◇ Regional Outlook ◇

FEDERAL DEPOSIT INSURANCE CORPORATION FOURTH QUARTER 2000

FDIC
BOSTON
REGION

Regional Perspectives

◆ ***Region's Economic and Banking Conditions*—Economic growth showed modest signs of cooling in 2000. Insured institutions reported stable conditions overall, but income and credit quality trends were not as favorable at larger banks. *See page 3.***

◆ ***Liquidity and Funding*—Core deposits have not been sufficient to fund loan and other asset growth; as a result, insured institutions have increasingly turned to alternative funding sources. These sources are more costly than core deposits and could encourage institutions to seek a higher-yielding, higher-risk asset mix to preserve interest margins. Also, increased use of noncore funding could limit liquidity and raise interest-rate risk. *See page 5.***

By the Boston Region Staff

In Focus This Quarter

◆ ***Emerging Risks in an Aging Economic Expansion*—This article focuses on the potential risks of current economic conditions to insured depository institutions. Although the current conditions may appear to be ideal, some imbalances are emerging: rising energy prices, tight labor markets, a less robust stock market, a large trade deficit and strong U.S. dollar, rising household debt burdens, increased corporate leverage and rising potential default risk, and, in some metropolitan areas, overheated housing and commercial real estate markets. At the same time, aggregate risk within the banking industry appears to have risen, as evidenced by softening profitability, growing reliance on noncore funding, heightened levels of interest rate risk, and increasing concentrations in traditionally higher-risk loan categories. A confluence of these trends could heighten the vulnerability of some insured institutions. *See page 11.***

By the Division of Insurance Staff

DIVISION OF
INSURANCE

DANIEL FRYE,
REGIONAL MANAGER

NORMAN WILLIAMS,
REGIONAL ECONOMIST

CAMERON TABOR,
SENIOR FINANCIAL
ANALYST

ANDREA PLANTE,
ECONOMIC ANALYST

The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation as an information source on banking and economic issues for insured financial institutions and financial institution regulators. It is produced for the following eight geographic regions:

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

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

The ***Regional Outlook*** is available on-line by visiting the FDIC's website at www.fdic.gov. For more information or to provide comments or suggestions about the Boston Region's ***Regional Outlook,*** please call Daniel Frye at (781) 794-5678 or send an e-mail to *dfrye@fdic.gov.*

The views expressed in the ***Regional Outlook*** are those of the authors and do not necessarily reflect official positions of the Federal Deposit Insurance Corporation. Some of the information used in the preparation of this publication was obtained from publicly available sources that are considered reliable. However, the use of this information does not constitute an endorsement of its accuracy by the Federal Deposit Insurance Corporation.

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

REVISION:

The article "Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding" in the Third Quarter 2000 issue of the ***Regional Outlook*** has been revised to correct a data-related error. The revision affects Chart 4 and Chart 11 of the report. Please see www.fdic.gov/bank/analytical/regional/ro20003q/correction.html for revised versions of Chart 4 and Chart 11, along with an additional explanation of how the revision affects the article.

Regional Perspectives

- **The Region's economic growth showed signs of slowing in 2000, but commercial real estate activity remained robust.**

- **Insured institutions reported stable conditions; strong loan growth continued among the Region's smaller banks.**

- **Slow core deposit growth in the Region has led insured institutions to seek alternative funding sources.**

- **Increased use of alternative funding sources may cause a decline in liquidity and an increase in credit and interest-rate risk.**

Regional Economic and Banking Conditions

New England Economy: Cool-Down in Growth Accompanied Cool Summer Weather

In one of the coolest summers in several years, it seemed only fitting that the Region's economic growth should cool from its heated pace as well. The effects of rising interest rates and a general slowing in national economic growth were evident in the Boston Region through late summer 2000. August 2000 year-to-date total nonfarm job growth in the Region essentially matched its 1999 pace and continued to trail that of the nation by a modest margin; however, some sectors showed slowing growth. On the plus side, services and government sector job growth remained at or above 1999 levels, and net job losses in manufacturing eased. On the minus side, job growth in all other sectors slowed through August 2000 from year-ago levels. The Region's rate of decline in factory sector payrolls in 2000 was less than half that of 1999; however, it was still double the national rate of decline. Of the states in the Region, only **Maine's** year-to-date employment gain exceeded the nation's. In fact, Maine's labor market was strong enough this past summer to allow many of the 4,800 striking workers from the Bath Iron Works shipyard to readily find other temporary work while on strike.[1]

Seasonally adjusted unemployment rates in August 2000 were well below the national rate in all the Region's states except **Rhode Island.** Most of the Region's states also saw summer unemployment rates that were at or below year-end 1999 levels. The exceptions were **New Hampshire** and Rhode Island, where August unemployment rates were significantly above December 1999 levels, in part because of slowing job growth. **Connecticut** continued to experience the Region's lowest adjusted unemployment rate, with **Massachusetts** a close second. Per capita income growth during first quarter 2000 generally remained well above the national rate, continuing a five-year trend.

The Region's housing markets also showed some signs of cooling, as August year-to-date permit issuance was down about 7 percent from 1999, compared with a 4 percent drop nationally. While the southern New England states accounted for much of the decline in new home building during the first eight months of 2000, **Vermont** also witnessed a drop in activity. Still, that state's roughly 14 percent decline followed two years of surging growth, so a slowdown in 2000 was not altogether surprising. Further, about half the drop was due to a return to more normal levels of multifamily construction following a surge during 1998 and 1999. Much of the multifamily buildup was due to an increase in projects at the state's ski resort areas.

Office Vacancy Rates Continue to Decline

Commercial real estate markets generally remained strong in the Boston Region. The Region's office vacancy rates continued to decline compared with one year ago, thanks to a lack of construction and rising demand (see Table 1, next page). Rents continued to rise, in some locations around **Boston** by as much as 40 percent in third quarter 2000 from a year ago.[2] However, the

[1] "No Lack of Work for BIW Strikers." *Portland Press Herald.* September 17, 2000.

[2] "Rents Can't Get Higher? Think Again." *Boston Business Journal.* August 28, 2000.

Table 1

Office Vacancy Rates Continue to Fall in the Region (percentage of office space vacant)		
	2Q00	2Q99
Boston, MA*	2.0	4.9
Cambridge, MA*	0.1	4.0
Hartford, CT	15.3	16.0
New Haven, CT	16.1	18.3
Stamford, CT	7.4	11.0
Southern NH	5.2	14.9

* Vacancy rates for downtown areas.
Source: Cushman & Wakefield; Spaulding & Slye Colliers; FW Dodge

scarcity of office and certain kinds of industrial space, particularly around greater Boston, may be cause for concern. Demand continues to outpace construction, forcing tenants to commit to high rental rates in advance in order to meet future space needs. Some tenants reportedly are seeking to lock in new space as much as three years in advance. According to ***Meredith & Grew Inc.,*** tenants are leasing space when it is available, even if they do not currently need it, in anticipation of future demand. Such practices not only inflate rents but may prove troublesome if market conditions falter, leaving tenants with high-rate rental contracts for space they will not occupy.

In downtown Boston, average rents for class A space are at an all-time high, and with more than 4.5 million square feet of leasing transactions completed in 2000 alone, the market continues to absorb any available space. According to ***Cushman & Wakefield,*** downtown Boston boasted a 2 percent vacancy rate as of the end of second quarter 2000. Some relief may be in sight within the next 24 months, as six new office towers are under construction, which will add a total of 3.9 million square feet to Boston's market (or about 8 percent of existing inventory in the central business district). However, a significant portion of this space reportedly has been preleased.

Hartford's office market continues to improve. Although its overall vacancy rate of 15.3 percent is still high, it is the lowest rate since the mid-1980s. Demand has not improved uniformly; most of the city's suburbs show markedly lower vacancy rates. Some analysts have indicated that office rents around Hartford are finally high enough to support new construction. However, given downtown Hartford's 23 percent vacancy rate as of second quarter 2000, it seems unlikely that any new construction will occur there. More likely, any new building will accommodate growing demand in the city's outlying areas first.

Boston Region Banks Report Stable Conditions

The Region's insured institutions continue to report stable conditions (see Table 2). Excluding credit card specialists, the aggregate return on assets for the Region was 1.28 percent as of June 30, 2000. This is an increase of 7 basis points from the same period in 1999. Net interest margins (NIMs) in the Region's largest institutions (assets greater than $25 billion) continued to decline, while margins at the medium-sized institutions

Table 2

Financial Performance of Region's Insured Financial Institutions Remains Solid

	Boston Region			<$1 billion			>$1 billion <$25 billion			>$25 billion		
	Jun-00	Jun-99	Jun-98	Jun-00	Jun-99	Jun-98	Jun-00	Jun-99	Jun-98	Jun-00	Jun-99	Jun-98
Return on Assets	1.28	1.19	1.22	1.09	1.05	1.14	1.19	1.10	1.13	1.40	1.27	1.28
Net Interest Margin	3.80	3.84	3.92	3.92	3.81	3.98	3.82	3.53	3.61	3.84	3.96	4.00
Past-Due Ratio	1.62	1.66	1.61	1.25	1.56	1.95	1.08	1.41	1.61	2.02	1.80	1.47
Net Charge-Off Ratio	0.52	0.40	0.42	0.09	0.05	0.09	0.21	0.20	0.24	0.85	0.63	0.63
Core Deposits/ Assets	47.86	51.48	54.77	69.74	71.05	73.56	60.32	61.58	65.31	35.54	41.04	44.57
Noncore Funding/ Assets	38.69	36.28	34.03	19.65	17.70	14.68	30.84	29.02	25.55	48.38	45.40	43.74

All data exclude credit card institutions.
Source: Bank and Thrift Call Reports; reported on a merger-adjusted basis

(assets between $1 billion and $25 billion) rose. The Region's small institutions (assets less than $1 billion) showed slight increases in NIMs compared with June 1999, but margins were unchanged during the past three quarters.

Some signs of weakening have emerged among the larger banks, as aggregate past-due loan and net charge-off ratios rose slightly. Nationally, many larger institutions have experienced increasing credit problems with syndicated commercial loans, and this is likely occurring in the Region's larger banks as well. While the past-due ratio has increased for the large banks, it continued to fall for the Region's smaller institutions and remained low in aggregate compared with that of the nation. Loan growth in small and medium-sized institutions continues to be robust, particularly in the commercial, commercial real estate, construction and development, and consumer sectors. The Region's largest institutions showed essentially no loan growth, in part because of sales of loans associated with divestitures related to merger activity.

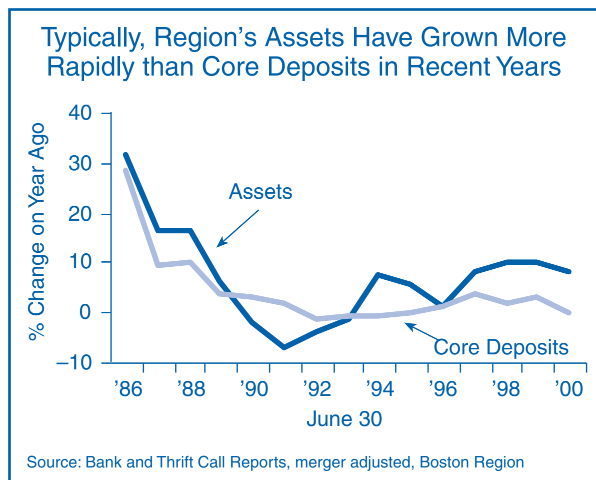
Current Trends in Liquidity and Funding

Core deposits alone have not been sufficient to fund loan and asset growth. To compensate, insured institutions have turned increasingly to alternative funding sources. These alternatives may decrease liquidity and increase levels of credit and interest-rate risk.

Core Deposit Growth Is Slow

Core deposits, the primary funding source for the banking industry, are declining in importance. Historically, loan and asset growth have been generally tied to the amount of new core deposits generated in the economy. However, during the past decade, this relationship has not held true. Typically, annual loan and asset growth have outpaced core deposit growth in the Region since the early 1990s (see Chart 1).

CHART 1



Slow core deposit growth may be attributed in part to the public's increased knowledge of, and access to, domestic and global capital markets. The recent high returns offered by the stock market are widely publicized and frequently advertised. The information obtained from advertisements and media sources such as the Internet and television could have encouraged many savers to select equities over traditional bank deposits. In addition, the advent of mutual funds and online trading on the Internet have made capital markets more accessible to less wealthy investors. Both mutual funds and online investing require less financial commitment and lower transaction costs than other methods of investing.

The hypothesis that banks are losing deposits to capital markets appears to be credible in light of national trends in time and savings deposits against equities and mutual fund shares. Since 1990, time and savings deposits as a percentage of total personal financial assets have fallen from 21 percent to 10 percent, while equities and mutual funds have soared from 19 percent to 35 percent (see Chart 2). Indeed, many bankers have recognized the public's preference for mutual funds and equities and have implemented nondeposit sales programs. These programs are designed to collect fee income from investors who management concedes would not otherwise deposit money at the bank.

Although core deposit growth has been slow across all types and sizes of institutions in the Region, institutions with total assets greater than $25 billion have experienced the greatest decline in core deposits. In recent years, these banks have had very little success in obtaining or maintaining core deposits. As Chart 3 shows, the largest banking institutions have actually experienced

CHART 2

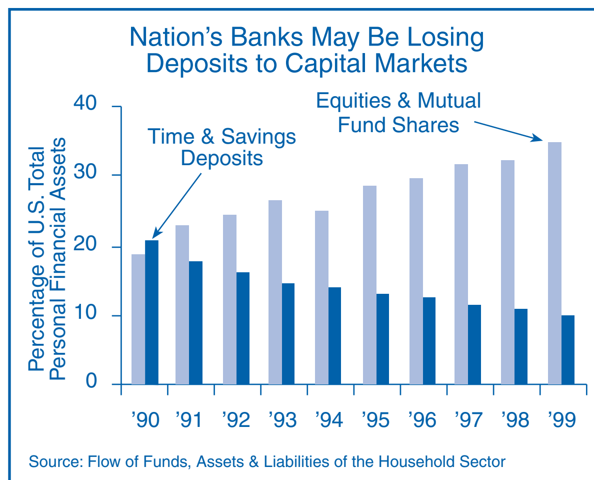
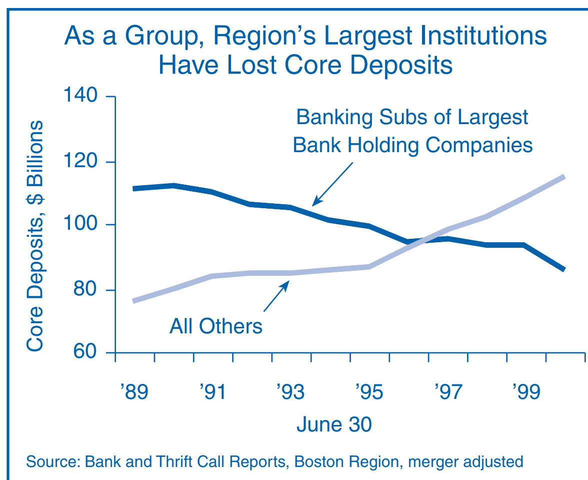


CHART 3



declines in core deposits. This is in part because regulators have required some of the largest institutions to sell retail branches as a result of merger activity. However, some of the decline may result from management's willingness to pursue alternative sources of funds rather than aggressively pursue or maintain core deposits. In addition, subsequent to mergers, some customers may leave the enlarged institution, believing they can obtain better service and value at a smaller institution.

For other institutions, marginal core deposit growth can be measured relative to new loans or new assets. Over the past seven years, the Region's insured institutions with less than $25 billion in total assets (excluding credit card banks) have matched every dollar of new *loans* with 74 cents in new core deposits. This fraction is reasonably consistent among all categories[3] of institutions, regardless of asset size, ownership type, or geographic location. The same institutions over the same period have matched each dollar of new *assets* with 42 cents in new core deposits. This fraction is even lower (33 cents) for large public institutions with total assets between $1 billion and $25 billion. The greater mismatch between core deposit and asset growth for these institutions may be related to stockholder pressures to increase returns through balance sheet expansion.

Borrowings Are Increasing

When core deposit growth does not match asset growth, other sources of funding are used. Regional data point primarily to borrowings, which are a more expensive and potentially volatile source of funds. They are expensive because the pricing structure is closely tied to the market, and borrowings are potentially volatile because lenders may either call the funds or withdraw them at maturity. Presumably, during a slowdown in the economy or when an institution experiences financial problems, the borrowings may become too expensive to maintain or may become unavailable for institutions without sufficient collateral or capital. To pay off the debt, management would have to sell assets or raise capital. As shown in Chart 4, despite the potentially volatile nature and expense of borrowings, borrowings as a percentage of assets are at an all-time high both in the Boston Region and nationally.

Gramm-Leach-Bliley Act May Spur Borrowing

Federal Home Loan Bank System (FHLB) advances are a primary source of credit for small banks and thrifts. As of June 30, 2000, FHLB advances to FDIC-insured institutions nationwide totaled $427 billion, or 29 percent of total borrowings outstanding. As shown in Chart 5, advances to members both in volume and as a percentage of total borrowings have increased rapidly. Recent regulatory changes promulgated as a result of the Gramm-Leach-Bliley Act (GLBA) appear to facilitate even more borrowing. These changes are as follows:

- All FDIC-insured institutions with less than $500 million in assets (community financial institutions) may become members of the FHLB. (Before GLBA was passed, only institutions with 10 percent of assets in residential housing assets could join.)

[3] Excludes credit card banks and insured institutions with more than $25 billion in total assets.

CHART 4

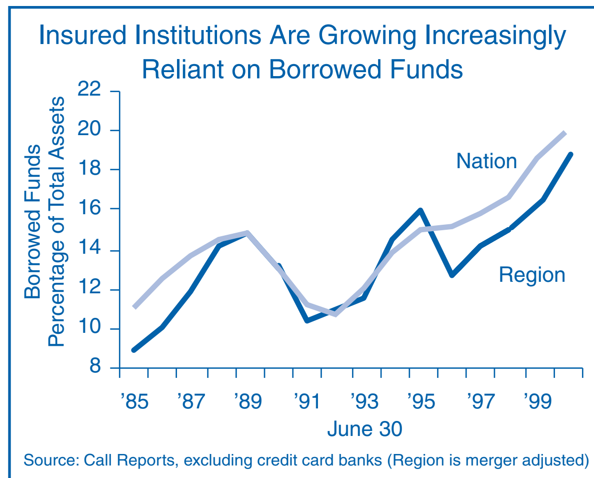
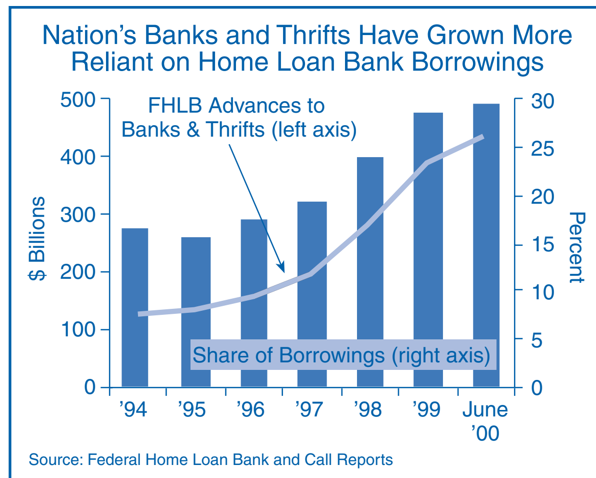


CHART 5



- Advances to "nonqualified thrift lenders" are no longer restricted to 30 percent of total assets.

- "Community financial institutions" may use advances to fund small business and small agricultural loans.

- "Community financial institutions" may also use small business and small agriculture loans as collateral for advances.

Increased exposure to borrowings may heighten risk levels for several reasons. First, some forms of borrowings carry regulatory risk. For instance, regulations, such as those promulgated as a result of the enactment of the GLBA, could be changed in the future and become more restrictive on FHLB borrowing. Second, borrowings tend to be relatively expensive and may cause significant earnings problems. Higher funding costs may entice return-conscious managers to assume more risk to compensate for the higher costs. Third, borrowings can be extremely sensitive to interest rates. Other features, such as callable advances, may also negatively affect funding costs. Fourth, borrowings increase liquidity risk by reducing the amount of available credit and lowering the amount of readily marketable assets. Typically, the most liquid investments are pledged as collateral for secured borrowings.

Another perspective is that secured borrowings may lead to greater losses to the FDIC insurance funds. Because of the secured nature of the borrowings, the highest-quality assets become encumbered. Therefore, if an institution failed, the FDIC would presumably have lower-quality assets available for sale to satisfy its obligations to insured depositors.

Funds Available from Asset Sales Are Declining Also

In addition to borrowings and core deposits, funds can be obtained from asset sales. Essentially, the entire balance sheet can be sold. However, sales can come with a cost. Typically, the most liquid assets have the least embedded credit risk, and the sale can raise an institution's risk profile. The most liquid major asset categories are short-term investments, securities, and residential loans underwritten to secondary market standards.

In the Region, the amount of cash held by institutions with less than $25 billion in total assets (excluding credit card banks) has been consistent across all time periods at about 2 to 3 percent of total assets. Not surprisingly, interest-bearing assets (such as deposits with other banks) have declined from 2.2 percent of total assets in June 1990 to 0.3 percent of total assets as of June 2000. These assets earn very little compared with other earning assets and may be management's first choice among the sources of funds. Federal funds sold and reverse repurchase agreements also appear to be stable at approximately 2 to 3 percent of total assets.

As discussed earlier, many institutions, particularly large public institutions, are seeking to increase returns on equity. One method of doing so is to borrow money and invest the funds in higher-yielding securities and loans. As a result, the significant increase in borrowings in the Region has been accompanied by increases in

available-for-sale securities and loans. Theoretically, management could sell the loans and securities when funds are needed. However, certain restrictions or costs may prohibit sale. The security or the loan could be pledged against a specific borrowing and may be unavailable for sale for any reason except to pay off the debt, or the resale market may be limited. Another reason might be that the security or the loan could carry unrealized losses that management does not wish to realize. As Chart 6 shows, Call Report filers in the Region appear to be shifting away from assets with short maturities to assets with longer maturities. This shift, along with recent increases in interest rates, has caused unrealized losses.

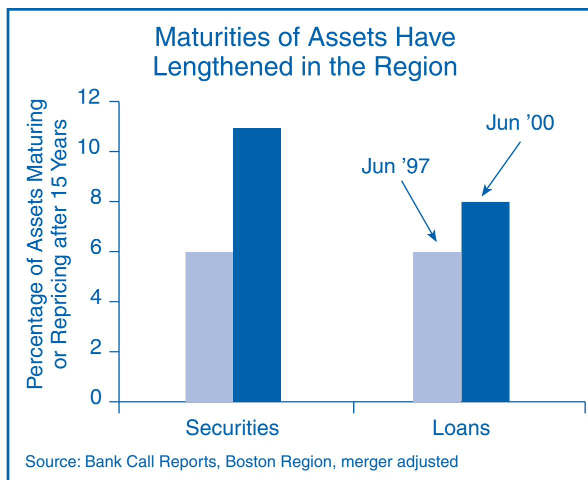
Another factor that may influence a loan's liquidity is the loan type. Generally, loans secured by 1- to 4-family mortgages are the most liquid because of the size of the secondary market. Government-sponsored agencies such as Fannie Mae and Freddie Mac, as well as many other market participants, stand ready to buy these mortgages. In addition, these loans are a primary source of collateral for FHLB borrowings. However, this asset class is also declining. In the Region, loans secured by 1- to 4-family mortgages represented over 28 percent of assets and 40 percent of loans in the early 1990s but represented only about 19 percent of assets and 30 percent of loans as of June 2000. While this decline is apparent in institutions of all sizes, it is most pronounced in those with assets of $1 billion or more. The Region's small institutions, which typically are heavier residential lenders, show slight declines in single-family residential mortgages, but those loans still account for about 40 percent of total assets and 57 percent of total loans.

Over the past decade, securitization activity has improved liquidity by allowing insured institutions to sell virtually any loan. However, the marketability of a loan depends on its quality. If loan quality declines, marketability may also decline. Moreover, the highest-quality loans may be sold first, leaving the institution with the lower-quality, higher-risk assets.

Other Sources of Liquidity

Other sources of funds include net income, principal reductions on loans and securities, and issuance of new stock. Thanks in part to the strong economy, net income at most institutions in the Region is at all-time highs. However, the strong earnings may be offset by slower principal reduction. In the past few years, interest rates have been relatively low, enticing borrowers to refinance or take on new debt. Since then, market interest rates have climbed and dampened prepayment speeds. Consequently, many new loans that are amortized over extended periods of time will pay back very little in principal. Further, if higher interest rates persist, borrowers may be less likely to refinance or prepay their debt. Issuance of new bank stock may be inhibited by lower returns in comparison to the stock market. According to ***Smartmoney.com,*** the nation's 58 largest commercial bank holding companies experienced an average stock price appreciation of 10 percent over the 52-week period ending September 22, 2000. This rate compares unfavorably to the ***Dow Jones Industrial Average's*** gain of 27 percent over the same period.

CHART 6



Source: Bank Call Reports, Boston Region, merger adjusted

Implications

Bankers in the Boston Region are discovering that because of recent increases, alternative funding is becoming increasingly expensive. Higher funding costs put downward pressure on margins and may lead managers to take on additional risk in order to maintain income. This may already have happened at some institutions. Aggregate data for all categories of institutions show declines in historically lower-risk assets, such as residential loans, and increases in higher-risk assets, such as commercial loans. As long as the economy remains strong, higher-risk assets generally offer higher returns. These higher returns may offset funding cost increases in the short term but may exacerbate earnings problems if the economy turns down. Economic problems would also magnify the growing liquidity risk that

accompanies an increasingly higher-risk asset mix funded with potentially volatile funding sources.

Boston Region Staff

The Boston Region Staff would like to express their appreciation to Thomas Wiggins, Bank Examiner, Division of Supervision, for his contributions to this article.

Emerging Risks in an Aging Economic Expansion

- **The economy and the banking and thrift industries are reporting generally healthy conditions. However, the economic expansion is aging, and it is unlikely that the vigor experienced during the first half of 2000 can be sustained.**

- **Likewise, record banking and thrift industry profits, healthy capital cushions, and good asset quality of recent years may not be sustainable. Declining net interest margins, rising commercial loan losses, tighter liquidity, and riskier asset composition are among the warning signs that industry performance may have peaked for this business cycle.**

- **Specific areas of concern include growing reliance on noncore funding; heightened interest rate risk; increased exposure to market-sensitive revenues; deteriorating credit quality; rising leverage among businesses and households; and signs of imbalance in some residential and commercial real estate markets.**

Although no readily apparent situations or imbalances suggest that a recession or widespread banking problems will develop in the near term, warning signs are present. A highly competitive banking industry shapes the environment in which pressures on insured institutions are unfolding. The presence of a large share of newly chartered banks in some areas appears to be raising the risk profile among all institutions in certain markets. Publicly owned companies remain under intense pressure to grow earnings and increase shareholder value. In addition, local banking environments exist in which a confluence of risks is generating heightened vulnerability for all participants, even during healthy economic times. Complacency in these environments may have negative repercussions for many insured institutions going forward.

Imbalances Are Appearing amid a Healthy Macroeconomic Environment

The performance of the U.S. economy contributes to the opportunities and risks financial institutions face. The current cyclical expansion, now nine and one-half years old, is displaying signs of aging while setting a record for longevity. A consensus forecast calls for moderate real gross domestic product (GDP) growth through 2001, following robust gains in the first half of 2000. Current conditions might be called a "soft landing," in which real GDP growth slows to a sustainable noninflationary rate of 2.5 to 3.5 percent, and unemployment hovers around recent rates.

Although the current macroeconomic environment might appear to be the best of all possible worlds, areas of concern exist. One is that sustained prosperity tends to foster higher levels of risk taking, overconfidence, and complacency. For example, the turmoil in world foreign exchange and financial markets during 1997 and 1998 illustrates how dramatic imbalances can develop and trigger disruptive adjustments even during healthy economic times.

Currently, no specific situation or imbalance seems to threaten the viability of the expansion. However, as detailed below, several likely will contribute to slower economic growth. Situations that warrant monitoring include the following:

- The repercussions from higher energy prices are unfolding. Historically, oil price shocks have weakened several other long-lived economic expansions.

- Short-term interest rates rose over the past year while longer-term rates declined, resulting in a modest inversion of the yield curve. This relationship may inhibit the profitability of some lenders' practice of borrowing short term and lending longer term and also complicate the interest rate risk management process for some insured institutions.

- Continuing low unemployment suggests that demand for additional workers will go unfilled, thus limiting economic growth or triggering bidding wars that increase workers' compensation and, potentially, inflation.

- Stock market sentiment is no longer strongly bullish. A pullback from high valuations and optimism could trigger negative repercussions on consumers' net worth and spending as well as on the level of business investment.

- A large international trade deficit and strong U.S. dollar may be an unsustainable combination over the

long run. Meanwhile, repatriated profits of U.S. corporations are being trimmed by the dollar's strength relative to the euro and other currencies.

- Household debt burdens are historically high, with leverage rising the most in recent years among low- and middle-income households. These households' access to credit has increased as lenders competed more fiercely for customers.

- Corporations are more highly leveraged, and potential default risk rose in the past year across a range of industries. Meanwhile, downgrades of publicly traded corporate debt issues are exceeding upgrades by a 2 to 1 ratio.

- In some metropolitan areas, overheated housing markets are developing, in which home prices are rising dramatically and exceeding gains in median incomes.

- Potential signs of excess commercial real estate construction are appearing in several urban areas where banks' construction loan growth also is strong.

Economic indicators of what lies ahead are not clear-cut, and each possible scenario contains a set of potential challenges for insured institutions and regulators. Should economic growth slow considerably, current vulnerabilities, such as highly leveraged borrowers' debt loads and overheated housing markets, could worsen significantly. As evidenced by the rash of bank failures during the 1980s, it doesn't always take a national recession for problems to develop. Alternatively, sustained rapid growth might foster new vulnerabilities and allow current imbalances to intensify or build up. For example, speculative construction could accelerate, stock market volatility could increase, or ballooning trade deficits could generate turmoil in foreign exchange markets.

Signs of Strain Are Also Appearing amid Healthy Banking and Thrift Industries

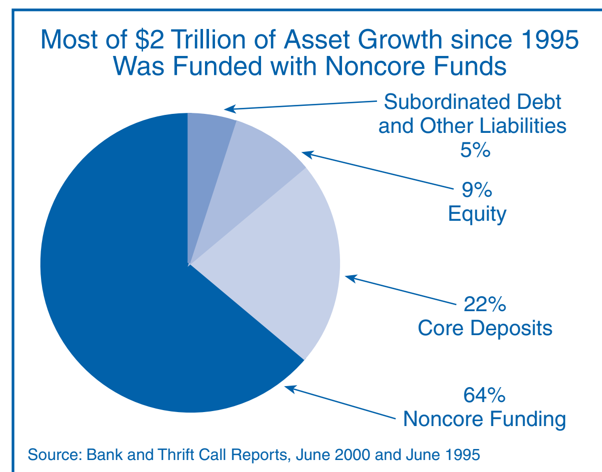
With the long economic expansion as a backdrop, insured institutions in the aggregate are performing very well. However, the record profits attained in recent years may not be sustainable. The losses posted recently by several large institutions are striking examples of increased appetite for risk resulting in significant financial loss during a period of strong economic growth. While these are isolated instances, they are indicative of the increasingly competitive environment facing the financial services industry.

Overall industry profitability is beginning to soften, led primarily by rising commercial loan losses at large institutions and declining net interest margins in institutions of all sizes. Credit card loss rates, which had been steadily falling since late 1997, have stalled in recent quarters, suggesting that recent increases in interest rates and energy costs not only are affecting businesses but also are taking a toll on some consumers. Other signs suggesting that aggregate risk within the system has risen include the growing reliance on noncore funding to support asset growth, heightened interest rate risk at many institutions, growing concentrations in traditionally higher-risk loan classes, and a shift in institutions' overall asset mix toward higher-risk categories. A brief discussion of these risks follows.

Funding Patterns Heighten Liquidity Concerns

Lackluster core deposit growth is placing pressure on bank earnings and contributing to rising liquidity risk in the banking system. During the past five years, the compounded annual rate of core deposit growth for all insured institutions was just 2.8 percent. Assets over this time grew at a 6.6 percent rate. Accordingly, a significant portion of the industry's growth has been funded by noncore sources (see Chart 1). The higher cost and rate sensitivity of these funds put downward pressure on net interest margins, particularly in a rising rate environment.

CHART 1



To compensate for higher funding costs, the industry has pursued growth in higher-yielding asset classes that are traditionally both riskier and less liquid. For example, almost 37 percent of the asset growth in the past five years has come from nonresidential real estate and commercial and industrial loans.

For institutions that fund illiquid assets with wholesale sources, any adverse events that trigger a lack of confidence in the institution may result in higher funding costs, thus placing further pressure on margins. In efforts to obtain funding, an institution also may pledge a greater portion of its best quality assets as collateral, further reducing liquidity. Finally, in instances where funding needs have exceeded available liquidity, the forced sale of illiquid assets to meet funding outflows could result in losses if market conditions are unfavorable. Presumably, the FDIC, as insurer, would suffer greater losses if such an institution failed, because it would be relying on proceeds from the liquidation of less liquid, and potentially lower-quality, assets to satisfy the claims of insured depositors.

Subprime lenders, in particular, tend to rely heavily on noncore funding to pursue aggressive growth strategies. Chart 2 illustrates the extent to which noncore funding exceeds the level of liquid assets for this group. The chart suggests the difficulty these institutions may encounter if forced to convert assets to meet funding outflows. Although subprime lenders may use noncore sources to fund riskier assets to a greater extent than the industry at large, this illustration exemplifies a systemic trend that is raising liquidity risk industrywide and is increasing risk to the insurance funds.

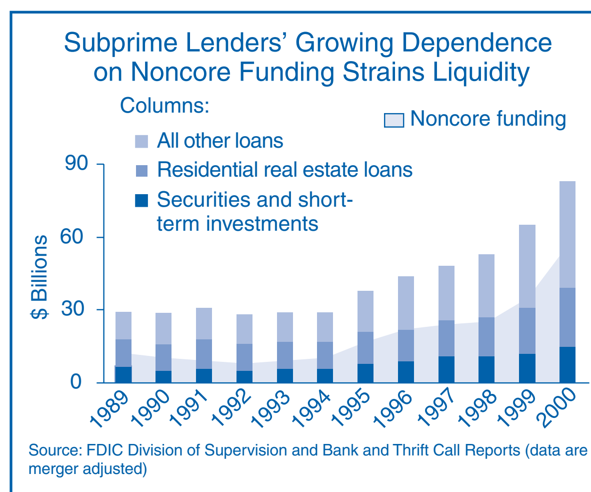
Increasing Levels of Interest Rate Risk Challenge Some Institutions

The refinancing boom of the late 1990s spurred a significant shift into longer-maturity assets for many insured institutions. During this period, a vast majority of mortgage borrowers opted for longer-term, fixed-rate loans, which they obtained at historically low rates. A great deal of the higher-rate or adjustable-rate loans that borrowers refinanced were held in the portfolios of insured institutions, which contributed to a general lengthening of the maturity of assets held at insured institutions.

The trend toward longer-term, fixed-rate assets has been particularly pronounced among mortgage lenders. For example, state-chartered savings banks, which are traditionally mortgage lenders, have experienced a dramatic increase in long-term assets. As of June 30, 2000, almost 45 percent of the median savings bank's earning assets were not scheduled to reprice for five years or longer (see Chart 3).

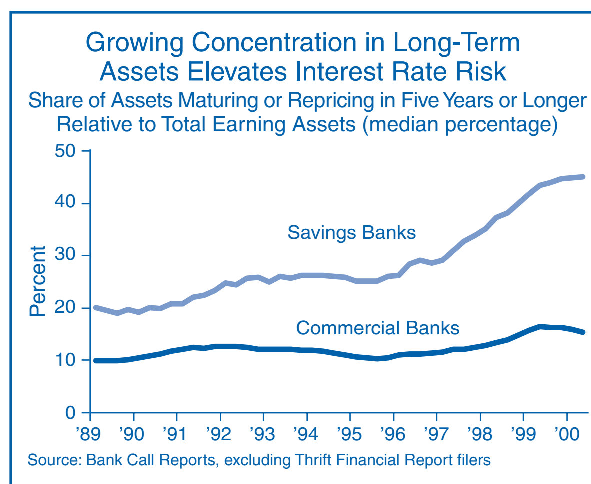
Fixed-rate mortgage-related assets at federally chartered thrifts have risen similarly. From year-end 1995 through first quarter 2000, the percentage of fixed-rate mortgage-related assets at thrifts with assets less than $1 billion rose from 49 percent to 60 percent of mortgage-related assets. Some thrifts and savings banks, therefore, have significant exposure to rising rates from low-yielding long-term assets.

Chart 2



Source: FDIC Division of Supervision and Bank and Thrift Call Reports (data are merger adjusted)

Chart 3



Source: Bank Call Reports, excluding Thrift Financial Report filers

While most commercial banks do not have as high exposure to rising rates as savings banks, some may have taken on significant risk. The median savings bank has a ratio of long-term assets to earning assets that corresponds to the ratio level for the 93rd percentile of commercial banks. Although the 93rd percentile is in the tail of the commercial bank distribution, almost 600 commercial banks have a concentration in long-term assets that exceeds that of the median savings bank. These institutions may be exposed to significant interest rate risk as well.

While assets have lengthened considerably for many institutions, there has not been a corresponding extension of liabilities. To the contrary, funding pressures are tending to make bank liabilities more rate sensitive. These diverging trends generate concern, especially in a rising interest rate environment. That is, rate increases drive up the cost of funds more rapidly than earning asset yields at institutions with liability-sensitive interest rate risk postures. In a significantly higher interest rate environment, many institutions' current postures likely would cause heavy margin erosion.

Most institutions that have high concentrations in long-term assets also have strong capital and an asset mix that contains lower credit risk than that of many other institutions. Among savings banks, interest rate risk primarily arises from significant concentrations in residential mortgage loans, whereas the typical commercial bank's exposure is more likely to arise from large holdings of long-term securities. However, some institutions with concentrations in long-term assets also may have lower capital levels, a higher-risk asset mix, or poor earnings. Rising rates could weaken these institutions and make it more difficult for them to weather adverse economic or other developments.

Dependence on Market-Sensitive Revenues Increases Earnings Volatility for Some Institutions

During the recent generally favorable conditions in financial markets, the share of revenue earned from business lines susceptible to financial market volatility has increased substantially for some of the industry's largest institutions. Among these revenue sources are fees and gains from asset management, brokerage, investment banking, venture capital, and trading activities. The 19 institutions most active in these lines of business earned over 26 percent of their net operating income from such sources in the second quarter of 2000. Other large institutions also have reported a growing dependence on these volatile sources of revenue.

Turbulence in the financial markets has led to greater earnings volatility for some of these institutions. Stress in the financial markets could weaken the demand for underwriting services or significantly reduce trading revenues or venture capital gains. Furthermore, the same factors that are causing volatility in the financial markets could hamper loan growth and lead to slower revenue growth from core business lines. Should increased earnings volatility from exposure to market-sensitive revenues combine with slower revenue growth from core business lines, some institutions could face significant earnings challenges.

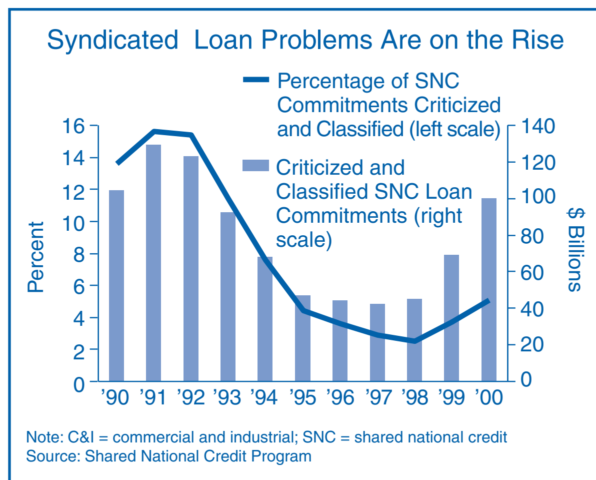
The Rising Level of Problem Business Loans Is Centered in Large Banks

Second quarter 2000 commercial and industrial (C&I) credit quality indicators at banks deteriorated for the eighth consecutive quarter. Noncurrent C&I loans—those on nonaccrual status plus those 90 days or more past-due—rose 13 percent over first quarter 2000 levels to $14.5 billion, or 1.4 percent of total C&I loans. Noncurrent loan levels for the period ending June 2000 were 40 percent higher than the year-earlier level. Net C&I loan loss rates also continue to edge higher but remain well below those experienced by banks in the late 1980s and early 1990s.[1]

Large banks, particularly those active in syndicated lending, are bearing the brunt of deteriorating C&I loan quality. Recent increases in criticized and classified shared national credits (SNCs), which are loans exceeding $20 million that are shared among three or more lending institutions, are illustrated in Chart 4. In the 2000 SNC review, criticized and classified credits increased 44 percent over 1999 levels to 5.1 percent of total SNC commitments. Furthermore, the bulk of the increase was in the more severe *classified* categories, which now comprise 64 percent of total criticized and classified credits, compared with 54 percent at the year-earlier review.

[1]During second quarter 2000, banks posted an annualized net C&I loss rate of 0.67 percent, up from 0.55 percent for second quarter 1999. For comparison purposes, net quarterly annualized C&I loss rates averaged 1.11 percent from fourth quarter 1991 to fourth quarter 1993.

Chart 4



C&I loan quality indicators continue to deteriorate despite generally favorable economic conditions. Three factors explain much of this deterioration: certain weak industries, rising corporate debt burdens, and the seasoning of syndicated loans underwritten from 1997 to 1998, when many banks significantly eased business lending standards.

Industry Sector Weaknesses

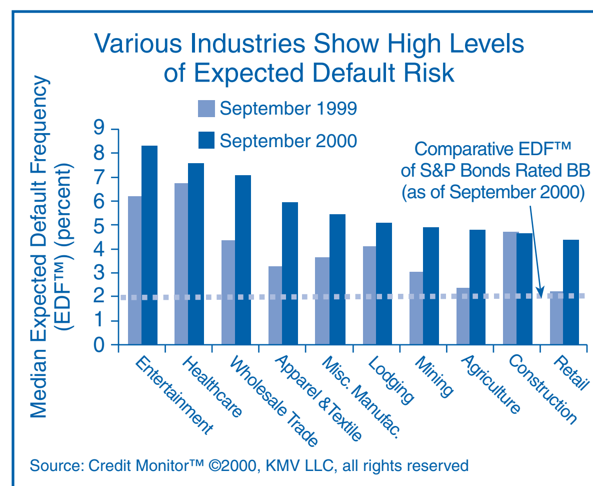
The financial stresses facing healthcare and entertainment companies (cinema operators in particular) have been well publicized. While the healthcare and entertainment sectors have contributed significantly to the decline in commercial credit quality, problems within these two sectors do not account for the full extent of the increase in noncurrent loans and problem SNC loans. Both of these sectors are within the broader services sector, which experienced a $4.6 billion increase in criticized and classified credits from the 1999 to the 2000 SNC review. However, this increase accounts for only 15 percent of the $30.8 billion increase in criticized and classified SNCs overall.[2] The expected default probabilities evident in market-based information can be used to identify other industry sectors experiencing financial stress. ***KMV LLC*** has developed a model that uses publicly available information to estimate the likelihood of default of individual firms.[3] KMV's model is used by many lenders to monitor and evaluate obligor risk and credit risk trends. Applied to the analysis of industries, the output of KMV's model is just one of a number of indicators that suggest weaknesses in certain industry sectors.

Sectors that include a high proportion of firms with high default probabilities (median one-year default probabilities exceeding 4 percent) are shown in Chart 5. Using entertainment as an example, the bars in the chart show that in September 2000, one-half of publicly held entertainment firms had greater than an 8 percent chance of defaulting on their obligations within one year. In September 1999, this same proportion of entertainment companies had a substantially smaller (6 percent) chance of defaulting within a 12-month period. The median likelihood of default for all the industries shown in the chart far exceeds that of ***Standard & Poor's***-rated, BB-grade (sub-investment-grade) obligors as of September 2000, as indicated by the dotted line in the chart.

Rising Corporate Debt Burdens

U.S. corporate debt burdens, as measured by the debt-to-net-worth ratio for nonfarm, nonfinancial businesses, continue to increase. This ratio reached 83 percent in the second quarter of 2000, up from 72 percent as of year-end 1996. Although debt burdens remain below the 1988–1992 average of almost 87 percent, U.S. businesses are nevertheless becoming increasingly vulnerable to rising credit costs and disruptions in credit availability.

Chart 5



---

[2] See the interagency release of SNC results at www.occ.treas.gov/ftp/release/2000-78a.pdf.

[3] KMV Credit Monitor® uses information from a firm's equity prices and financial statements to derive KMV's Expected Default Frequency (EDF™), which is the probability of the firm defaulting within a one-year period. The main determinants of a firm's likelihood of default: the firm's asset value, the volatility of the firm's asset value, and the degree of financial leverage.

Seasoning of 1997–1998 Vintage Loans

Results of recent supervisory surveys suggest that banks are tightening terms and conditions on loans to small-, middle-, and large-market obligors. However, this tightening follows a relaxation of standards in prior years that has contributed to a heightened level of risk in banks' loan portfolios.[4] Not coincidentally, the period between 1995 and 1998 saw a sharp rise in the proportion of lower-graded, higher-risk credits categorized as leveraged transactions by ***Loan Pricing Corporation.*** Leveraged loan originations—those priced at 150 basis points or more over the London Inter-Bank Offer Rate (LIBOR)—rose from 12 percent of total syndicated loan originations in 1995 to 31 percent in 1999. According to a recent ***Standard and Poor's*** commentary, many banks have acknowledged that 1997 and 1998 vintage credits are beginning to produce higher problem loan levels.[5]

Household Sector's Leverage Is High, and Imbalances Are Appearing

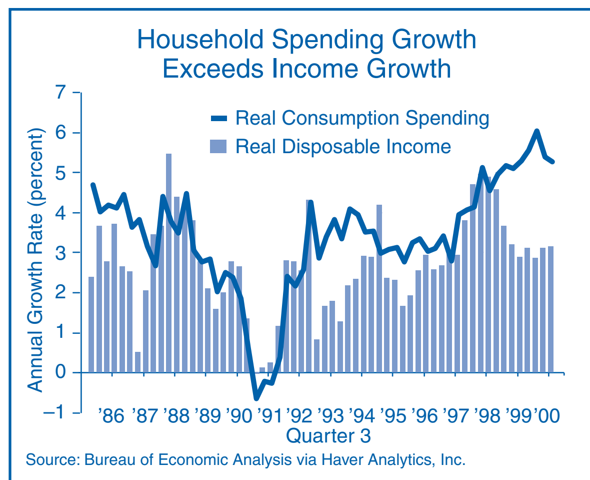
Consumers are enjoying the benefits of the economic expansion, as jobs are plentiful, home ownership remains generally affordable, and credit seems to be readily available for financing motor vehicles and other major purchases. These conditions contributed to record high sales of cars and light trucks during the first nine months of 2000, helping sustain the consumer spending growth shown in Chart 6. One corollary of high vehicle sales, however, is softening prices for used vehicles. Consequently, some lessors—including banks—are realizing lower-than-expected residual values on leased vehicles, which, in turn, are triggering losses in their lease portfolios. This situation illustrates one problem that lenders can encounter even in good economic times.

Spending growth remained robust in recent quarters even as gains in disposable income slowed. The gap between income and spending growth is "financed" as households draw down savings, tap capital gains, refinance mortgages, assume more debt, or undertake some combination of these measures.

[4] See Federal Reserve Board's *Senior Loan Officer Opinion Survey on Bank Lending Practices for May and August 2000* and Surveys of Credit Underwriting Practices for 1999 and 2000 from the Office of the Comptroller of the Currency.

[5] "U.S. Bank Loan Portfolios Reflect Rise in Corporate Bond Defaults." July 20, 2000. *Standard and Poor's Commentary*.

CHART 6



Source: Bureau of Economic Analysis via Haver Analytics, Inc.

From 1995 through 1998, and likely since then, the increase in both leverage and debt servicing burdens has been concentrated among low- and middle-income households. Among families holding debt in 1998, debt payments exceeded 40 percent of disposable income for nearly 20 percent in the $10,000 to $24,999 income group and nearly 14 percent in the $25,000 to $49,999 group.[6] One concern is that these debt-laden families may have inadequate financial resources to make payments should adverse conditions or job loss occur. In such instances, lenders could be doubly affected if households draw on their credit card and home equity lines of credit, further compromising their repayment ability, in order to sustain spending in excess of income. The recent rise in credit card losses in banks' card portfolios and rising losses in the portfolios of subprime lending specialists may indicate that strains among some households are spilling over to lenders. ***Moody's Investors Service*** expects credit card losses to rise through 2001, according to a recent analysis of prospects for the U.S. credit card industry.

Overheated residential real estate markets in several metropolitan statistical areas (MSAs) may be another warning of economic imbalances. Dramatic gains in home resale prices in San Francisco stand out (see Chart 7), but this market is not alone in experiencing appreciation considerably higher than income growth. In some markets, where financial-services or information-technology workers are concentrated, bidding wars for properties may reflect the fact that affordability is

[6] Kennickell, Arthur B., Martha Starr-McCluer, and Brian J. Surette. January 2000. "Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances." *Federal Reserve Bulletin.* Vol. 86, 1–29.

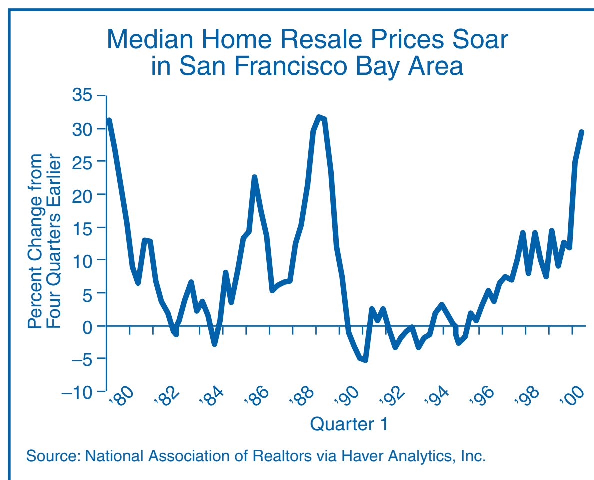
enhanced by gains in wealth rather than in income. Even so, similar surges in home resale prices in the past often were not sustainable. The subsequent years of stagnant or falling collateral values caused financial stress among some homeowners and their lenders. Further concern about residential real estate lenders arises because pockets of speculative construction under way in some markets may produce units that become increasingly difficult to sell at anticipated asking prices.

Construction and Development Loan Growth Is Accelerating

Commercial real estate (CRE) construction across all property sectors has grown during this expansion, with office construction particularly active. The amount of office space completed in mid-2000 was the largest since 1989 and is projected by ***Torto Wheaton Research*** to continue rising. Not surprisingly, construction and development (C&D) loan volume, growth rates, and concentrations are trending upward rapidly. While total private real estate spending grew about 6.5 percent over the four quarters ending midyear 2000, C&D loans at insured institutions rose by 26 percent. C&D loan growth has remained above 20 percent since 1997, and the aggregate volume of C&D loans is the highest since 1989.

Such growth is contributing to higher concentrations of C&D loans relative to Tier 1 capital. At current levels, concentrations do not begin to approach those of the late 1980s. However, several metropolitan areas have a large percentage of insured institutions reporting high and rising concentrations. Table 1 (next page) shows MSAs with at least 15 nonspecialized community banks[7] and at least one-third of those institutions reporting concentrations in C&D loans equal to at least 100 percent of Tier 1 capital. The Atlanta MSA stands out. Sixty-five percent of Atlanta's 85 nonspecialized community institutions reported C&D loans exceeding 100 percent of Tier 1 capital on June 30, 2000, and 35 percent reported a concentration exceeding 200 percent. The aggregate C&D concentration for all 85 institutions in the MSA was 156 percent, the highest among MSAs with at least 15 institutions of similar size and nature. Several other markets also include significant shares of institutions with high concentration levels.

Chart 7



Source: National Association of Realtors via Haver Analytics, Inc.

Nine of the 16 markets highlighted in Table 1 not only have a relatively high percentage of C&D loan exposure but also appear vulnerable to overbuilding in two or more property types.[8] While these markets show no clear signs of emerging economic stress, lenders there clearly may be at greater risk should economic or real estate conditions sour. Other concerns regarding CRE lending arise from a recent ***Office of the Comptroller of the Currency*** survey, which reports heightened credit risk in CRE portfolios and predicts it will increase through 2001. In addition, respondents to a midyear 2000 FDIC survey of examiners reported more frequent comments about excess office and retail space.

Increasing Share of De Novo Institutions Raises the Stakes in Some Markets

A common element among the metropolitan markets listed in Table 1 (next page) is the presence of newer institutions. In 10 of the 16 markets, at least 20 percent of the nonspecialized community institutions are less than three years old. The drive to build market share among these institutions, particularly if they are publicly traded entities, is increasing the competitive pressure on banks and thrifts in these markets. In some instances, the aggregate cost of deposits within the MSAs has risen faster than in the nation as a whole, risk

[7] The term "nonspecialized community bank" refers to institutions with total assets under $1 billion that are not specialty institutions such as credit card or trust banks.

[8] See "Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding," *Regional Outlook,* third quarter 2000, which identifies markets where new construction is high relative to existing stocks of space.

Table 1

High C&D Loan Exposure Appears in Various MSAs		
MSAs with 15 or More Nonspecialized Community Institutions*	Share (%) of Institutions* with C&D Concentrations > or = 100% of Tier 1 Capital	Aggregate C&D Loans Relative to Aggregate Tier 1 Capital (as %) in This MSA*
Atlanta, GA	**65**	**156**
Phoenix–Mesa, AZ	**56**	**131**
Memphis, TN–AR–MS	52	154
Portland–Vancouver, OR–WA	**47**	**146**
Oakland, CA	47	163
Nashville, TN	44	103
Riverside–San Bernardino, CA	42	110
San Diego, CA	41	90
Grand Rapids–Muskegon–Holland, MI	40	81
Seattle–Bellevue–Everett, WA	**39**	**98**
Salt Lake City–Ogden, UT	**38**	**56**
Fort Worth–Arlington, TX	**38**	**110**
Dallas, TX	**36**	**95**
Las Vegas, NV–AZ	**35**	**119**
Lexington, KY	34	80
Denver, CO	**33**	**113**

*Sample includes institutions with total assets under $1 billion that are not specialty institutions such as credit card or trust banks.
Note: Boldface indicates major MSAs identified at risk for excess commercial real estate construction in Regional Outlook, third quarter 2000.
C&D = construction and development, MSA = metropolitan statistical area
Source: Bank and Thrift Call Reports for June 30, 2000

profiles are being elevated, and aggregate leverage ratios are falling, despite the influx of capital from the new institutions. Highly competitive environments have the potential to increase risk taking by negatively affecting underwriting standards and balance sheet composition.

Farm Sector Challenges Continue

Much of the agricultural industry is experiencing stress because of low commodity prices, compounded in some areas by low yields resulting from weather- or disease-related problems. Strong global competition and high worldwide production during the past several years have resulted in large crop inventories, depressed prices, and limited prospects for a price turnaround in the near term. In the aggregate, record levels of government payments have helped the nation's farms maintain a generally stable financial condition but have not eliminated the stress in this sector. In fact, the ***U.S. Department of Agriculture*** projects that at least one in four farm businesses in several regions[9] will not cover net cash expenses in 2000, suggesting that the viability of highly leveraged farmers may be in question.

Fortunately, the aggregate condition of nearly 2,100 insured agricultural banks—institutions with 25 percent or more of loan portfolios in agricultural credits—remains healthy. Generally, agricultural banks continue to report favorable asset quality, earnings, and capital positions. However, they are experiencing somewhat elevated levels of noncurrent loans compared with nonagricultural institutions. Agricultural banks are disproportionately represented among the weakest 25 percent of institutions nationwide in terms of noncurrent

[9] These are USDA's Basin and Range, Mississippi Portal, Fruitful Rim, and Southern Seaboard regions. See www.ers.usda.gov/briefing/farmincome/fore/regional/regional.htm.

loan levels. In addition, rising levels of carryover debt at farm banks may translate into higher losses in the future if commodity prices remain low.

The strains in the farm sector also have implications for nonfarm banks in agricultural areas. In several agriculture-dependent states, such as Montana and the Dakotas, for example, where farmers' earnings are depressed and the economies not well diversified, nonagricultural banks are reporting higher noncurrent levels than insured institutions elsewhere in the nation.

Summary

The long-lived economic expansion has contributed to the banking and thrift industries' record levels of profitability and asset quality. However, as the expansion has matured, both consumer and corporate leverage has risen considerably. Bank liquidity is becoming increasingly strained by lackluster core deposit growth, which has been insufficient to fund strong loan demand. This trend has resulted in a decided shift into higher-risk asset classes to mitigate margin pressures arising from the greater reliance on noncore-funding sources. Furthermore, interest rate risk has risen significantly for many institutions, and after nearly a decade of improving asset quality, the level of problem loans is increasing.

Clearly, high levels of profitability in recent years have been achieved, in part, by an increased appetite for risk. Concern arises because insured institutions' current profitability is being negatively affected by some recent trends, despite the sustained economic expansion. And, while capital levels have remained fairly stable, the amount of risk being leveraged on the industry's capital base is on the rise. Just as a rising tide is said to float all boats, a strong economy can mask potential problems that will become evident should the economic tide turn, particularly in institutions or markets where above-average risk is concentrated. Insured institutions' safety and soundness may be most vulnerable in situations where banks and thrifts are exposed to multiple challenges, whether because of strategic decisions or because of repercussions from economic and banking forces beyond their control.

Daniel Frye, Regional Manager
Joan D. Schneider, Regional Economist
Steve Burton, Senior Banking Analyst
Allen Puwalski, Senior Financial Analyst
Ronald Spieker, Chief, Regional Programs and Bank Analysis

The authors would like to acknowledge the Washington and regional staff of both the Division of Insurance and the Division of Supervision for their analyses and comments, which were instrumental in writing this article.

Subscription Form

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

Institution Name ____________________

Contact Person ____________________

Telephone ____________________

Street Address ____________________

City, State, Zip Code ____________________

Please fax or mail this order form to:

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

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

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

Federal Deposit Insurance Corporation
Washington, DC 20429-9990

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE, $300

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