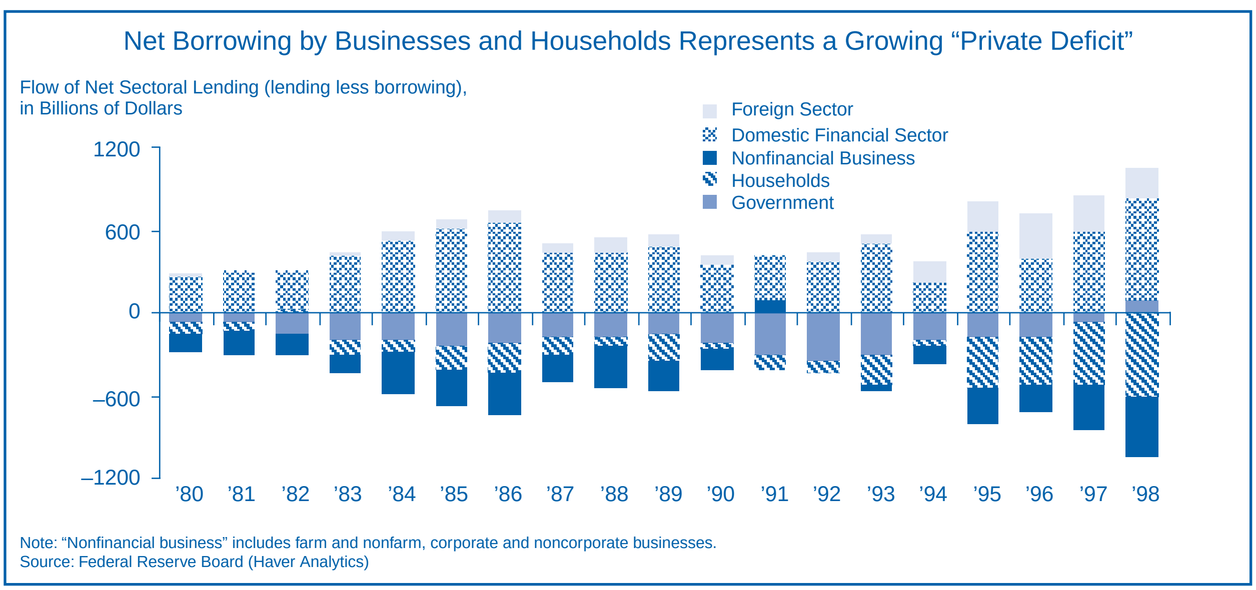
Taken together, the sum of annual net borrowing by businesses and households has been referred to as the "private deficit." During the late 1990s, as the combined budget of federal, state, and local governments moved from deficit to surplus, the private deficit rose sharply; between 1996 and 1998, it 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



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.

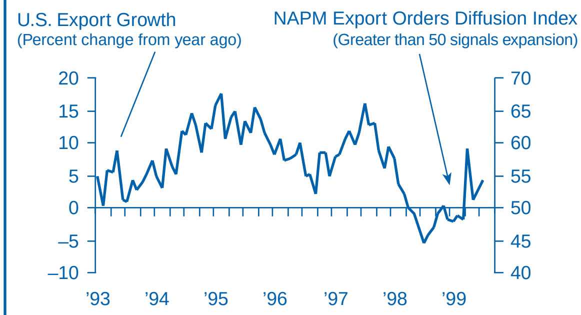
A global economic recovery during the first three quarters of 1999 has led to higher demand for investment capital outside the United States. The ***International Monetary Fund*** estimates that growth in the global economy will increase from 2.5 percent in 1998 to 3.0 percent in 1999 and 3.5 percent 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 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.

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)

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.

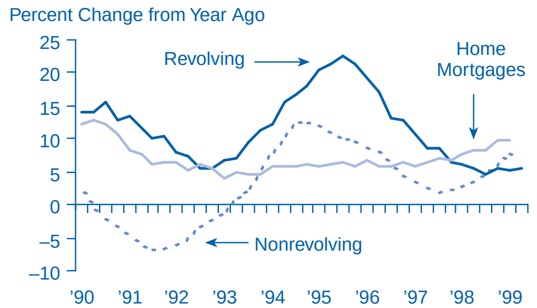
Consumer Lending

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.

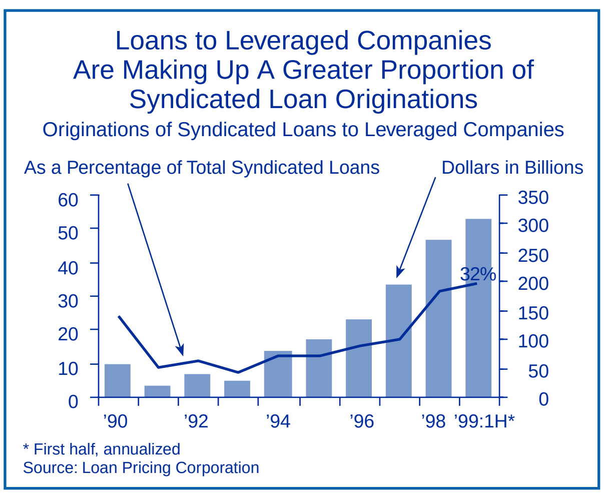
Factors driving growth in leveraged lending include a high volume of corporate mergers and acquisitions, increasing investor demand for higher-yielding loans, and a shift in preference for loans over bonds by high-yield issuers.[25] While bank syndicators pass a large volume of these loans along to nonbank 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.

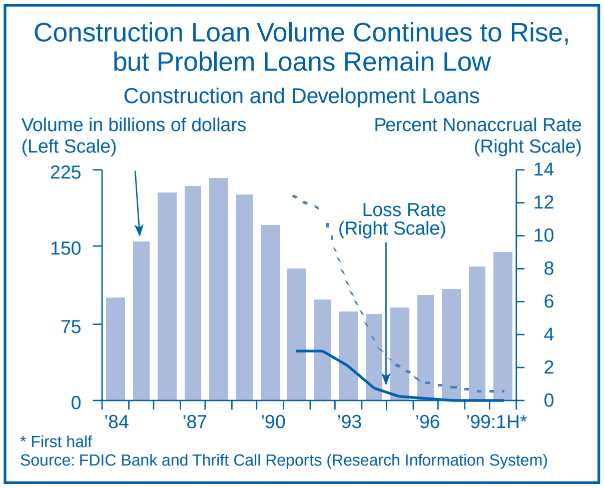
Office Vacancy Rates Are Rising in Many Top Markets

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



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.

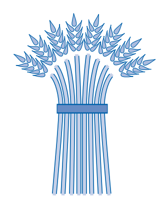
The FDIC also recently published the findings of a targeted evaluation of the underwriting practices of banks operating in three of the fastest-growing metropolitan areas in the country—Atlanta, Dallas, and Las Vegas.[29] Results indicated that competition was generally driving pricing margins down to 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.

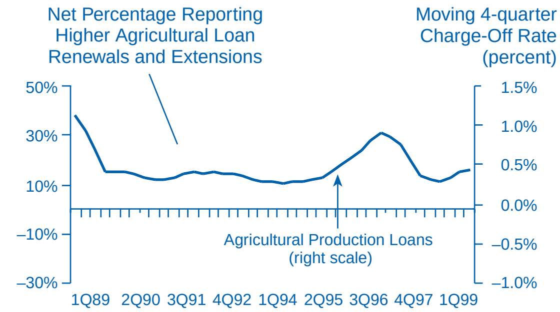
[32] Farm banks are defined by the FDIC as those with over 25 percent of their loans in agricultural production or secured by agricultural real estate.

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.

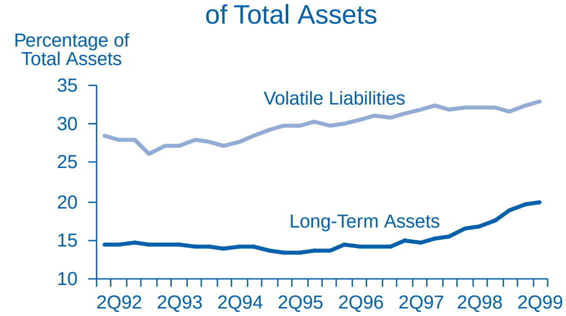
Banks and Thrifts Appear Increasingly Vulnerable to Rising Interest Rates

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

Long-Term Assets and Volatile Liabilities Have Been Growing as a Percentage of Total Assets



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.

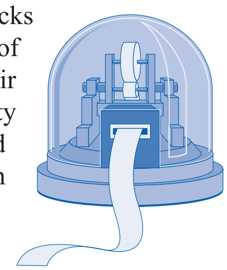
Implications

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.

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Regional Perspectives

- **The Boston Region had a more marked deceleration in job growth than the nation did during the first eight months of 1999; manufacturing continued to shed jobs at a faster pace than the nation.**

- **Insured institutions performed well, but some measures of credit quality and profitability showed a modest decline.**

- **Commercial real estate office markets remained healthy in the Region with declining vacancy rates, while retail and industrial markets showed mixed results during the first half of 1999.**

- **Commercial lending has increased in the Region, but this could reflect greater loan demand more than an easing in underwriting standards or pricing.**

Economic and Banking Conditions

Job Growth Slowed and Unemployment Rates Declined through August

The Boston Region's average, year-to-date nonfarm payroll growth slowed to 1.6 percent by August compared with 2.3 percent for the nation.[1] All of the New England states experienced slower job growth in 1999, although **Maine's** deceleration was modest. In keeping with the 1998 trend, job growth was stronger in the northern three states than in **Connecticut, Massachusetts,** and **Rhode Island**. Across sectors, only manufacturing payrolls declined during the first eight months, off 2.3 percent in New England versus a drop of 1.9 percent nationally.

The Region's trade and government sectors posted gains on par with their 1998 rates, while growth in all other sectors deteriorated during the first eight months of 1999. Job growth also trailed the nation in all sectors, except construction, where the New England states generally saw gains that exceeded the nation. Construction employment was pushed higher by a spurt in new home building during 1998 that continued at a slower pace into 1999, as well as by strong commercial construction activity in certain metropolitan markets. Connecticut, while posting increases, has fallen short of the national pace in construction employment gains. Anecdotal reports attribute this slower gain to difficulties in finding sufficient numbers of qualified tradesmen and laborers among the state's unemployed rather than to a lack of demand.

Labor markets remain tight, with unemployment rates in some substate markets falling below 2 percent. As is evident in Table 1, **New Hampshire** experienced the Region's lowest average unemployment rate[2] during the first eight months of 1999. In contrast, Maine and Rhode Island reported the Region's highest unemployment rates, but even these rates were considerably

Table 1

Region's Labor Markets Continue to Tighten (Unemployment Rates)		
	1998	1999*
Massachusetts	3.3	3.0
Connecticut	3.4	3.0
New Hampshire	2.9	2.6
Maine	4.4	3.7
Rhode Island	4.9	3.7
Vermont	3.4	2.9
Region	3.5	3.1
Nation	4.5	4.2

* Jan-Aug average, annual rate
Source: Bureau of Labor Statistics

[1] January through August average employment, percent change from year ago.

[2] The 1999 rates in Table 1 are January to August 1999 averages divided by the same months in 1998, then multiplied by 1998 full-year unemployment rates to calculate an annualized figure.

below the national average. Analysts have suggested that the Region's tight labor market, mostly attributed to modest population growth that remains at less than half the national rate, has resulted in an employment growth rate that has lagged the nation's since the late 1980s. This gap in employment growth widened in 1999 to its highest level in more than four years. Tight labor markets are likely to constrain the Region's job growth for the remainder of the current economic expansion.

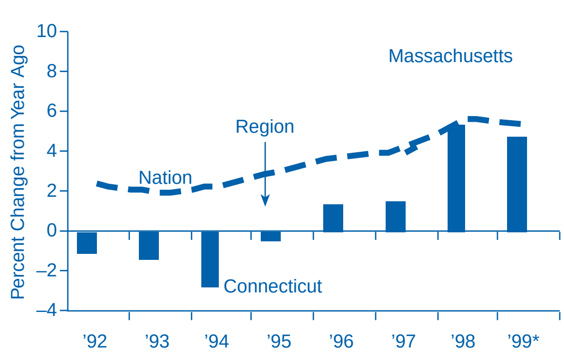
Home Prices Were Rising, but Sales and Building Slowed

Chart 1 shows the trend of appreciation in home sales prices for the nation, Region, and the Region's most populous states. The rise in home sales prices during 1998 outpaced the nation for the first time since 1987. The Region experienced an average price increase of 6.5 percent in 1998 and a 7.5 percent advance during the first half of 1999, compared with year-ago gains of 5.5 and 5.2 percent, respectively, for the nation.[3] Massachusetts, continuing the trend begun in 1995, posted the Region's strongest price appreciation during first-half 1999, as prices rose at a nearly 9 percent annual rate. Connecticut, while not the slowest in the Region (that position was shared by **Vermont** and Rhode Island), saw much more modest appreciation of 4.7 percent.

[3] Annual home price appreciation ranged between 18 and 22 percent in the Region from 1984 to 1987, compared with gains of 3 to 9 percent nationally. Thus, the current gap above national appreciation rates of roughly 2 percentage points is historically modest.

CHART 1

Region Again Outpacing Nation in Price Gains



* January–June, annual rate
Source: Office of Federal Housing Enterprise Oversight

New England existing home sales, as reported through the ***National Association of Realtors*** Multiple Listing Service, rose at a 6 percent annual rate during the first half of 1999, roughly matching the national rate, but down from a 13 percent increase in 1998. This slowing was anecdotally attributed to a general lack of suitable inventory in certain price ranges, particularly in high-demand housing markets, such as those around greater **Boston.** Maine and Rhode Island were the only two states in the Region where 1999 home sales growth accelerated from 1998; both states experienced annual growth around 20 percent during the first six months of 1999. Vermont, which posted an increase in 1998 after three years of decline, saw sales fall during first-half 1999. Growth in Massachusetts slipped from 10 percent during the past two years to about 1 percent during the first six months of 1999, as housing inventory thinned in the greater Boston area. Connecticut's advance cooled from 14 percent in 1998 to 5 percent during first-half 1999, and, after three years of double-digit gains, New Hampshire's growth slowed to 7 percent through June 1999.

Home building activity through May was described in depth in ***Regional Perspectives,*** Third Quarter 1999. With data available through July, the overall deceleration in building noted in last quarter's article remained the same, although state trends were significantly different in many cases (see Table 2). Nationally, building also decelerated compared with last year.

TABLE 2

RESIDENTIAL PERMIT ISSUANCE SURGED IN 1998...1999 POSTING GENERALLY SLOWER GROWTH (PERCENT CHANGE FROM YEAR AGO)

	JAN–JULY 1999	1998	1991–1997*
NATION	6.1	11.9	7.2
REGION	1.9	16.8	4.4
MASSACHUSETTS	5.5	12.0	5.2
CONNECTICUT	–12.7	27.4	3.7
MAINE	3.8	33.4	4.0
NEW HAMPSHIRE	8.5	6.8	7.6
RHODE ISLAND	11.8	–1.1	2.0
VERMONT	26.0	20.0	–1.6

* COMPOUND ANNUAL RATE
SOURCE: U.S. BUREAU OF THE CENSUS

Insured Institutions Continued to Perform Well, but Show Some Signs of Weakening

The Boston Region's insured institutions[4] continued to perform well through June 1999, but several key indicators showed signs of deterioration. Asset quality remained favorable, with total past-due loans at 1.57 percent, a slight increase from a year ago. Net charge-offs are still low but increased slightly between the end of second-quarter 1998 and June 30, 1999. Noninterest income helped to support earnings as net interest income declined. Boston Region banks and thrifts posted a collective return on assets of 1.15 percent and a return on equity of 13.61 percent. These profitability measures compared favorably with the national averages, but were below prior-year levels. The aggregate earnings numbers were driven largely by subsidiaries of the Region's three largest banking organizations, which accounted for 52 percent of the Region's total assets. As Table 3 indicates, smaller institutions demonstrated the greatest erosion of earnings primarily because of declining net interest margins.

[4] Because of unique business characteristics, credit card institutions were excluded for purposes of this analysis.

Table 3

Earnings Are Showing Signs of Decline

	Nation		Boston Region		Big Three		Assets > $1 Billion		Assets ≤ $1 Billion	
	Jun 98	Jun 99	Jun 98	Jun 99	Jun 98	Jun 99	Jun 98	Jun 99	Jun 98	Jun 99
Return on Assets	1.17	1.13	1.21	1.15	1.25	1.19	1.16	1.16	1.17	1.04
Return on Equity	14.04	13.42	14.27	13.61	17.22	15.94	13.11	13.81	10.76	9.64
Net Interest Margin	3.80	3.76	3.84	3.76	3.82	3.76	3.73	3.65	3.99	3.86
Past-Due Ratio	1.96	1.89	1.54	1.57	1.32	1.71	1.54	1.32	1.96	1.59
Net Charge-Offs/ Loans	0.35	0.34	0.22	0.28	0.29	0.42	0.20	0.22	0.12	0.06
Tier 1 Leverage	7.54	7.62	7.52	7.41	6.32	6.33	7.57	7.29	10.26	10.15

Note: Credit card institutions are excluded from the above data.
Subsidiaries of the Big Three are excluded from the >$1 billion and ≤$1 billion categories.
Source: Bank & Thrift Call Reports

Healthy Real Estate Market Conditions Continue in the Boston Region

Office Vacancy Rates Hold Steady throughout Most of the Region

Commercial office markets remained healthy throughout the Region in the first half of 1999. Projects that were previously in the pipeline were completed, releasing much needed space into the market. Most office markets in the Region experienced positive net absorption. Demand for premium space was high in most markets, and in the downtown Boston market, where sustained demand was met with low supply, speculative construction began to emerge. Current trends caused rents in Boston to increase to some of the highest levels in the nation as the "space crunch" continued.

Office markets performed well throughout the Region as vacancy rates continued to fall, particularly in the Boston area (see Table 4). Overall vacancy rates in Boston's central business district (CBD) remained below 5 percent through the first half of 1999, with Class A space in the CBD more limited with a 3.2 percent vacancy rate, according to a report from the real estate firm ***Spaulding & Slye Colliers.*** As of second-quarter 1999, average Class A rents surpassed rates in San Francisco and New York, reaching $48.23 per square foot. The report also noted that almost 5 million square feet of office space was in demand, up from 3.5 million square feet in 1998, which will likely push rental rates up even farther. According to the firm ***Cushman and Wakefield,*** office vacancy rates in **Stamford, New Haven,** and **southern New Hampshire** fell slightly in the first half of 1999, while **Hartford's** CBD vacancy rate held steady at a high 17.8 percent. However, the Boston suburban market saw office vacancy rates increase from 9.9 percent to 10.4 percent in the first half of 1999. The real estate firm ***Grubb & Ellis*** reported that 1.1 million square feet in the suburbs was absorbed in the first half of 1999. The report also noted that an additional 1.8 million of speculative space, of which only 16 percent was preleased, was scheduled to be available in the latter half of 1999. The additional space may push vacancy rates slightly higher.

Retail and industrial markets experienced mixed results through the first half of 1999. According to ***F.W. Dodge,*** the industrial vacancy rate in Hartford increased by 2.6 percent. While the Hartford retail vacancy rate has been increasing throughout the decade, the 7.5 percent rate in the second quarter was in line with the national average. The industrial vacancy rate in the greater Boston area (defined roughly as the area within Interstate 495) increased slightly as developers continue to turn to build-to-suit projects, and companies such as Sun Microsystems, Staples, and 3Com vacate market-rate space for newly built corporate campuses. However, the greater Boston retail market, characterized by strong demand, has experienced a decline in the vacancy rate to 1.9 percent.

TABLE 4

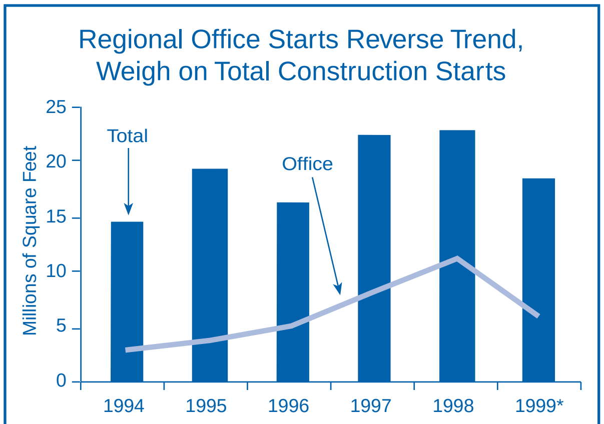
Office Vacancy Rates Continue to Fall (percent of downtown office space vacant)		
	2Q99	2Q98
Boston, MA	4.9	6.1
Hartford, CT	17.8	18.0
New Haven, CT	18.3	22.0
Stamford, CT	11.0	11.8
Southern NH	14.9	15.6

Sources: Cushman & Wakefield, Spaulding & Slye Colliers

Office Construction Starts Decline, but Retail and Industrial Markets Are Still Active

Total construction starts in the Region were down 27 percent in the first quarter of 1999 compared with the previous year, led by a decline in office starts (see Chart 2). Office construction starts were down 59 percent in

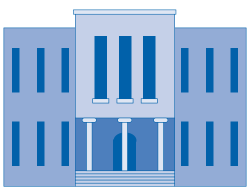
CHART 2



* Annualized rate based on year-to-date numbers
Source: F.W. Dodge via FDIC Real Estate Report

the Region from one year ago, the first decline in six years, led by decreases in all states except Maine. Markets appear to be keeping themselves in check. As of the second quarter of 1999, more than 2 million square feet of new construction was in progress in the Boston CBD, but much of the space was preleased. Combined with a decline in projects in the completed or bidding stage, office vacancy rates should remain low.

A significant amount of retail and industrial development is in the pipeline compared with recent years. Over 5 million square feet was added to the initial planning stage in the Boston; Hartford; **Providence;** and **Burlington,** Vermont, markets. Compared with one year earlier, retail and industrial starts were up a combined 7 percent in the Region as of first quarter 1999. Retail starts in Hartford were rising in 1999 following a sluggish period of growth in the prior year; however, starts remained comparatively low when measured against the higher levels attained in the mid-1990s.



The Hartford retail and industrial markets have been undergoing a structural change over the past few years. Many larger companies, such as Lechmere, Caldor, and Home Quarters, have filed for bankruptcy, leaving blocks of space vacant. New construction activity has been dominated by build-to-suit projects because much of the older, existing space is not suitable for "big box" retailers and national companies. This vacated space could be problematic for lenders that may be left with obsolete properties as potential buyers opt for build-to-suit projects.

Certain Areas Experience Growth in CRE Loans, Exposure

As of second-quarter 1999, construction and development (C&D) activity in the Region's institutions with less than $25 billion in assets increased 20 percent over the prior year. For those institutions, C&D loans made in the **Portland,** Maine; New Haven, Connecticut; **New London,** Connecticut; and Providence, Rhode Island, Metropolitan Statistical Areas increased over 40 percent in the same time. Healthy economic conditions have contributed to strong growth over the past two years throughout the Region; however, aggregate concentrations relative to Tier 1 capital remain low at only one-fifth the peak levels reached in the late 1980s.

The strong economy and real estate markets have contributed to increased non-C&D commercial real estate (CRE) loan activity in certain groups of institutions in the Region. Institutions with assets of less than $1 billion have grown CRE loans by an average of 10 percent for the past four years, with an increase of 13 percent realized for the 12 months ending June 30, 1999. CRE loans now represent over 11 percent of these 385 institutions' total assets, the highest level in recent history. The higher growth and concentration levels are being attributed, in large part, to decreased competition for CRE loans from the Region's larger institutions rather than "heated" real estate market conditions. The larger institutions have actually reduced investment in CRE loans over the past four years, which has resulted in aggregate CRE loan growth for the Region of under 4 percent per year during that period. The smaller institutions have filled some of the void left by the larger institutions; however, exposures remain modest relative to the strong Tier 1 capital levels of smaller institutions.

Implications for Banks

Low vacancy rates may be starting to drive speculative projects in certain areas of the Region as developers of office space look to satisfy demand. An increase in the supply could place downward pressure on rents and therefore affect valuations on existing structures. In addition, smaller institutions with high concentration levels, particularly those operating in active real estate markets, should ensure that underwriting standards adequately address the inherent risks associated with a downturn in real estate.

Commercial Lending Showing Strong Gains Nationally and in the Region

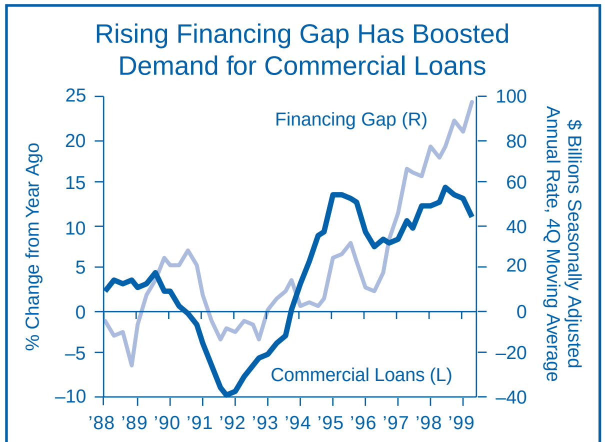
Certain Factors May Be Driving Corporations to Take on More Bank Debt

Nationally, commercial loan growth began to accelerate in early 1992 and, after stabilizing during 1996, accelerated through 1998. Commercial loan volume is driven by many factors; however, it is fundamentally attributed to interaction between the pricing (including underwriting criteria and other nonpecuniary "costs") of loans relative to other sources of capital for U.S. businesses, and firms' demand for supplemental funding. A close correlation is evident between commercial loan growth and the "financing gap." This gap is the shortfall of internally generated funds with respect to capital outlays of all nonfarm, nonfinancial corporations in the nation.[5] As this gap widens, firms' need for outside financing (which includes commercial credit extended by insured institutions) grows. Chart 3 shows this relationship since 1988. The commercial loan data in the chart include all insured institutions, but if data are broken down by size class, growth has been dominated by large institutions with assets over $1 billion. The chart also shows how commercial lending growth eased recently, even though the financing gap continued to grow. ***Federal Reserve*** surveys suggested that lenders were tightening underwriting standards in mid-1999 (raising the indirect costs of bank credit). Interest rates rose in the latter half of 1999, while at the same time increased corporate bond issuance or some flight to quality into treasuries placed upward pressure on corporate bond yields. These factors may have affected commercial loan growth. Also, to reduce exposure to commercial loans, insured institutions may have moved some of these loans off-book through securitizations or syndications, possibly masking continued strong growth in commercial loan production.

Although overall economic growth has accelerated modestly in recent years, giving rise to greater business investment, the expanding financing gap may also be related to a noncyclical increase in capital outlays by U.S. corporations, particularly in the area of computers and information technology. In addition, limits on domestic firms' ability to raise prices significantly in recent years (as demonstrated by stable or declining gains in broad U.S. price indices) and modestly rising unit labor costs have pressured corporate profit margins (see Chart 4).

Greater growth in capital outlays, combined with slower growth in overall revenues and tighter margins, typically cause firms to seek alternate, outside sources of investment funding, such as commercial bank loans. No data are available to measure the financing gap in subnational markets. However, the recent national growth can most likely explain, at least in part, some of the acceleration in commercial lending experienced in the

CHART 3



Sources: Federal Reserve and Bank and Thrift Call Reports

CHART 4

* Profits with inventory valuation and capital consumption adjustments/ gross domestic product of nonfinancial corporate business
Source: Bureau of Economic Analysis and Bureau of Labor Statistics

[5] From the ***Flow of Funds Accounts of the United States,*** the financing gap for nonfarm, nonfinancial corporate businesses is defined as total capital expenditures (fixed investment in plant and equipment—roughly 90 percent of this account—and the net change in inventories) less the sum of U.S. internal funds (profits after taxes and dividends plus consumption of fixed capital) and the IVA (inventory valuation adjustment, which adjusts corporations' book-value inventories for differences in accounting methods and for the effects of price changes).

Boston Region, even though this Region's overall pace of economic growth has remained fairly constant in recent years.

Commercial Lending in the Boston Region Following the National Trend

Commercial and industrial (C&I) lending has been active in the Region's insured institutions. C&I loans increased about 14 percent per year for each of the past three years, the highest growth rate of any loan type except credit cards. The median C&I loan growth rate in the Region was 15 percent from June 1998 to June 1999 and was driven by institutions located in southern New England (see Chart 5).

Connecticut's median C&I loan growth was particularly strong at 27 percent, well above the growth rates reported in the Region's other five states. Recent interstate merger activity within what were previously the state's largest banks (Fleet, BankBoston, and First Union) may be contributing to this rapid growth. However, rapid loan growth, particularly in potentially higher risk sectors, has often been a precursor to loan problems and should be undertaken cautiously.

The Region's small institutions (assets less than $1 billion) have experienced considerable growth in C&I loans over the past few years. Total commercial loans, which remain a small percentage of assets (just under 5 percent), increased at an average annual rate (merger-adjusted) of 11 percent from the lowest level in June 1993 to June 1999. This growth was the greatest of any loan category in the Region's small institutions.

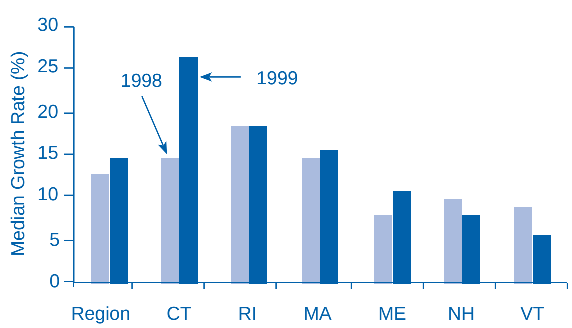
In addition, C&I loans, which represent 20 percent of assets in the Region's large institutions (assets greater than or equal to $1 billion), also grew at an average annual rate of 11 percent since June 1993. The Region's three largest institutions, representing a little over half the Region's total assets, drove the concentration measure as C&I loans accounted for 26 percent of assets in those institutions. The remaining institutions with assets greater than $1 billion held 8 percent of assets in C&I loans, which have increased at an average rate of 15 percent since 1993.

Since bottoming out in June 1993, C&I loan concentration levels have been rising toward the high levels reached in the mid-1980s. Commercial loans comprised 16 percent of total assets as of June 30, 1999, the highest concentration level since 1986, and 213 percent of Tier 1 capital, which was 81 percent of the maximum level reached in 1986.

Commercial loan delinquencies have been increasing modestly for the past two years and were 1.62 percent as of June 30, 1999. This level was the highest reported since March 1997 but does not approach the highs of over 11 percent earlier in the decade. C&I loan delinquencies in the Region's smaller institutions have been decreasing and were below national totals for banks with assets of less than $1 billion as of June 30, 1999. The overall increase in commercial loan delinquencies has been driven by the Region's large institutions (see Chart 6). Should cash flow weaken or interest rates rise, borrowers with high levels of commercial debt will face higher debt-service burdens that may result in additional increases in commercial loan delinquency levels.

CHART 5

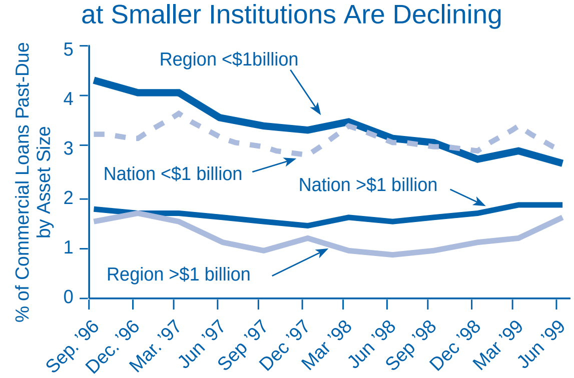
Strength in Commercial Loan Growth Is Most Pronounced in Southern New England



Source: Bank and Thrift Call Reports

CHART 6

Past-Due Commercial Loans at Smaller Institutions Are Declining



Source: Bank and Thrift Call Reports

Small-Business Lending Focus Differs by Institution Size

Industry Consolidation Continues

The consolidation of the banking industry has resulted in fewer, but larger, banks in terms of asset size. As banks grow in size, how does this affect the small-business lending market? The number of institutions in the Boston Region declined 30 percent from 558 in June 1993[6] to 428 as of June 1999. In contrast, the average asset size almost doubled from $492 million to $933 million. The presumption in the marketplace has been that as banking institutions merge, lending to small-business declines.

Historically, the banking industry has been the primary source of credit for small businesses. As banks grow in size, either through marketplace growth or industry mergers and acquisitions, these institutions may focus more on larger markets, seek a more national business scope, or search out larger borrowers. As a result, some lines of business, including small-business lending, may be less desirable because of decreased profitability compared with other business activities that increase margins, maximize efficiencies through economies of size and scope, and provide greater returns on allocated capital.

What Has Happened to Small-Business Lending?

Small-business loan[7] volume in the Region's insured institutions increased by almost 3.5 percent per year since 1993. Small-business real estate loans (56 percent of all small-business loans) grew by only 2 percent per year from 1993 to 1999, while small-business commercial loans (non-real estate secured) grew about 6 percent per year. In comparison, total commercial real estate and commercial loan growth were 1 percent and 11 percent, respectively. During this period, asset growth averaged about 7 percent per year and total loan growth was about 6 percent per year.

On the surface, small-business lending does not appear to have kept pace with overall asset and loan growth. However, accurately measuring small-business loan growth is difficult for various reasons. Borrowers obtain financing from a variety of sources—nonbanks as well as banks headquartered both within and outside the Boston Region. Community Reinvestment Act (CRA) data provided by the ***Federal Financial Institutions Examination Council***[8] for 1998 show that 51 percent of the total number of small-business loans representing 19 percent of the total dollars loaned to borrowers in the Region were made by lenders headquartered outside the Region. This figure represents a slight decline from 1997.

Out-of-Region lenders, most active in the category of small-business loans of less than $100,000, account for 57 percent of the total number of loans made in that category but only 30 percent of the total dollars. These statistics show that out-of-Region lenders are pursuing the smallest dollar loans in this category more aggressively. Out-of-Region lenders account for about 11 percent of both number and dollars of loans in the $100,000 to $250,000 category and about 15 percent each in the over $250,000 to $1 million category. Other factors to keep in mind are that small-business loans are defined by loan size, not by the size of the business, and that the loan size definition has not been adjusted for inflation. As a result, as borrowers' credit needs grow, borrowers migrate out of the small-business loan reporting categories.

Call Report data for Boston Region institutions with assets greater than $1 billion (excluding credit card institutions) as of June 30, 1999, show that small-business commercial loans increased about 3 percent per year on average since 1993, with the largest single-year growth of 19 percent occurring in the past year. Asset growth in these institutions averaged 6 percent per year, and total loans increased about 5 percent per year. Nationally, small-business commercial loans grew at an average annual rate of 8 percent, slightly above the 6 percent increase in asset growth and the 7 percent

[6] June 1993 is used because that was the first period for which small-business loan information was collected on Call Reports and Thrift Financial Reports.

[7] Small-business loans are defined as business loans under $1 million. Loans may be secured by nonresidential real estate or unsecured. Loans are reported in three size categories: loans less than $100,000, loans from $100,000 to $250,000, and loans greater than $250,000 but less than $1 million. The size of the loan, not the size of the borrower, defines a small-business loan.

[8] All insured institutions, with the exception of small institutions, are required to file CRA data. A small institution is defined as a bank or thrift that, as of December 31 of either of the prior two calendar years, had total assets less than $250 million and was independent or was an affiliate of a holding company that, as of December 31 of either of the prior two calendar years, had total banking and thrift assets of less than $1 billion.

increase in loan growth. Certain factors may have affected the slower regional growth compared with the nation. In particular, loan securitizations, sales, and acquisition-related divestitures are not reported on Call Reports and could lead to an understatement of small-business loan production.

Small-business loans in the Region's small institutions grew at an average annual rate of 13 percent from 1993 to 1999 compared with asset and loan growth of about 7 percent each per year. Small-business loans secured by real estate (69 percent of the total small-business loans in these institutions) increased at an average annual rate of almost 12 percent, and small-business commercial loans increased about 15 percent per year.

Demand for small-business loans remains high and is expected to increase. A study conducted by ***Conning & Co.,*** an insurance research and investment company, using data from ***Regional Financial Associates,*** shows that the number of New England small businesses is expected to increase 1.2 percent between 1997 and 2002 after an increase of 0.7 percent between 1992 and 1997. Nationally, the number of small businesses is expected to increase 1.4 percent between 1997 and 2002 after increasing 1.1 percent between 1992 and 1997.

Technological advancements also have affected small-business lending. Use of credit-scoring models has reduced loan processing costs compared with traditional underwriting practices, and scoring models continue to be used more frequently by larger institutions and nonbanks to assess potential borrowers' creditworthiness. The Region's large banks are reporting the most significant increase in small-business lending in the under $100,000 loan category. Credit-scoring models can be applied more easily to loans of this size. The large institutions, on a merger-adjusted basis, have realized average small-business commercial loan growth of 8 percent per year since 1994 in the under $100,000 category. This category increased almost 40 percent between June 1998 and June 1999 as the large institutions aggressively targeted the smaller business loans. However, small-business loans secured by real estate and small-business commercial loans greater than $250,000 have not increased in the large institutions. This further suggests that these institutions are placing greater reliance on credit-scoring models to assess borrowers' repayment ability on more traditional commercial loans, not on loans that require more costly forms of underwriting and collateralization. This trend is consistent with the general trend that shows large banks reducing exposure to CRE loans.

The small institutions experienced average small-business commercial loan growth of about 19 percent per year in the $250,000 to $1 million category from June 1993 to June 1999. The large category of small-business loans secured by real estate experienced 14 percent average growth during this same period compared with small overall declines in the large institutions. On the basis of this rapid growth, small institutions appear to be more willing to make small-business loans secured by real estate and are making larger loans as competition intensifies in the less than $100,000 market. This trend could result in increased levels of credit risk in the smaller institutions as portfolios become less diverse. However, the smaller institutions appear to be more actively seeking collateralized loans to help protect against potential loss. As credit scoring grows in acceptance and use, particularly by the larger institutions, small institutions may see growth potential diminish because of increased competition.

Boston Region Staff

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