Regional Outlook

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FDIC
CHICAGO
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DIVISION OF
INSURANCE

SUZANNAH L. SUSSER,
REGIONAL MANAGER

JOAN D. SCHNEIDER,
REGIONAL ECONOMIST

RONALD W. SIMS, II,
FINANCIAL ANALYST

In Focus This Quarter

◆ ***High Loan-to-Value Lending: A New Frontier in Home Equity Lending***—**High loan-to-value home equity loans have grown in popularity as consumers have sought ways to consolidate credit card debt and lenders have sought ways to deal with declining profit margins on traditional home equity loans. High loan-to-value loans pose unique risks for lenders because of their hybrid nature: they combine characteristics of both a secured home equity loan and an unsecured consumer loan. Losses on such loans are increasing rapidly, and the current rate of loss raises concern about how these loans might perform in an economic recession.** *See page 4.*

By Diane Ellis

◆ ***Commercial Development Still Hot in Many Major Markets, but Slower Growth May Be Ahead***—**Following the experience of the 1980s, the threat of an oversupply of commercial real estate is watched with keen interest by market participants and observers alike. This article highlights nine metropolitan areas that may be vulnerable to overbuilding based on the rapid pace of development occurring within those markets, various indicators of current and prospective demand, and projections by credible industry analysts. These concerns could be mitigated to the extent that reduced credit availability within the capital markets leads to a slowing in construction activity.** *See page 11.*

By Steven Burton

◆ ***Recent Trends in Syndicated Lending***—**A strong U.S. economy, intensifying lender competition, and increasing marketability of bank loans have driven record volumes of syndicated lending in the 1990s. These factors led to several years of liberalized underwriting in the syndicated market. While evidence suggests that some banks have tightened standards and terms for loans to large commercial borrowers, market developments and underwriting trends over the past several years have implications for credit quality, earnings, and liquidity at institutions that hold or originate syndicated loans.** *See page 19.*

By Steven E. Cunningham, Ronald L. Spieker

Regional Perspectives

◆ ***Economic and Banking Overview: Third Quarter***—**The Region's economy showed some signs of weakening toward year-end 1998. Unemployment rates edged up in most states, and output fell in several important manufacturing industries. Meanwhile, farm income was trimmed by low commodity prices and farmland prices were softening. Such developments raise questions about the strength of the Region's economic growth in the coming year.** *See page 25.*

◆ ***Rapid Commercial Real Estate Loan Growth Is Prevalent***—**In the commercial real estate (CRE) sector, CRE loans rose rapidly over the past year at a third of the Region's community banks, even though signs of surplus space may be appearing in some markets. Over half of these institutions also held high concentrations of CRE loans in their portfolios.** *See page 27.*

◆ ***Financial Market Turmoil Highlights Risk Management Practices***—**Aggregate performance measures for banks and thrifts in the Region remained favorable in the third quarter. However, the repercussions for banks and their customers from recent financial market turmoil highlight the need for sustained monitoring of banks' risk management, underwriting standards, and other practices. Insured institutions may face increasing challenges to earnings and credit quality should financial markets remain unsettled or should economic conditions deteriorate as 1999 unfolds.** *See page 29.*

By the Chicago Region Staff

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The National Edition of the Regional Outlook is now available

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I am pleased to announce the first publication of the *Regional Outlook National Edition.* Since its inception, the *Regional Outlook* has been published quarterly in eight separate volumes that were tailored specifically for each FDIC Region. This format was ideal for the reader who wanted detailed analysis of a specific Region.

Beginning this quarter, the FDIC will publish in a single volume the highlights of our Regional analysis of trends affecting FDIC-insured institutions across the United States. The eight unabridged Regional editions will continue to be published for readers who want more detailed information about trends in their Regions. All editions will continue to offer the In Focus series of articles on trends affecting the risk exposures of FDIC-insured institutions.

For example, this quarter the In Focus series highlights important trends affecting commercial lenders and consumer lenders. The Regional Perspectives articles explore in more detail how these and other trends may affect FDIC-insured institutions around the United States.

Both the Regional and National editions are available by subscription or on the FDIC's website at www.fdic.gov. As always, we welcome your comments on the content or format of this publication. Please refer to the back cover and inside the front cover for information about how to subscribe or comment.

Sincerely,

George French
Executive Editor

High Loan-to-Value Lending: A New Frontier in Home Equity Lending

- **High loan-to-value (HLTV) loans are typically junior liens on owner-occupied single-family residences, but there is limited collateral protection because the combined loan amounts often exceed the value of the home.**

- **Nonbank, specialty lenders have dominated this line of business, and their growth has been fueled by strong demand for asset-backed securities collateralized by HLTV loans.**

- **Insured depository institution involvement in HLTV lending has been increasing, and opportunities for further involvement opened up when market turmoil resulted in a contraction of HLTV specialists.**

- **HLTV lending involves unique risks because it combines characteristics of both secured home equity lending and unsecured consumer lending.**

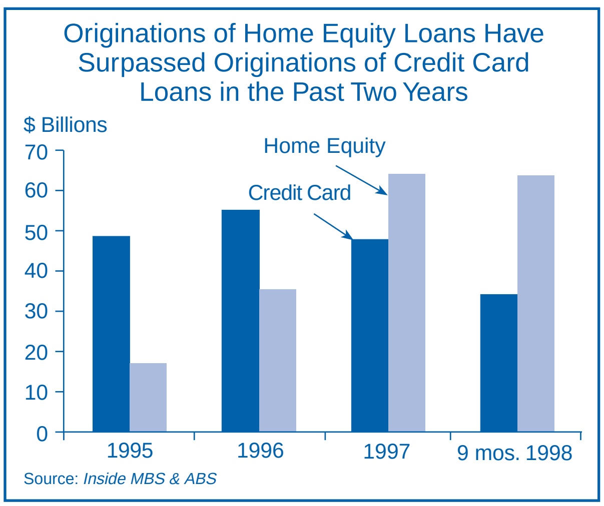
Just a few years ago, it would have been difficult to imagine a mainstream lender writing a home equity loan in excess of the equity that the consumer had in his or her home. However, intense competition and declining profit margins in traditional home equity lending have lenders looking to boost volume and profits by relaxing underwriting standards. At the same time, consumers are signaling their desire to transfer their credit card balances to lower-costing home equity loans. These trends have given lenders, including insured depository institutions, the impetus to enter the HLTV home equity market. Furthermore, new opportunities have opened up for insured depository institutions to get involved in HLTV lending as a result of turmoil in the equity and asset-backed securities market, which resulted in a severe liquidity crisis that effectively sidelined many HLTV specialists.

HLTV Lending Taps Consumers' Desire to Shift Credit Card Debt into Home Equity Loans

For the better part of the 1990s, credit card lending was dubbed the Wild West of consumer credit. This title was earned, in part, by lenders' aggressive marketing and solicitation of their cards and consumers' willingness to push their holdings of credit card debt to record high levels. After several years of double-digit growth in credit card outstandings, the growth has slowed. However, this slowdown does not necessarily mean that the Wild West has been tamed. In fact, home equity lenders are blazing new frontiers in consumer credit. Chart 1 shows that the originations of home equity loans for asset-backed securitizations have surpassed the originations of credit card loans over the past two years.

It could be said that the home equity industry owes its resurgence to the boom in credit card lending that preceded it, because today's home equity borrowers primarily use these loans to consolidate their outstanding debt. A survey by the ***Consumer Bankers Association*** found that, whereas in 1991 home improvement was the primary reason for taking out a home equity loan, debt consolidation is now the primary reason, with 40 percent of borrowers using a home equity loan for this purpose in 1997. This shift also is evidenced by another recent survey by ***Brittain Associates, Inc.,*** which estimated that during a 24-month period ending June 1998, 4.2 million households converted $26 billion in credit card debt to home equity mortgage debt. Given the high levels of credit card debt on households' balance sheets, it should be no surprise that consumers with other borrowing options are looking for ways to consolidate their debt and reduce their borrowing costs.

CHART 1



Source: *Inside MBS & ABS*

HLTV Loans Are Hybrid Loans

HLTV loans are considered hybrid loans and can be thought of as a marriage between secured lending and unsecured credit card loans. HLTV loans are typically junior liens on owner-occupied single-family residences where the combined loan amounts exceed the value of the home—sometimes by as much as 125 to 150 percent. Some lenders also make HLTV first mortgages, which enable consumers to finance their down payment and closing costs and consolidate other debts.

In return for pledging their home as collateral, borrowers are charged lower rates of interest than on unsecured consumer loans. Even at 125 to 150 percent loan-to-value, the rates on HLTV loans generally are lower than credit card loans. In 1997, the average rate on an HLTV was 13 to 14 percent, whereas the average rate on a credit card loan was 16 percent. Because HLTV loans carry lower interest rates and are long-term loans (15 to 30 years), the monthly payment on one is often considerably less than the total monthly payments on the loans that were paid off in the consolidation.

HLTV loans also appeal to consumers because they can benefit from the tax deductibility on a portion of their interest payments. Current IRS rules allow interest to be deducted on that portion of the loan that is equal to or less than the value of the home at the time the loan is closed.

The primary disadvantage of converting unsecured credit card and other consumer debt to an HLTV loan is that in the event of default, the borrower could lose his or her home. However, many consumers burdened by the high cost of unsecured consumer debt apparently have viewed the chance to lower their monthly payments as worth the risk. HLTV loans have been particularly popular in California, where property value declines in the early 1990s left homeowners with little or no equity in their homes. The inset box shows the typical characteristics of an HLTV loan and an HLTV borrower.

Typical HLTV Borrower Characteristics

Annual Income	$60,000
Job Tenure	5 years
Age	Late thirties
FICO Score	680
Outstanding Nonmortgage Debt	$20,000
First Mortgage Amount	$110,000
Property Value	$130,000

Typical HLTV Loan Characteristics

Amount	$30,000
Contract Interest Rate	13 to 14%
Term	25 years
Loan to Value	110%

Notes: HLTV = high loan-to-value; FICO = Fair, Isaac Company
Source: General Accounting Office, based on interviews with public and private officials

Underwriting of HLTV Loans Emphasizes the Borrower's Credit Quality

Because of their limited or nonexistent collateral protection, HLTV loans typically are considered unsecured loans and the emphasis in underwriting is on the borrower's credit quality rather than on collateral value. Large HLTV lenders use credit scoring to underwrite their loans, and a major component of their scoring is a credit bureau or Fair, Isaac Company (FICO) score. Other important factors are the borrower's debt-to-income ratio, mortgage credit history, consumer credit history, bankruptcies, foreclosures, notice of defaults, deeds in lieu of foreclosure, and repossessions.

HLTV loans are not necessarily subprime loans; the term "subprime" refers to the credit quality of the borrower rather than the margin of collateral protection. Instead, many lenders assert that HLTV loans are made to "prime" borrowers and can point to the fact that FICO scores on HLTV loans have been rising, averaging approximately 689 in 1998. Scores above 680 are generally associated with "A" credit quality; however, the average ignores the fact that major HLTV lenders allow FICO scores to go much lower, typically as low as 620.[1] ***Standard & Poor's*** recently reported that performance problems clearly exist on loans for which the borrower's FICO score is below 650.[2]

[1] H.T. Katz and G.T. Costello, Fitch IBCA Credit Rating Company. "Securitization of 125 LTV Mortgages." *Structured Finance Special Report,* March 4, 1998. Underwriting guidelines summary matrices are provided for seven large HLTV lenders.

[2] "High LTV Security Performance Expected to Improve as FICO Scores Rise and FHA Title 1 Loans Disappear." *Inside MBS & ABS,* November 13, 1998, p. 9.

TABLE 1

HLTV UNDERWRITING GUIDELINES					
QUALIFYING PARAMETERS	A+	A	B+	B	C+
FICO SCORE	700+	680–699	660–679	640–659	629–639
MORTGAGE HISTORY (PAST 12 MONTHS)	1x30*	1x30	1x30	1x30	1x30
BANKRUPTCY (YEARS SINCE DISCHARGE)	3	3	3	5	5
MAXIMUM DEBT TO INCOME (%)	50	50	45	45	40
MAXIMUM LOAN TO VALUE	125	125	125	125	125
MAXIMUM CASHOUT	$35,000	$25,000	$15,000	$5,000	$1,000
MAXIMUM LOAN AMOUNT	$100,000	$75,000	$65,000	$45,000	$30,000

* NUMBER OF TIMES DELINQUENT MULTIPLIED BY DAYS DELINQUENT.
NOTE: HLTV = HIGH LOAN-TO-VALUE; FICO = FAIR, ISAAC COMPANY.
SOURCE: THE 10K FILING OF A MAJOR HLTV LENDER.

The agencies that rate asset-backed securities collateralized by HLTV loans offer another perspective on the credit quality of HLTV borrowers. ***Moody's*** has described HLTV borrowers as in the "A–" to "B" grades, and Standard & Poor's has characterized the loans as "A–" to "B+" in terms of credit quality. Any grade below A can be considered subprime. Indeed, according to ***Mortgage Information Corp.,*** the bulk of subprime mortgage activity occurs in the A– category. However, some analysts have preferred to characterize HLTV borrowers as squarely in between the subprime and prime designations.

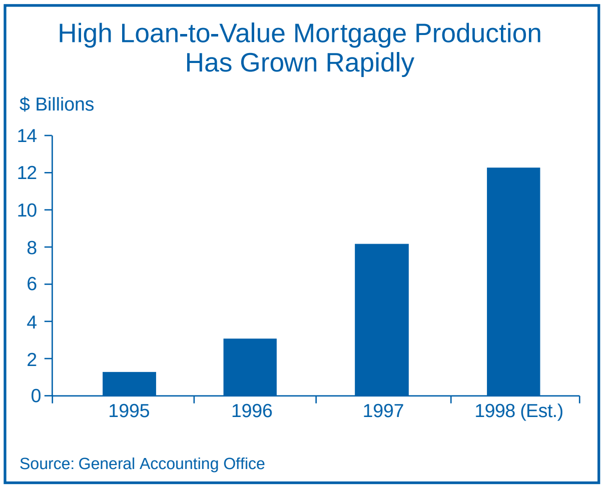
Whatever the label given to the quality of borrowers, they typically have a large amount of high-cost revolving debt, and converting this debt into a second lien on their home is an attractive alternative. They also might have some degree of poor credit performance. Table 1 shows the underwriting criteria used by one of the largest HLTV lenders. Because underwriting classification systems are not uniformly applied among HLTV lenders, this table should be viewed only as a guide.

Fueled by Easy Access to Capital, HLTV Loans Have Grown Rapidly

On the basis of the volume of loans securitized, the HLTV loan market has expanded rapidly over the past several years (see Chart 2). Originations have grown from $1 billion in 1995 to $8 billion in 1997 and are expected to be around $12 billion in 1998.

Nonbank, specialty finance companies presently dominate the HLTV market, and their easy access to capital

CHART 2



has been an important factor behind their growth. These specialists depend on their ability to securitize the loans and sell them in the asset-backed securities market. Strong investor demand for all kinds of asset-backed securities has allowed HLTV lenders to raise a substantial amount of funding without a strong degree of corporate credit quality. However, their reliance on the asset-backed securities market to fund operations exposes them to *liquidity risk* if demand for these securities declines.

A healthy initial public offering market also has fueled the growth of these specialty lenders, and gain-on-sale accounting has allowed lenders to establish an earnings track record and attract debt and equity investors. Gain-on-sale accounting requires securitizers to calculate and record a gain on sale from securitizations; however, the use of gain-on-sale accounting exposes lenders to *prepayment risk.* If the securitized loans prepay at a faster rate than the assumption used to calculate the gain, the company could be forced to take a write-down, which can affect earnings, liquidity, and capitalization. Institutions that invest in securities collateralized by HLTV loans also are exposed to prepayment risk. (For more information on gain-on-sale accounting, see "Gain-on-Sale Accounting Can Result in Unstable Capital Ratios and Volatile Earnings" in ***Regional Outlook,*** second quarter 1998.)

In addition to the easy access to capital, favorable economic conditions also have encouraged HLTV lending. The long economic expansion has brought about the return of home price appreciation to nearly all parts of the country, which has encouraged HLTV lending because rising home values serve to reduce lender and investor exposure fairly quickly. The median sales price of existing single-family residences has increased an average of 4.39 percent per year since 1995, according to the ***National Association of Realtors.***

Market Turmoil Hit HLTV Specialty Lenders Hard

The market volatility that began last summer illustrated the importance of *liquidity risk* and *prepayment risk.* HLTV specialists were faced with a liquidity crunch when they were hit hard in the equity downturn, in many cases significantly harder than the general market. Investors retreated from HLTV lenders and their asset-backed securities, in part as a result of a "flight to quality" as the Asian crisis spilled over into other global markets. A core of investors participating in the HLTV market also exited the market when prepayments occurred at faster rates than anticipated, largely a result of lower market interest rates, and forced lenders to take write-downs of interest-only residuals. Another factor in the investor retreat from this market was the growing skepticism concerning the performance of HLTV loans during an economic downturn.

When investor demand for asset-backed securities dried up, HLTV lenders were unable to securitize their loans profitably. This situation created a severe liquidity crisis for specialty lenders who relied heavily upon this source of funding. As a result, some lenders were forced to put themselves up for sale, and others were forced to undergo massive restructuring.

HLTV Lending Presents Unique Risks to Home Equity Lenders

In addition to the risks associated with the securitization of HLTV loans (liquidity and prepayment risk), HLTV lending poses some unique risks for lenders who hold these loans in their portfolio, service them, or guaranty the performance of asset-backed securities. Because HLTV loans are a relatively new product, their *credit risk* is untested and could be affected by the following factors:

- **Increased rate of default.** Data on the performance of HLTV loans are limited; however, the loss potential is starting to become visible when vintage analysis is performed. Chart 3, next page, shows that when recent vintages are adjusted for seasoning, charge-off rates on HLTV loans are increasing at a rapid rate. Both the severity and frequency of default are much higher than for traditional A-quality home equity loans and are even higher than subprime home equity loans. The fact that charge-offs are higher than subprime loans suggests that the credit quality of HLTV borrowers is not too different from subprime borrowers and that when default occurs, the loss is more severe because of the lack of collateral protection. Lenders who do not accurately forecast the magnitude and costs of default associated with HLTV loans, or who make underwriting mistakes, might find that this line of business is not as profitable as anticipated.

  Lenders that rapidly increase HLTV exposures might consider the use of vintage analysis, also called "static pool" analysis, as a means of evaluating loan portfolio performance. This technique is effective when there is rapid growth, which can make it more difficult to accurately track delinquency and default trends when only an average delinquency or default ratio is calculated. Refer to "Subprime Lending: A Time for Caution" in ***Regional Outlook***, third quarter 1997, for additional discussion on vintage analysis.

- **Untested performance in a recession.** HLTV lending has existed for only a few years and has yet to be tested by economic recession. The rapid rise in charge-offs on HLTV loans has occurred in a relatively robust economic environment, and the losses during an economic downturn could be considerably higher than anticipated. Moody's has asserted that losses will mimic those of credit cards, and losses on credit card loans are usually higher than other consumer mortgage-related products.

HLTV lenders' heavy reliance on credit-scoring models raises further questions about how these loans might perform in a recession because these models are largely unproven in a recession as well. To improve the accuracy of credit-scoring models and the model's ability to appropriately price the risk assumed, lenders can continually test and refine credit-scoring models to ensure that actual performance approximates projections.

Changes in the borrower's financial condition present a greater risk to HLTV lenders than in other types of secured lending, which introduces additional *credit risks.* In the event of default, the lender is likely to suffer a complete loss because foreclosure is probably infeasible and the size of HLTV loans is much larger than other types of unsecured or partially secured loans. Therefore, adverse changes in the borrower's financial condition are very important and can be affected by the following factors:

- **Debt reloading.** The primary reason consumers take out an HLTV loan is to consolidate credit card and other high-cost consumer debt. However, lenders cannot prevent HLTV borrowers from running up additional credit card debt after the loan is made. Consequently, these loans might serve to only postpone or amplify credit problems. A recent survey by Brittain Associates, Inc., indicates that a large percentage of borrowers who take out home equity loans proceed to run up credit card debt shortly thereafter. Their survey of over 6,000 borrowers who used home equity loans to consolidate their debts revealed that only 30 percent of those borrowers remained free of credit card debt one year later.

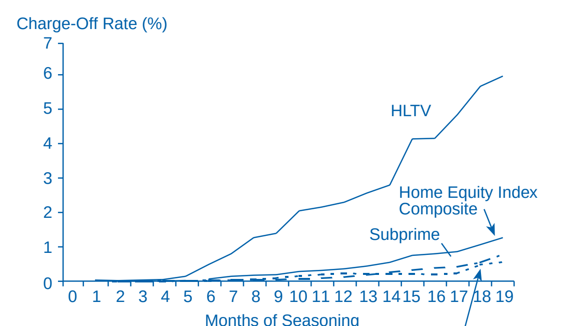
- **Long-term exposure.** Consumer loans typically have been made on a short-term basis; however, HLTV loans are made for terms up to 30 years. Therefore, the credit quality on an HLTV loan is more vulnerable to catastrophic events such as borrower job loss, illness, or divorce. Furthermore, the term of these loans far exceeds the predictive power of FICO scores, which have proven to be predictive for about a two-year period according to Moody's.

Because of their fixed terms and limited collateral protection, there are some unique *operational risks* associated with servicing and collecting an HLTV loan. Servicing and collecting an HLTV loan differs somewhat from servicing and collecting both secured lending and credit card lending because of the following factors:

- **Limited default remedies.** The servicing and collecting of HLTV loans are complicated by the fact that the threat of foreclosure is not as severe as in traditional secured lending. According to Moody's, HLTV lenders must adopt a collection strategy similar to credit card lenders that will require early intervention and the ability to "talk" the borrower into

CHART 3

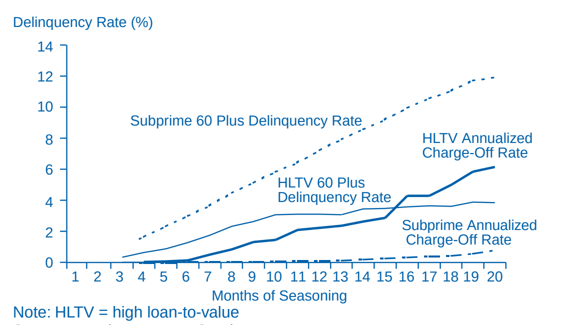
Charge-Offs Are Rising More Rapidly on HLTV Loans Than for Any Other Type of Home Equity Loan (1996 and 1997 Origination Years); ...



Note: HLTV = high loan-to-value
Source: Moody's Investor Services

CHART 4

...However, Delinquency Rates on HLTV Loans Are Lower Than on Subprime Loans Because Loans Are Charged Off Sooner (1996 and 1997 Origination Years)



Note: HLTV = high loan-to-value
Source: Moody's Investor Services

making a payment without resorting to foreclosure. However, unlike credit card lenders, HLTV lenders have less flexibility in collection because lines cannot be adjusted and interest rates cannot be raised. The different demands for servicing and collecting these loans, compared with traditional and subprime home equity loans, could strain institutions that do not have an adequate investment or expertise in collecting these loans.

According to Moody's, HLTV lenders generally write off their loans as a loss once they become 180 days delinquent. In contrast, subprime lenders go through a lengthy foreclosure procedure. The speedier resolution of HLTV loans is reflected in a lower level of delinquencies in HLTV portfolios compared with subprime portfolios (see Chart 4, previous page).

- **Limited borrower flexibility and motivation.** After a borrower has taken out an HLTV loan, opportunities to refinance are limited, and selling the home often is not feasible because of the large amount of cash needed at closing. As a result, counseling borrowers might prove to be harder than in credit card lending. Also, with negative equity in their homes, borrowers might have less incentive and ability to work with the lender to bring the loan current than to allow foreclosure.

Insured Depository Institution Involvement in HLTV Lending Is Increasing

Insured depository institution involvement in HLTV lending reportedly has been growing. Their precise involvement is difficult to quantify because these loans are not delineated in bank or thrift Call Reports. However, one indication of their growing involvement is cited in the Consumer Bankers Association 1998 home equity loan study. Twenty-five percent of respondents to its survey offered home equity loans with loan-to-values in excess of 100 percent, up from only 5.8 percent one year earlier.

Banks and thrifts can become involved in HLTV lending by using a variety of strategies. They can lend directly to HLTV borrowers or purchase HLTV loans from loan brokers and hold them in portfolio. Institutions also can originate the loans and securitize them or sell them to another company that will securitize them. A more indirect way for insured depository institutions to get involved in this market is to lend to HLTV specialty lenders in the form of warehouse lines. Institutions also can service HLTV loans or invest in asset-backed securities secured by HLTV loans.

In light of the contraction of HLTV specialists, the question arises as to whether banks will view this as an opportunity to further expand their presence in HLTV lending, given that consumer demand for these products is still strong. Recent press reports indicate that this is happening, as some insured depository institutions recently have piloted HLTV lending programs by buying loans and keeping them in portfolio.[3] Another way that banks have recently become involved in HLTV lending is by investing in HLTV specialists. Many HLTV specialists have been looking for opportunities to affiliate with firms that have plentiful and stable sources of liquidity ("deep pockets"), and insured depository institutions have been viewed as ideal candidates. Several of the largest HLTV specialists have an insured depository institution as an affiliate.

Insured Depository Institutions Are Subject to Real Estate Lending Standards

Unlike many of the specialty finance companies, insured depository institutions are subject to regulations prescribed by the federal supervisory agencies. In 1992, the federal banking and thrift supervisory agencies finalized a uniform regulation and interagency guidelines for real estate. The regulation, in part, requires institutions to adopt and maintain written policies that establish appropriate limits and standards for all real estate loans, including HLTV loans. When a bank adopts a policy, the regulation requires consideration of the Interagency Guidelines for Real Estate Lending Policies. These guidelines state that institutions should establish their own internal loan-to-value limits for real estate loans; however, they also indicate that the internal limits should not exceed 90 percent on a home equity loan.[4] The guidelines recognize that it might be appro-

[3] Timmons, H. "Banks Poised to Move in as High-LTV Lenders Fall." *American Banker,* October 28, 1998.

[4] The guidelines state, "A loan-to-value limit has not been established for permanent mortgage or home equity loans on owner-occupied, 1- to 4-family residential property. However, for any such loan with a loan-to-value ratio that equals or exceeds 90 percent at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral."

priate to deviate from these guidelines and state that loans made in exception to these guidelines should be identified in the institution's records and reported to the board of directors at least quarterly. Furthermore, the guidelines state that the aggregate amount of all loans in excess of the supervisory loan-to-value limits should not exceed 100 percent of total capital.

Competition from HLTV Loans Is Driving a Loosening in Underwriting on Other Home Equity Loans

Even for insured depository institutions not directly involved in the HLTV market, the competition posed by this product already is evident in the underwriting of other types of home equity products. The Office of the Comptroller of the Currency reported in its latest survey of the 77 largest national banks in the country that underwriting on home equity loans has been loosening for three years, a time period that corresponds with the life of the HLTV market. They reported that in 1998, the percentage of banks tightening standards on credit card loans is nearly matched by the percentage of banks loosening their underwriting standards on home equity loans. Competition was cited as the primary reason for loosening home equity standards, and an easing of collateral requirements was the primary method.

Conclusion

HLTV lending has provided a new option for consumers to work their way out from under burdensome credit card debt. It also has provided lenders with a new and potentially profitable line of business. Insured depository institution involvement in this line of business is growing and could continue to grow, especially if liquidity problems that have affected HLTV specialists continue. As with any line of business, success is dependent upon understanding the particular nature of the HLTV business and making the appropriate commitment of resources and expertise. With HLTV lending, there are unique risks involved because of the compound nature of these loans, which contain characteristics of both a secured home equity loan and an unsecured consumer loan. The risks involved in HLTV lending are further heightened by the fact that the performance of these loans is largely untested in an adverse economic environment.

Diane Ellis, Senior Financial Analyst

Commercial Development Still Hot in Many Major Markets, but Slower Growth May Be Ahead[1]

- **Oversupply within commercial real estate markets typically arises from the difficulty developers face in accurately predicting future demand for a given project, particularly when projections are based on temporary or unsustainable increases in demand. Easy access to investment capital in the form of lower borrowing rates or relaxed underwriting standards can exacerbate the overproduction of space.**

- **This analysis identifies nine major metropolitan markets believed to be vulnerable to broad-based overbuilding.[2] This vulnerability stems from rapid ongoing development across multiple property types, which threatens to outpace absorption or demand levels over the next one to two years. Overbuilding concerns are heightened by cyclical and secular demographic and economic trends that portend lower demand for commercial space.**

- **Trends in the capital markets may have tempered the appetite for further development in some rapidly expanding metro areas. Should such trends continue, construction activity could moderate, thereby mitigating some of the overbuilding concerns expressed in this article.**

Since the boom development years of the 1980s, and the bust that followed, the financial community has devoted considerable resources to analyzing commercial real estate trends. The primary purpose of these efforts is to detect, as early as possible, warning signs of potential imbalances between supply and demand. The markets highlighted in this article are considered vulnerable to possible overbuilding on the basis of various early warning signs. Each of these markets is experiencing rapid commercial real estate development across multiple property types. In addition, each market exhibits one or more of the following characteristics: high vacancy rates relative to the pace of development, declining employment growth trends, declining in-migration trends, projected increases in vacancy rates by credible industry experts, and significant dependence on industry sectors vulnerable to either weak Asian markets or a slowing domestic economy.

The term "vulnerable" is used here to signify a potential, as opposed to a certain, outcome. In previous cyclical downturns, falling commercial real estate values were preceded by economic events that resulted in lower demand: Declining energy prices preceded the mid-1980s decline in Southwestern real estate markets; weaknesses in the financial sector preceded the late 1980s decline in Northwestern real estate markets; and sharp defense cutbacks preceded the early 1990s decline in Southern California real estate markets. It remains to be seen whether weakening Asian markets or prospects for slower economic growth serve as catalysts for slower commercial real estate demand in the current cycle. Whatever the catalyst, markets most affected by a downturn in real estate values will be those in which optimistic expectations, the basis for current construction activity, fall farthest from the mark.

Why Do Markets Become Overbuilt?

Commercial property developers often face substantial lags between a project's conception and its completion: The longer the construction period, the greater the uncertainty surrounding demand projections. These risks can be largely mitigated if the developer enters into presale contracts or preleasing agreements with financially sound parties prior to breaking ground on construction. However, it is not unusual in rapidly developing and highly competitive markets for developers to anticipate or "speculate" what demand levels will be, based on current trends. If the market in question is experiencing a period of temporary or unsustainable growth (a "boom" period, for example), then projections may lead to an overly optimistic outlook for future demand, particularly when forecasts are weighted heavily toward recent rental, sales, and demographic trends. Projection error also arises from

[1] In fall 1998, the FDIC's Division of Insurance published a report ranking the risk of overbuilding within major metropolitan markets (see "Ranking the Risk of Overbuilding in Commercial Real Estate Markets," *Bank Trends,* October 1998). This paper, which was based mainly on market information as of year-end 1997, highlighted six major metropolitan areas where the rapid pace of current construction activities raised concerns over the potential for broad-based overbuilding.

[2] "Broad-based overbuilding" signifies potential overbuilding in two or more of five property types: office, industrial, retail, apartment, and hotel.

the failure to consider competitors' planned development activities.

If a developer's demand projections fail to materialize, the result is an overhang of commercial property beyond what the market can absorb during a reasonable time frame. Easy access to investment capital can exacerbate overproduction of space by reducing or eliminating incentives to make reasoned and prudent investment decisions. Excessive leverage, where the developer has little personal capital at risk on a particular project, is a familiar example often associated with the excessive development of the 1980s. Loan pricing that fails to adequately account for the risks involved in a construction project is another example of how financing incentives could lead to imprudent development decisions.

Ranking the Risks of Overbuilding

The October 1998 ***Bank Trends*** (see footnote 1) study employed a three-step process to rank the vulnerability of markets to possible overbuilding. First, major metropolitan markets were ranked in terms of current construction activity[3] relative to existing space for each of five property types: office, industrial, retail, apartment, and hotel. Second, relative construction activity was compared with current vacancy rates to assess the competitive pressures faced by newly developed projects. Third, market-related research was reviewed to determine which markets analysts considered candidates for possible supply/demand imbalances. Although the same approach was used in this updated analysis, additional factors were considered, including employment and population growth trends, the dependence of rapidly developing metropolitan areas on specific employers or industries, and the relationship between current economic trends and the potential demand for commercial real estate space.

[3] Construction activity generally refers to recent completions plus projects in process of being built. In the case of office and industrial properties, the source of data is ***CB Commercial/Torto Wheaton Research***, and construction activity refers to completions for the last four quarters plus projects under construction. For all other property types, the source is ***F.W. Dodge*** and ***ERE Yarmouth***, and construction activity refers to completions, projects in process of being built, starts, and pending projects.

Most Active Construction Markets

Charts 1 through 5 show the level of construction activity, for each property type, relative to the total stock of space as of June 30, 1998, for the top 15 major metropolitan markets. Although slowing somewhat, development in the Las Vegas market continues to lead all other markets in relative terms for office, industrial, and hotel construction. Las Vegas is also among the most active markets in apartment and retail construction. Other markets experiencing rapid development across multiple property types include Salt Lake City, Charlotte, Atlanta, Portland, Phoenix, Orlando, Dallas, Austin, Nashville, Jacksonville, and Seattle. As the charts show, office, industrial, apartment, and hotel construction activity rose from year-end 1997 levels among a majority of the fastest-developing markets. Retail development, however, appears to have slowed in a majority of the most active development markets during the first half of 1998.

Comparing Construction Activity with Vacancy Rates

Newly completed speculative projects must compete with existing vacant space. Accordingly, it is worthwhile to compare measures of relative construction

CHART 1

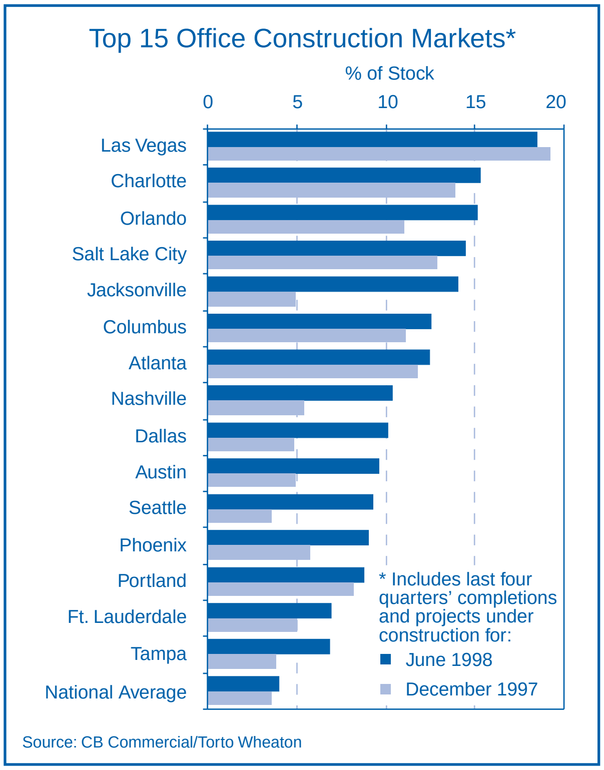


CHART 2

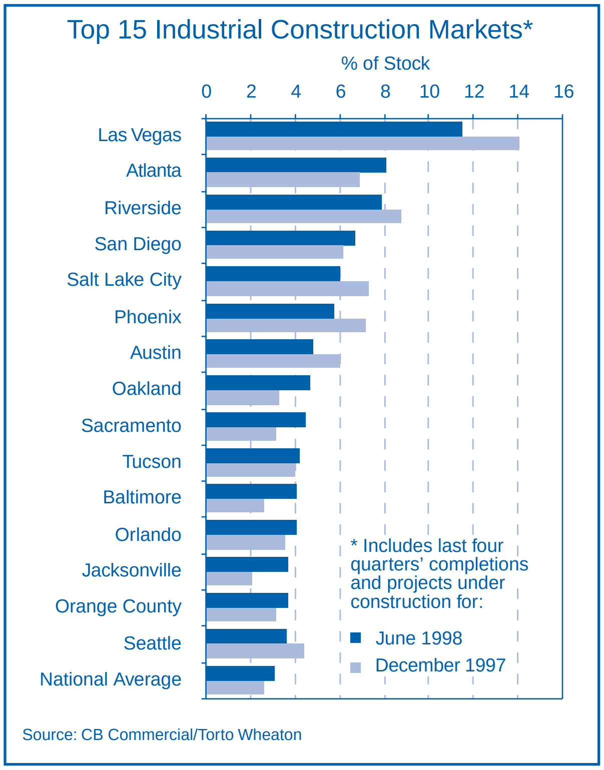


CHART 3

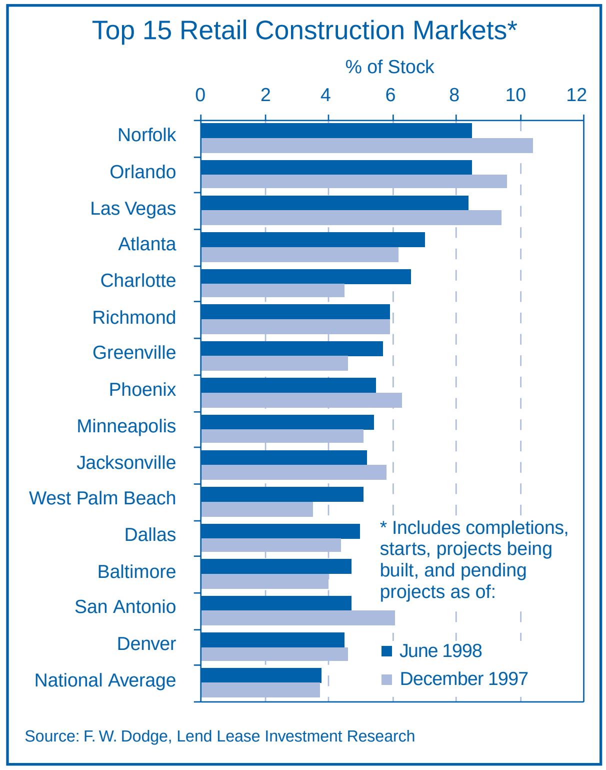


CHART 4

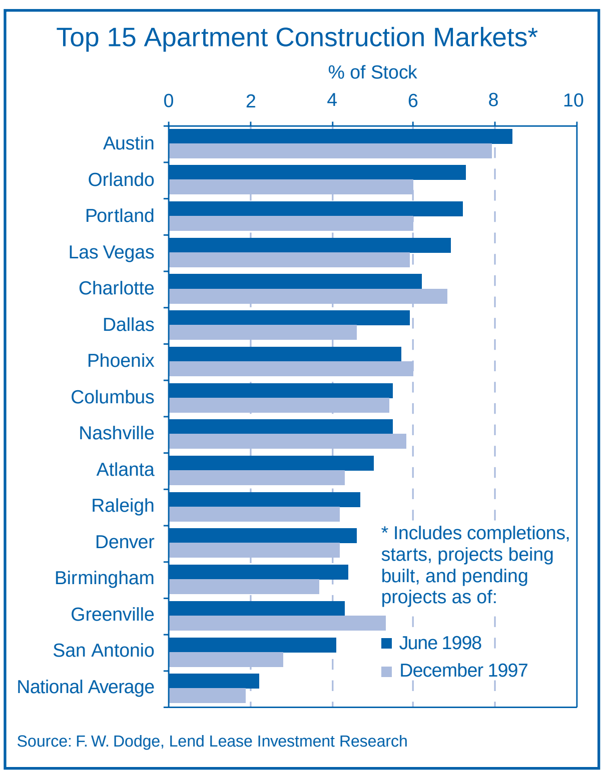


CHART 5

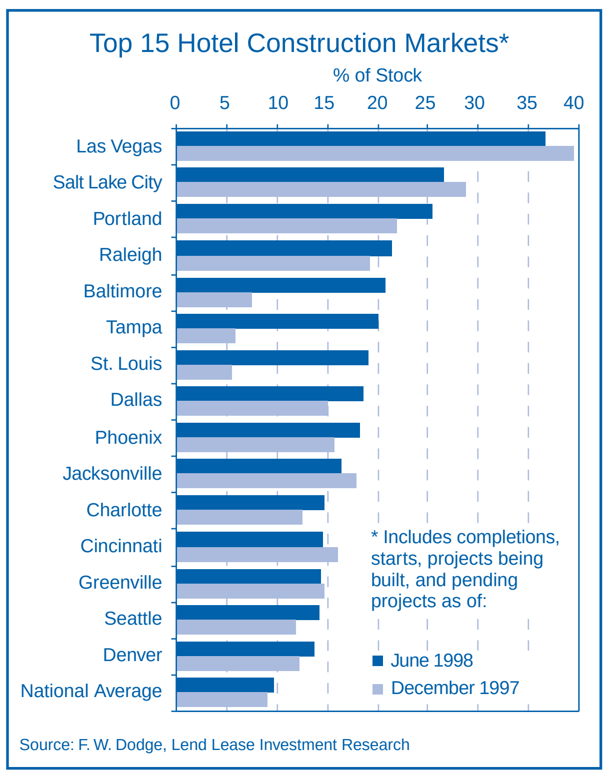


CHART 6

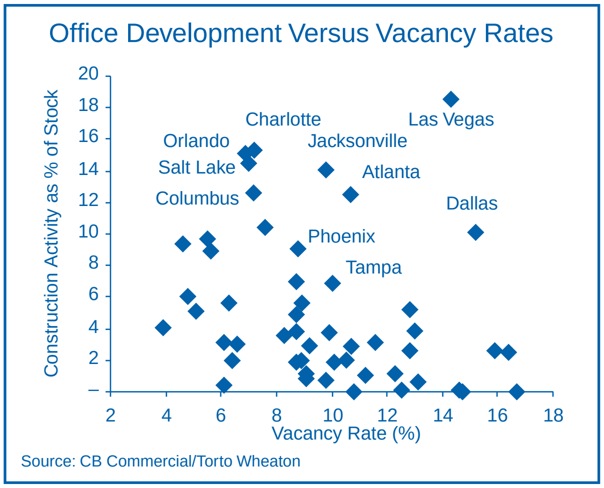
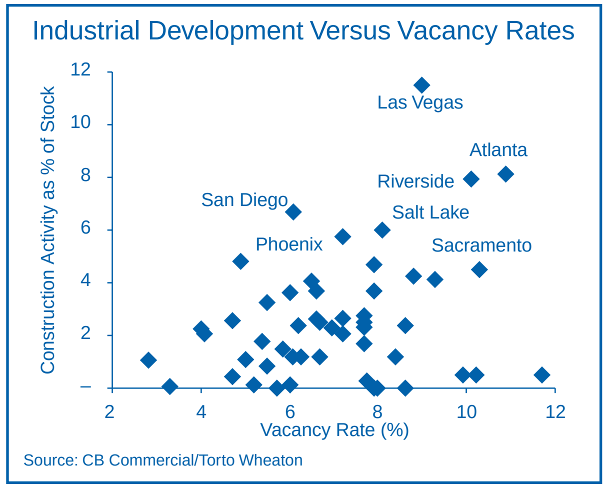


CHART 7



activity with current vacancy rates (as shown in Charts 6 and 7 for office and industrial space). The main idea behind these charts is that market segments with high existing vacancy rates raise the degree of competitive pressure for newly built space; markets with high vacancies may have less justification for continuing increases in new stock.

In the office sector, Las Vegas stands out as having the highest level of new development combined with high existing vacancy rates. Although the pace of development is markedly slower, office markets in both Atlanta and Dallas appear to be expanding rapidly despite high existing vacancy rates. In the industrial sector, Las Vegas, Atlanta, Riverside, Salt Lake City, and Phoenix all appear to be experiencing rapid development despite relatively high existing vacancy rates.

Analyst Outlooks for Commercial Real Estate Advocate Caution

The first six months of 1998 saw continuing strong market fundamentals in most major markets and most property types: ***CB Commercial/Torto Wheaton Research (CBC)*** reported continuing nationwide declines in office and industrial vacancy rates accompanied by increasing rental growth rates,[4] ***Wheat First Union (Wheat)*** reported improvements in occupancy and rental rates across the 30 major apartment markets it follows,[5] and ***Smith Travel Research (Smith)*** reported continuing improvements in average daily room rates despite a modest decline in occupancy rates for the lodging sector (through the first nine months of 1998).[6] The performance of the retail sector has been more mixed, as indicated by a significant decline in estimated rental growth rates from 1996 to 1997 (CBC) while retail vacancy rates have held steady over the past 12 months ***(F.W. Dodge)***.[7]

Despite these generally positive trends, market observers are becoming more cautious about the outlook for commercial real estate markets. Much of their concern stems from significant increases in projected supply in the face of moderating absorption rates. CBC, for example, projects that nationwide office vacancy rates will rise from 9.3 percent as of June 1998 to 12.1 percent by June 2000 as a result of a sharp increase in completions combined with moderating absorption. Markets with the highest and most significant increases in projected office vacancy rates are highlighted in a recent ***Lehman Brothers*** study, which identifies 17 office markets as "danger zones." [8]

Analysts have also raised concerns over rapid development in other property types. F.W. Dodge, for instance, anticipates a sharp rise in the ratio of retail completions

[4] CB Commercial/Torto Wheaton Research, *The Office Outlook, The Industrial Outlook,* and *The Retail Outlook,* Fall 1998.

[5] Wheat First Union, *Industry Report: Quarterly Apartment Review,* October 21, 1998.

[6] Smith Travel Research, *Smith Travel Research Announces 1998 September and Third Quarter U.S. Lodging Industry Reports,* www.str-online.com/news/releasedir/pr981104_3rdgtr.html.

[7] F. W. Dodge, *Real Estate Analysis and Planning Service: 2nd Quarter 1998.*

[8] These markets are Salt Lake City, Columbus, Austin, Nashville, Charlotte, Orlando, Las Vegas, Baltimore, Atlanta, Dallas, Phoenix, Philadelphia, Indianapolis, Chicago, Sacramento, Miami, and Houston (Lehman Brothers, *Commercial REIT Research: Eye on Office Markets,* October 1998).

to absorptions over the coming two years. In addition, the pace of hotel development has picked up substantially over the past two years to levels not seen since the late 1980s (see Chart 8). According to Smith, hotel completions continue to outpace demand and are expected to result in lower occupancy levels in 1999. For the apartment sector, Wheat cautions against a continuing escalation in apartment permits despite some expected slowing in employment growth in various markets over the coming 12 months.[9]

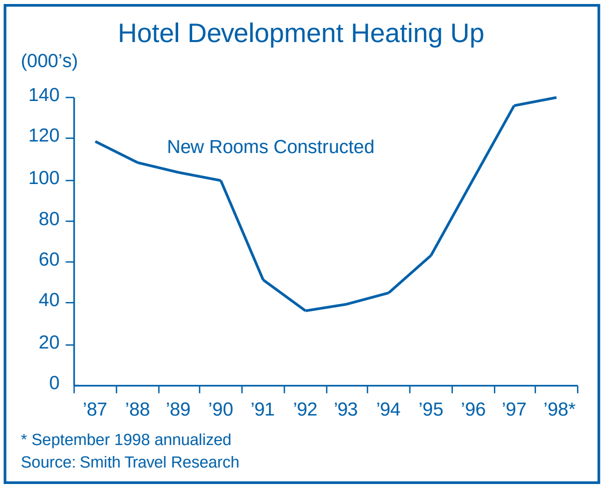
Economic Conditions May Temper Commercial Real Estate Demand

The nation's economy has shown unprecedented resiliency, even as some indicators suggest that growth may moderate in the near term. For instance, weakened global markets have placed increasing pressures on exporters, who have seen a falloff in demand in the wake of weaker foreign currencies relative to the dollar. Domestic firms, too, face rising competition from cheaper imports. These factors have created negative near-term expectations for corporate profitability, which in turn have resulted in rising layoffs and slowing employment growth. Although most economists feel that prospects for a recession are remote in the near term, even a modest slowdown in economic growth could result in higher vacancy rates in markets experiencing rapid development.

Over the longer term, various economic and demographic trends imply a weaker outlook for commercial real estate demand relative to past real estate cycles. In a recent analysis of the commercial mortgage-backed securities (CMBS) market, ***Moody's*** identifies the following trends, each of which implies secular declines in demand for one or more property types[10]:

- more efficient office space utilization as measured by continuing declines in square feet per worker;
- more efficient inventory management as measured by a proportional increase in the ratio of inventory growth to growth in warehouse space;
- shifts in spending patterns by baby boomers, the largest age cohort, away from goods and toward services;

CHART 8



- declining scrappage rates of obsolescent buildings because of a decline in the average age of the current stock of space relative to the comparable stage of prior cycles; and
- expected declines in labor force growth as the proportion of older workers increases.

In addition to these factors, other analysts have pointed out that tight labor markets and overtaxed infrastructure (e.g., water, roads, sewer, and public transportation) constrain demand by limiting growth within a particular market. Suburban areas that have seen the bulk of new construction over the past few years may be particularly hard hit if there is a backlash against the congestion and infrastructure capacity issues that accompany rapid growth.[11]

Markets Most Vulnerable to Overbuilding

Based on a review of supply and demand trends coupled with analyst opinions and projections, the following markets appear to be most vulnerable to broad-based overbuilding in the coming one to two years (see also Table 1, next page, for prevailing trends in these markets). These markets are discussed in more detail in the Regional Perspectives section.

[9] Wheat specifically notes deteriorating supply/demand ratios in Dallas, Houston, Orlando, Charlotte, Nashville, and the San Francisco Bay area.

[10] Moody's Investor Service, *CMBS and the Real Estate Cycle: Less Margin for Error,* October 9, 1998.

[11] See, for example, Price Waterhouse/Lend Lease Investment Research, *Emerging Trends in Real Estate 1999.*

Table 1

Markets Most Vulnerable to Overbuilding: Summary of Trends and Expectations

	1H97 to 1H98 Vacancy Rates	Construction Activity ('95 to 1H98)	Employment Growth Trends	Net-Migration Trends	Projected Vacancy Rate Trends
Las Vegas	↗	↗	↘	→	↗
Atlanta	↗	↗	↘	↘	↗
Nashville	↗	↗	↘	↘	↗
Salt Lake City	↗	↗	↘	↘	↗
Charlotte	→	↗	↘	→	↗
Portland	↗	↗	↘	↘	↗
Phoenix	↘	↗	↘	↘	↗
Dallas	↗	↗	↘	↗	↗
Orlando	→	↗	→	↗	↗

Note: Arrows for vacancy and construction are intended to capture prevailing trends across all property types; experience with respect to a specific property type in a particular area may differ. H = half.
Sources: CB Commercial, F.W. Dodge, Regional Financial Associates, and Smith Travel Association.

Las Vegas

Las Vegas's hotel, office, and industrial development far surpasses that of other major markets, with ratios of construction activity to current space of 37 percent, 19 percent, and 12 percent, respectively. Rapid development is occurring despite high and increasing office and industrial vacancy rates, which place additional competitive burdens on newly completed space. The area's retail and apartment sectors are also developing rapidly, ranking third and fourth, respectively, among major markets. Although Las Vegas continues to enjoy one of the fastest employment growth rates in the country, the rate of job growth has slowed considerably from 1994 to 1996 levels. Its real estate markets are highly dependent on the gaming sector, which could be especially vulnerable to a nationwide slowdown in economic activity. The city would be particularly hard hit by a downturn in real estate prices, as fully 10 percent of its workforce is employed in the construction sector (twice the national rate).

Atlanta

Of the nation's largest metropolitan markets, Atlanta ranks among the top ten in office, industrial, retail, and apartment construction, with ratios of construction activity to current space of 12 percent, 8 percent, 7 percent, and 5 percent, respectively. Development, much of which is widely reported to be speculative, is very active despite relatively high office and industrial vacancy rates. Atlanta's expanding real estate markets have been driven largely by strong in-migration and employment growth rates. However, both these rates are slowing, and many market observers are concerned that the area's development cycle has reached its peak.[12]

Nashville

Nashville ranks among the top ten metro markets in office and apartment development, with ratios of construction activity to existing space of 10 percent and 6 percent, respectively. Although not among the top 15 markets, Nashville's hotel sector is expanding rapidly as well (construction activity stands at 12 percent of current space). Nashville's economy is reported to be slowing because of recent losses in manufacturing-sector jobs and slowing net-migration rates. The rapid pace of development has recently placed downward pressure on office, industrial, and hotel occupancy rates.

Salt Lake City

Salt Lake City ranks among the top five markets in the nation in office, industrial, and hotel development, with ratios of construction activity to current space of 14 percent, 6 percent, and 27 percent, respectively. The main drivers behind the area's rapid development have been high-tech corporate expansions, population in-migration, and preparation for the 2002 Winter Olympic Games. However, both job growth and in-migration rates are slowing, which could result in lower absorption rates for commercial space in the near term. Over

[12] See the November 1998 issue of the Federal Reserve Board's *Beige Book*.

the longer term, analysts have expressed concerns that development and job growth attributable to the Olympics will result in a significant glut of space following the Winter Games.

Charlotte

Charlotte ranks among the top five metro areas in office, retail, and apartment development, with ratios of construction activity to current space of 15 percent, 7 percent, and 6 percent, respectively. The area's hotel sector is also developing rapidly. Charlotte's real estate markets are highly dependent on the health of the financial industry, which has been the primary driver of development activity. However, job growth in the financial services sector has recently slowed, and the manufacturing sector (which accounts for 19 percent of all jobs) is experiencing net job losses.

Portland

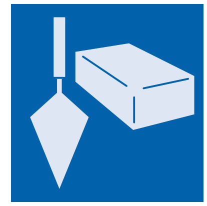
Portland has the third most active hotel and apartment development in the nation, with ratios of construction activity to current space of 25 percent and 7 percent, respectively. The area's office market is also expanding rapidly. Portland's development has been driven largely by in-migration and job growth in the technology sector. However, because of the significance of exports to the overall economy (exports to Asia account for approximately 7 percent of Oregon's gross state product), the technology sector is particularly vulnerable to weak Asian markets. Accordingly, job growth has moderated, reaching its lowest level in five years. The area has also experienced a recent decline in construction-sector jobs. Although still strong, in-migration rates have fallen from 1996 levels.

Phoenix

Phoenix ranks among the top ten metro markets in industrial, retail, hotel, and apartment development, with ratios of construction activity to existing space of 6 percent, 6 percent, 18 percent, and 6 percent, respectively. The area is also experiencing rapid development in the office sector. Phoenix has one of the fastest-growing job markets in the country. Although still strong relative to the nation, employment growth has slowed somewhat since 1996, as has the rate of in-migration. The prominence of the semiconductor and high-tech businesses makes Phoenix especially vulnerable to the economic slowdown in Asia.

Dallas

Dallas ranks among the top ten metro markets in office, hotel, and apartment development, with ratios of construction activity to existing space of 10 percent, 19 percent, and 6 percent, respectively. The area is also experiencing rapid development in the retail sector. Dallas's economy remains one of the fastest growing in the country, and in-migration to the area continues to rise. However, economic growth has slowed somewhat recently because of weakening high-tech and energy sectors. Although its industrial base is more diversified today than in the mid-1980s, Dallas remains exposed to a large energy sector, whose profits are vulnerable to declining oil and energy prices. Concerns over the volume of planned office development have led to widely published reports of curtailments in credit availability to speculative office projects. Although tighter credit availability may ease pressures on vacancy rates over the long term, the market will still have to absorb the large volume of space presently under construction, much of which is speculative.



Orlando

Orlando ranks among the top three metro markets in office, retail, and apartment development, with ratios of construction activity to existing space of 15 percent, 9 percent, and 7 percent, respectively. Of the nine markets discussed in this article, Orlando's current pace of construction is perhaps easiest to support, thanks to rising employment and in-migration growth. However, despite strong employment growth, office vacancy rates have edged higher over the past 12 months because of the rapid pace of construction. Orlando may be more vulnerable than other metropolitan areas to a slowdown in the national economy owing to its dependence on the tourism sector.

Credit Availability Affects the Pace of Commercial Development

CMBS and real estate investment trusts (REITs) have generated a significant share of funding for commercial real estate over the past several years.[13] As a result, any disruption in CMBS and REIT markets strains credit availability for new commercial development. For instance, widening CMBS spreads in the wake of September's market volatility have caused many issuers to either delay or cancel new CMBS issues. REITs, too, have reportedly curtailed purchases because of falling per-share values and a corresponding decline in equity issues to support acquisitions.

Weaknesses in the CMBS and REIT markets also may be dampening many lenders' enthusiasm for commercial real estate development. Construction lenders will be less willing to make speculative loans to the extent that permanent funding is not available, and CMBS and REITs served as major providers of such funding. REITs were particularly aggressive purchasers in such markets as Atlanta, Orlando, and Dallas.[14] Tightened construction lending conditions appear to be borne out by the November 1998 issue of the ***Federal Reserve Board***'s *Beige Book,* which indicates that new construction for speculative commercial projects has either been curtailed or come to a virtual halt throughout many Federal Reserve districts, including Atlanta and Dallas. Most districts also reported tightened credit conditions and higher loan pricing, which could further dampen construction activity.

The turmoil faced by CMBS and REITs presents both opportunities and risks for banks. Many industry participants view tighter credit accessibility as a positive development in light of the rapid pace of construction, which, in some cases, has been accompanied by extremely tight loan pricing margins and a loosening of underwriting standards. However, some lenders may view the changing fortunes of CMBS and REITs as an opportunity to regain market share. In any case, it will take several months for recent market events to be fully reflected in hard numbers for construction activity. Whether tightening credit availability proves to be a temporary phenomenon given the recent, albeit gradual, recovery in CMBS spreads and the broad recovery in the equity markets, remains to be seen.

Summary

This article updates a previously published analysis that used year-end 1997 data to rank the potential vulnerability of major metropolitan areas to overbuilding. Using primarily midyear 1998 information, this update adds three markets to the six identified in the initial analysis as vulnerable to broad-based overbuilding. This assessment is based on a number of factors including construction activity trends, local area employment and population migration trends, as well as a collection of views and projections from credible industry analysts. For many of these markets, the prospects for near-term declines in commercial real estate demand may be increasing because of slower economic growth and weakened markets abroad. Certain secular demographic and economic trends also suggest the possibility of lower demand levels in the current cycle relative to prior cycles. Although data through June 1998 indicate ongoing rapid development, there is growing evidence that recent events in the capital markets have at least temporarily tempered the appetite for further development in some rapidly expanding metro areas. For these markets, most participants view the curtailment in credit availability in a positive light because it would serve to moderate the severe cyclical swings in real estate values experienced by several markets during the 1980s.

Steven Burton, Senior Banking Analyst

[13] See "Strong Demand and Financial Innovation Fuel Rebounding Commercial Real Estate Markets" in *Regional Outlook,* fourth quarter 1997.

[14] See Lehman Brothers, *Commercial REIT Data Book,* December 9, 1997.

Recent Trends in Syndicated Lending

- **A strong U.S. economy, intensifying competition, and the increasing marketability of bank loans have driven record volumes of syndicated lending in the 1990s.**

- **After several years of liberalized underwriting, evidence suggests that some banks have tightened standards and terms for loans to large commercial borrowers.**

- **Market developments and underwriting trends over the past several years have implications for credit quality, earnings, and liquidity at institutions that hold or originate syndicated loans.**

Commercial and industrial lending is a major source of revenue for commercial banks, yet this business line has lagged other major lending categories in terms of liquidity, standardization, and commoditization. However, in recent years the transformation of commercial lending has accelerated and is altering the way lenders do business. This trend has been particularly apparent in syndicated commercial lending. This article briefly defines syndicated loans, reviews the 1990s boom in the market, and discusses the implications of competitive pressures and secondary market liquidity for underwriting trends and risk profiles of commercial banks active in this market.

Syndicated Lending Overview

A syndicated loan is a credit extended to one large or medium-sized corporate borrower that is originated by a group, or syndicate, of lenders. Syndicated lending differs slightly from participation lending, which is common in commercial banks. Although both types of lending allow for flexibility in reducing company-specific risk and adhering to legal restrictions for loans to one borrower, only one lender originates a participation loan, which is then sold in undivided participation interests either concurrently or subsequently to third parties.[1] A syndicate usually consists of a group of institutions that work closely on a number of deals that are sold to subscribers at origination.

Syndicated loans can generally be categorized according to rating, terms, pricing, or target investors. The investment-grade loan market, often referred to as the pro-rata or retail market, is the lowest-risk segment of syndicated lending and comprises approximately 80 percent of all volume originated from 1987 to 1997. These loans commonly take the form of liquidity backstops or lines of credit and are marketed to commercial bank investors. ***Loan Pricing Corporation (LPC)*** defines these credits as those rated BBB–/Baa3 or better, or nonrated deals with pricing equal to or less than rated deals in these bands. Near-investment-grade, leveraged, and highly leveraged markets, often referred to as B, C, and D tranche term loans or non-investment-grade loans, include credits with longer maturities, greater risk, and higher pricing. Non-investment-grade loans are typically structured for institutional investors and compete more directly with the traditional high-yield bond market. LPC defines non-investment-grade loans as those rated BB+/Ba1 or worse, or nonrated deals with pricing greater than deals graded BBB–.[2]

Competitive Trends in the Syndicated Loan Market

A handful of large U.S. commercial banking companies originate the vast majority of U.S. syndicated corporate credits across all quality types. According to LPC, 14 U.S. banking companies were among the top 25 syndicated lenders (based on the number of agent or co-agent transactions) and accounted for half of 1998 syndicated loan transactions to U.S. corporations through mid-November.[3] In 1997, nine U.S. banking companies were among the top 25 and executed 36 percent of the market's transactions. Before 1997, the most active domestic commercial banks saw their market share erode from a peak of 45 percent of transactions in 1992 to 34 percent in 1996, primarily because of intensifying competition from nontraditional syndicated lenders such as investment banks and foreign banks. Although U.S. banks have recently recovered market share (as Japanese banks have significantly withdrawn from the market), a strong U.S. economy, expanding liquidity in the bank loan market, and a trend toward one-stop shopping

[1] American Bankers Association, *Banking Terminology,* 3rd ed., 1989, p. 345.

[2] Loan Pricing Corporation, *Gold Sheets*, Third Quarter 1998 Review, p. 2.

[3] Loan Pricing Corporation, *Gold Sheets*, November 16, 1998, p. 6.

in the financial services industry have attracted competitors to the syndicated market in the 1990s.

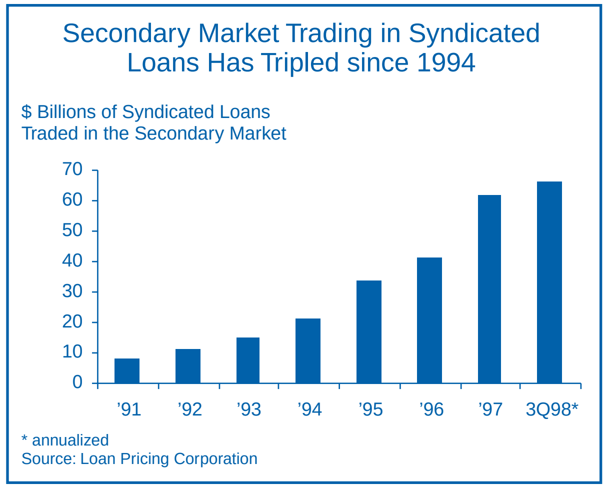
Syndicated Loan Liquidity

U.S. commercial banking companies retain or buy a large volume of syndicated loans, yet estimates show that most of the volume is sold to other institutional investors. Information from the shared national credit program[4] indicates that at year-end 1997, FDIC-insured commercial banking companies had extended facilities and commitments totaling $1.8 trillion, of which an estimated $565 billion was funded. To put this figure in perspective, an official of the ***Office of the Comptroller of the Currency*** estimated that 57 percent of outstanding syndicated loans were held by foreign banks; 26 percent by originating banks, mutual funds, and insurance companies; and 17 percent by subscribing banks.[5] Indeed, according to ***BankAmerica Corporation***, the number of nonbank institutional investors in bank loans, including prime rate mutual funds, hedge funds, and insurance companies, increased from 14 in 1993 to more than 100 in 1998. These investors have played a pivotal role in enhancing the bank loan as a distinct asset class by increasing trading activity, demanding third-party loan ratings, and contributing to the development of loan derivative products.

Perhaps the most important new development in syndicated lending has been the deepening secondary market for bank loans as many new investors seek to purchase them. As shown in Chart 1, the volume of secondary trading in bank loans has grown sharply, more than tripling between 1994 and 1997 to over $60 billion. Trading in 1998 through the third quarter was on pace to top the 1997 level. Traded loans are often non-investment-grade issues, which have been the focus of most demand by the burgeoning institutional investor base. One important force behind the development of a bank loan secondary market has been rapid expansion in the number of bank loans rated by third-party rating services.

Independent credit ratings of bank loans were initiated in 1995 when "several years of rapid development in the

CHART 1



syndicated bank loan market generated a critical mass of interest in the credit characteristics of these instruments."[6] ***Standard and Poor's, Moody's, Duff and Phelps,*** and ***Fitch/IBCA*** are now actively involved in rating bank loans. Through 1997, Standard and Poor's and Moody's combined rated $677 billion in loans. As rating activity increases access to and availability of standardized analysis and research for bank loans, including market analysis, ratings criteria, and historical loss recovery rates, investors are becoming more comfortable with loans as a distinct asset class. Moreover, independent loan ratings allow investors to value a company's loans relative to its other rated loans or bonds.

Bank loan secondary market activity and independent ratings have prompted the development of new ways to package and improve the market acceptance of these assets. As a result, the securitization of bank loans and the development of various types of derivative products have proliferated. As discussed in "CLOs Lure Another Major Bank Asset off the Balance Sheet," in ***Regional Outlook***, third quarter 1998, collateralized loan obligations (CLOs) are a major market development allowing for the securitization of corporate loans. A large investor appetite for varied types of asset-backed securities and a desire to move assets off the balance sheet to lower risk-based capital requirements have helped promote a sharp increase in this type of securitization. Loan derivatives also may allow lenders to better manage the trade-off between maintaining borrower relationships and avoiding excessive concentrations of risk. This trade-off has become increasingly

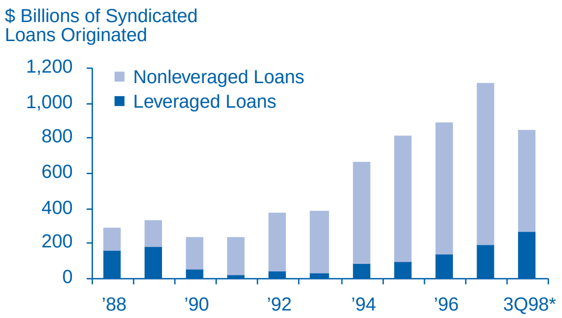
[4] The shared national credit program is a cooperative examination program conducted by the three federal banking agencies and cooperating state agencies to review large, complex credits held at multiple institutions. Loans subject to review are syndicated loans or groups of loans and commitments of $20 million or more shared by three or more supervised institutions.

[5] "Concerns Mounting Over Risks in Booming Syndication Market," *American Banker,* January 29, 1997, p. 20.

[6] "Bankrupt Bank Loan Recoveries," *Moody's Investor Service,* June 1998, p. 5.

CHART 2

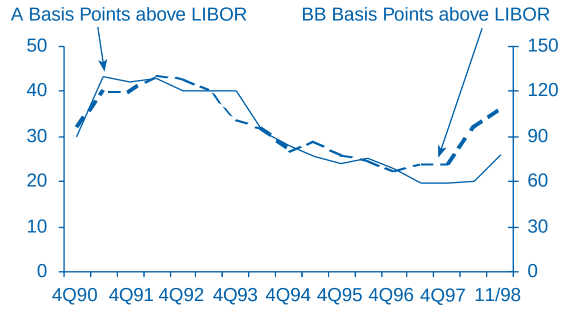
After Several Record Years, Syndicated Loan Originations Have Slowed



* annualized
Source: Loan Pricing Corporation

CHART 3

New Syndicated Loan Pricing Has Reversed after Several Years of Narrowing Spreads



Note: LIBOR = London Interbank Offered Rate
Source: Loan Pricing Corporation

important with the trend toward one-stop shopping in financial services.

One-Stop Financial Providers

For several years, analysts have noted a trend toward financial services supermarkets—financial institutions positioning themselves as providers of a complete array of advisory services and financial products. One aspect of this trend has been the tendency of traditional lenders to improve their ability to offer a full array of equity and debt underwriting, as characterized by the expansion of Section 20 activities among major U.S. commercial banking companies. Traditional securities underwriters view entry into the syndicated loan market similarly. For example, no investment bank had a syndicated loan underwriting department in 1994, but several are now making inroads into the market, especially the leveraged market, and some increased their syndicated loan volume fivefold in 1997.[7] In some cases, the desire of commercial banks to move toward one-stop financial services and the resulting approaches to relationship management have affected the underwriting of loans to large commercial borrowers that have multiple financing and advisory service needs.

Historical Perspective on Syndicated Loan Underwriting Trends

Increased interest by investors in bank loans and strong competition for business resulted in syndicated lending at historically narrow spreads and on more liberal terms. Accordingly, the syndicated loan market was a borrowers' market for much of the 1990s. As shown in Chart 2, the volume of syndicated loan originations increased almost fivefold between 1991 and 1997, with record volume levels achieved in each of these years. Much of the volume was driven by growth in the origination of loans for the purpose of refinancing existing debt, especially from 1995 to 1997, as borrowers took advantage of increased lender competition and investor demand to reduce funding costs and extend maturities. In some cases, borrowers were able to refinance loans obtained just months earlier at significant savings and more favorable terms.

Chart 3 shows that lending spreads compressed sharply from 1993 to 1997, particularly for lower-quality credits. LPC stated that "[e]xcessive competition has driven spreads and fees to all-time lows, with the investment grade market purely a relationship play."[8] Consistent with the financial supermarket concept discussed above, as relationship lending proliferated, many lenders were evaluating transactions on the basis of overall relationship returns rather than individual transaction returns. Consequently, borrowers willing to offer an institution ancillary business, such as cash management, securities underwriting, or securitization services, were likely to receive more favorable loan pricing than borrowers seeking to execute just one loan deal.

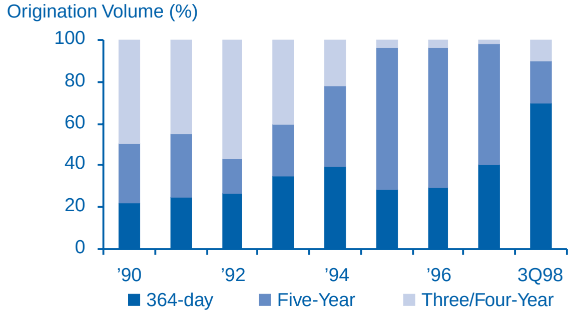
During the same period, a clear trend toward weakened underwriting resulted in deteriorating risk/return rela-

[7] "The New Kids in the Syndicate: Investment Banks Are Moving in on the Leveraged Syndicated Loan Market," *Bloomberg*, March 1998, p. 35.

[8] Loan Pricing Corporation, *Gold Sheets,* First Quarter 1995 Review, p. 9.

CHART 4

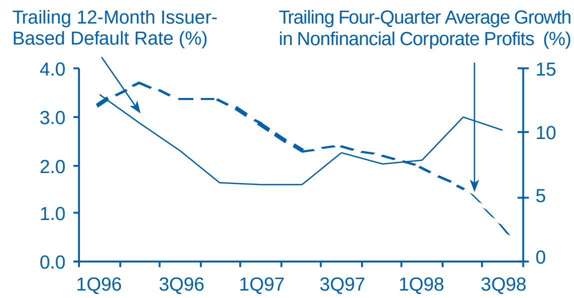
After Several Years of Lengthening, the Average Maturity of New Investment-Grade Syndicated Loans Has Shortened in 1998



Source: Loan Pricing Corporation

CHART 5

Defaults on Speculative-Grade Corporate Bonds Have Risen and Growth in Corporate Profits Is Slowing



Sources: Moody's Investor Services, Federal Reserve Board

tionships across syndicated lending categories. Financial indicators market analysts use to evaluate whether lenders are being adequately compensated for risk generally weakened. For example, the ratio of debt to earnings before interest, taxes, depreciation, and amortization rose to relatively high levels for an increasing number of leveraged and highly leveraged loans.[9] Moreover, lengthening maturities reflected looser underwriting. A decline in the spreads between loans of one-year and five-year maturities made it cost-effective to borrow for longer periods. LPC indicated that the differential between fees on undrawn 364-day revolving loans and undrawn five-year loans had dropped by one-half during this period.[10] As a result, many borrowers extended maturities on new credits, and, as shown in Chart 4, the average maturity of investment-grade loans originated in the mid-1990s lengthened significantly.

Recent Underwriting Developments

Beginning in late 1997, lenders and investors began to resist aggressively priced investment-grade and near-investment-grade loans. This resistance led to a leveling of pricing, fewer refinancing opportunities for borrowers, and increased focus on the higher-risk leveraged lending market, where nonbank institutional investor demand was strong and pricing was richer. In response, overall syndicated lending volume declined almost 16 percent during the first three quarters of 1998 compared with the same period in 1997. However, within total new syndicated loan volume, leveraged loan originations grew 77 percent to $200 billion during the same period, accounting for approximately one-third of all syndicated credits—the largest proportion of the market since 1989. Of particular note was that this growth in higher-risk lending came at a time when losses in speculative-grade bonds had been trending higher and growth in profits for nonfinancial U.S. corporations had been slowing (see Chart 5).

Global economic turmoil and the flight to quality that disrupted the capital markets during the third quarter of 1998 spilled over into the bank loan market and solidified a shift to a lenders' market. LPC noted in its third-quarter 1998 review of syndicated lending that "[r]ates and fees are on the upswing meaning opportunistic refinancings…continue to dwindle. Concessions suddenly are going to lenders rather than borrowers, and volume continues the drop [from levels] seen earlier in the year."[11] Growth in leveraged lending also declined sharply as the number of institutional investors in the market fell by one-half from the second quarter.[12]

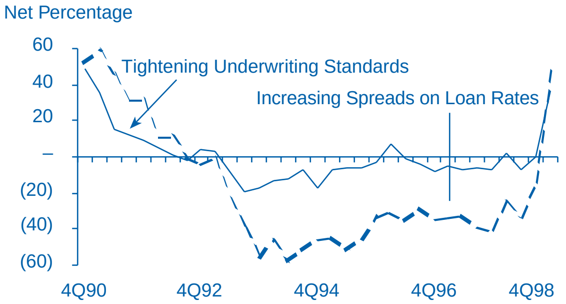
The shifting dynamics of the market in late 1998 were characterized by the aforementioned slowdown in originations, a sharp increase in pricing (see Chart 3, previous page), and evidence that underwriting had become more stringent. The volatility in credit markets resulted in deals being rescinded or incorporating "market flex" pricing language that enabled lenders to manage the yield requirements of investors due to changing yields on competing capital markets instruments. The influ-

[9] Ibid., pp. 16-17.
[10] Ibid., p. 43.

[11] Loan Pricing Corporation, *Gold Sheets,* Third Quarter 1998 Review, p. 3.
[12] Ibid.

CHART 6

Some Banks Have Tightened Underwriting Standards and Terms to Large and Medium-Sized Corporate Borrowers

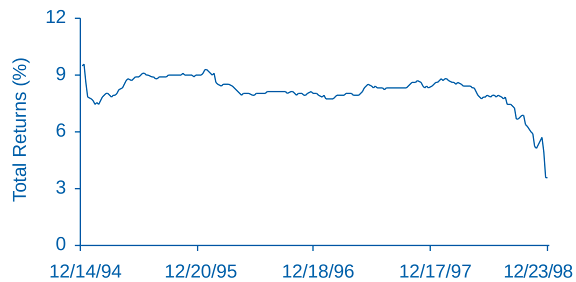


Source: Federal Reserve Board

CHART 7

Total Returns* on Leveraged Loans Have Fallen

Rolling 52-Week Total Returns Measured by the Goldman Sachs/Loan Pricing Corporation Liquid Leveraged Loan Index



* Total Return = Accrued Interest + Bid Changes + Gains from Repayments
Source: Loan Pricing Corporation, Goldman Sachs, Bloomberg

ence of the secondary market on new loan pricing became apparent as investors required underwriters to factor in higher secondary market yields. In addition, as shown in Chart 6, the Federal Reserve Board's November 1998 Senior Loan Officer Opinion Survey on Bank Lending Practices reported that a significant minority of surveyed lenders had tightened lending standards and terms for commercial loans to large and middle-market firms.[13] On net, nearly 40 percent of domestic bank respondents had tightened lending standards for these borrowers for the three months ending November 30, and nearly half had increased pricing. These percentages are the highest reported since the last recession.

Underwriting was also influenced by increased borrower demand for bank loans—a secondary effect of the market volatility in late 1998. The aforementioned Federal Reserve Board survey noted an increased demand for bank commercial loans primarily as a result of shifts from other sources of credit, namely the bond and commercial paper markets. For example, one industry participant estimated that the loan market represented roughly 60 percent of capital market financing in January 1998, 40 percent in July as the high-yield bond market boomed, and nearly 100 percent in September as the bond markets stalled.[14]

Implications for Insured Institutions

Although recent evidence suggests that some lenders have tightened standards and terms for loans to large commercial borrowers, market developments and underwriting trends over the past several years have implications for credit quality, earnings, and liquidity at institutions that hold or originate syndicated loans.

- *A slowing economy and stress in industries exposed to weakened international economic conditions could result in increased losses during an economic downturn, especially for banks that are holding higher-risk syndicated loans.* Although nonbank institutional investors hold the bulk of the riskier tranches of syndicated deals, some banks ventured into riskier, longer-term issues in response to narrow pricing on traditional loan pieces held by banks.[15] Should liquidity become an issue in the secondary market, banks planning to sell these pieces may face losses. For example, as reflected in Chart 7, the rolling 52-week total return on the ***Goldman Sachs/LPC*** Liquid Leveraged Loan Index, which measures the performance of a diversified portfolio of the most actively traded performing leveraged loans, has fallen from over 8 percent in early 1998 to less than 4 percent in December 1998. Falling prices have caused reduced returns as required spreads on these credits have risen.

[13] Large or middle market firms are those with annual sales greater than $50 million.
[14] "Syndicated Lenders Swiftly Surmounted September Dip," *American Banker,* December 10, 1998, p. 25.
[15] "Banks Compete with Funds in Buying Long-Term Tranches of Syndications," *American Banker,* March 19, 1997, p. 1.

- *Downstream subscribers that purchased thinly priced or loosely structured loans may not be adequately compensated for risk. This lack of compensation may be especially important for institutions that do not receive ancillary relationship income.* Evidence suggests that downstream lenders became more willing to accept loans during the 1990s without receiving full documentation or making an independent credit analysis. The Office of the Comptroller of the Currency reportedly attributed this trend to a desire to add loan volume coupled with comfort about company prospects because of the strong economy and strong corporate profits.[16] As a result, on a risk-adjusted basis, the returns on these credits may hamper the performance of investing institutions.

- *Sustained reductions in syndicated loan liquidity may adversely affect revenues and increase percentages of loan amounts retained by active syndicating institutions.* If institutional investors remain withdrawn from the loan market for an extended period, syndicates may have increasing difficulty marketing deals, especially in the non-investment-grade segment. As a result, institutions dependent on revenues generated by this activity may face declining income as fewer deals are executed, or they may have to hold larger percentages of undersubscribed transactions. This situation may be further exacerbated by consolidation in the U.S. banking industry, which has combined several major syndicate agents in the 1990s and has reduced the number of potential downstream investment-grade subscribers in the market.

- *Rising demand from borrowers exploiting relative pricing in the loan and capital markets may have credit and liquidity implications for underwriting institutions.* Sustained volatility in the capital markets may increase the demand for bank loans and will likely significantly increase funding costs for many borrowers. For example, LPC recently compared loans that were extended to seven companies in early 1998 with similarly structured loans extended to the same companies after the third-quarter disruption in the capital markets. The analysis revealed significant increases in required yields, ranging from 112 to 388 basis points.[17] Rising funding costs combined with a trend toward slower growth in corporate profits may reduce loan repayment capacity of borrowers in more troubled industries. In addition, banks that have extended liquidity backstops or backup lines of credit may be required to fund facilities that traditionally are not heavily used by borrowers. For example, without appropriate pricing adjustments, banks providing backup commercial paper loans may be called upon to fund these facilities as a result of volatility and relatively high spreads in the commercial paper market.

Increases in credit spreads on securities and syndicated loans, the recent rise in speculative corporate bond defaults, and slowing corporate profits may portend an increase in commercial credit problems for commercial banks. Now more than ever, those involved in bank risk management should pay close attention to fundamentals, including careful credit analysis, diversification, and maintenance of prudent underwriting standards. Attention to these fundamentals may help alleviate the need to overreact to sudden changes in the market environment.

Steven E. Cunningham, CFA, Senior Financial Analyst
Ronald L. Spieker, Chief, Regional Programs and Bank Analysis Section

[16] "Concerns Mounting over Risks in Booming Syndication Market," *American Banker,* January 29, 1997, p. 20.

[17] Loan Pricing Corporation, *Gold Sheets,* November 16, 1998, p. 21.

Regional Perspectives

- **The Region's economy showed some signs of weakening toward year-end 1998. Unemployment rates edged up in most states, and output fell in several important manufacturing industries. Meanwhile, farm income was trimmed by low commodity prices, and farmland prices were softening. Such developments raise questions about the strength of the Region's economic growth in 1999.**

- **In the commercial real estate sector, construction and nonresidential real estate loans rose rapidly over the past year at a third of the Region's community banks even though signs of surplus space are appearing in some markets. More than half of these institutions also held high concentrations of CRE loans in their portfolios.**

- **Aggregate performance measures for banks and thrifts in the Region remained favorable in the third quarter. However, the repercussions on banks and their customers from recent financial market turmoil highlight why banks' risk management, underwriting standards, and other practices need sustained monitoring. Insured institutions may face increasing challenges to earnings and credit quality if financial markets remain unsettled or economic conditions deteriorate.**

Economic and Banking Overview: Third Quarter

Regional Update: Economy

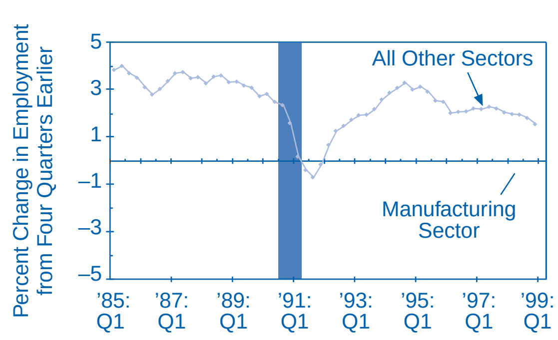
Recent developments suggest that 1999 may continue to challenge the Region's ability to maintain healthy and balanced economic growth. Since midyear 1998, increasing evidence indicates that a broad-based slowdown is under way. Consequently, the levels of activity or growth rates (or both) in manufacturing, single-family housing, and other sectors may have peaked for this cyclical expansion. Indeed, even though unemployment rates remain low, they have edged up in Illinois, Michigan, Ohio, and Wisconsin. Meanwhile, sustained softness in crop and hog prices is raising concerns about the health of the farm sector.

Many manufacturing industries in the Region are being affected by slackening domestic and foreign demand, competitive pressures from imports, or both. For example, output fell in the year ending in November 1998 among producers of iron and steel (–15.2 percent), paper and paper products (–1.9 percent), chemicals and related products (–1.8 percent), and fabricated metals (–0.2 percent). Industries that experienced slowing gains in output growth compared to earlier in 1998 include motor vehicles and parts (0.6 percent), food products (0.7 percent), and rubber and plastics (2.4 percent). Because the manufacturing sector's share of economic activity in this Region is about 50 percent higher than in the nation, a widespread and sustained weakening may negatively affect many households and communities throughout the Region, with potential implications for their lenders.

The Region's labor market is showing signs of weakening. Partly because of conditions in the manufacturing sector, job growth in the Region slowed to 1.4 percent for the year ending in October 1998, lagging national gains. Within the Region, employment by manufacturers in October, when the impact of the strikes against General Motors had dissipated, was only marginally higher than in December 1997 and was falling on a year-over-year basis (see Chart 1).

CHART 1

Region's Job Growth Is Slowing



Note: Value shown for 1998: Q4 is the average for October and November.
Source: Bureau of Labor Statistics via Haver Analytics, Inc.

After posting a record low of 3.7 percent in the second quarter of 1998, the Region's unemployment rate edged up to 3.9 percent in the third quarter, and held there through November. Increasing layoffs in the steel, farm and construction equipment, paper, chemicals, food products, and financial services industries are a contributing factor. Because some of these layoffs are permanent due to mergers or job cuts, the effect on household finances may be more damaging than that of short-term layoffs.

Slower job growth has translated into moderating personal income gains for the Region's households. This could worsen households' debt-payment ability unless debt obligations are reduced proportionately. Should consumer confidence weaken ahead, as it did from April through October 1998, a resulting retrenchment of household spending also could negatively affect many producers in the Region. (See ***Chicago Regional Outlook***, fourth quarter 1998, for more details.)

The number of year-to-date residential construction permits in the Region remains high but below the peak reached in 1996. Although low interest rates are attractive to potential buyers, unsettled financial markets and weakening labor market conditions may undermine the willingness of households to purchase new homes in coming quarters.

These developments are affecting the health of the business sector. Nationally, growth in corporations' operating profits slowed considerably over the past year and then turned negative in the third quarter of 1998. In the Region, new business incorporations in 1997 were modestly lower than their 1996 peak, while business failures are about 25 percent higher than four years ago.

Regional Update: Banking

In the aggregate, the Region's institutions held leverage capital equal to 8.07 percent of average assets on September 30, 1998; return on assets edged up to 1.27 percent; and asset quality remained sound. At the end of the third quarter, 2,082 insured institutions operated in the Region, 65 fewer than at year-end 1997. Assets of $953 billion were $32 billion higher than at year-end 1997, with 72 percent of total assets held by the Region's 100 largest institutions.

However, a few institutions in the Region continue to experience some problems:

- Loan delinquencies exceeding 5 percent are reported by 186 institutions (about 9 percent). Most of these institutions have relatively strong capital positions, and slightly less than half of the past-due debt is secured by real estate.

- Fifty-eight of the Region's institutions have composite ratings of 3, 4, or 5, mainly the result of poorly rated management, asset quality, or earnings. Twenty-six of these institutions are headquartered in Illinois.

- Seventy-two institutions were unprofitable. Of these, 34 have been operating fewer than five years, 2 are specialized credit card banks, and about two-thirds of the remainder are small institutions with assets under $100 million.

Impact of Financial Market Turmoil

Various financial market crosscurrents came together late in 1998 as Russia defaulted on its debt to foreign banks, hedge funds experienced difficulties, and concerns intensified about the stability of emerging market countries. The reaction to these events included a sharp increase in risk aversion and a flight to quality. These conditions drove interest rates on long-term Treasury securities to 30-year lows; triggered increased credit spreads; and heightened volatility in equity, foreign exchange, and other financial markets. Against this backdrop, the Federal Reserve eased monetary policy three times between late September and year-end 1998 in an effort to calm market conditions. Among the ways these developments affected banks are the following:

- Some borrowers, unable to raise funds in the capital markets, turned to banks as a source of funds.

- Borrowers' preference for fixed-rate mortgages lengthened the average maturity of lenders' residential portfolios or forced lenders to sell some fixed-rate loans in the secondary market.

- The value or liquidity, or both, of emerging market debt and mortgage-backed securities declined significantly.

- Collateral values (e.g., equity and debt securities) fell in some cases.

Table 1

Some Institutions in the Region Show Rapid Loan Growth			
Type of Loan	Percentage of Community Banks* with Growth (%)		
	20% to 30%	30% or More	Total over 20%
Total Loans & Leases	7	7	14
Construction Loans	5	27	32
Commercial Real Estate Loans	10	25	35
Total CRE Loans	10	24	34
Commercial Loans	8	22	30
1- to 4-Family Residential Loans	8	9	18
Home Equity Lines	5	19	24
Total Residential Loans	8	9	18
Credit Card Loans & Related Plans	4	9	13
Other Consumer Loans	6	13	19
Total Consumer Loans	6	12	18
Farm Loans Secured by Real Estate	5	13	18
Other Farm Loans	4	8	12
Total Farm Loans	5	8	13

* Institutions with $1 billion or less in total assets.
Note: Data are adjusted for mergers.
Source: Bank & Thrift Call Reports

- Foreign and other institutions with compromised credit quality faced higher funding premiums.

Consequently, institutions' risk management, pricing, and funding strategies may deserve increased attention. For example, properly pricing loans and valuing collateral for their inherent risks (e.g., credit quality, prepayment potential) is more difficult when uncertainty and volatility are high, and historical relationships upon which risk-management models are built may no longer hold.

Against this background of economic and financial market uncertainty, rapid loan growth may be a cause for concern. Indeed, a number of the Region's institutions have shown rapid loan growth for various types of credits during the past year. Fourteen percent expanded their total loan portfolios by more than 20 percent, and half of these institutions grew their portfolios by 30 percent or more (see Table 1). More than one-third of the Region's institutions experienced rapid expansion of commercial real estate and construction loans; 30 percent saw strong gains in commercial loans; and 24 percent quickly grew their home equity portfolios.

Some growth rates in Table 1 may overstate risks because the associated loan portfolios are quite small. However, the pervasiveness of rapid loan growth when economic growth is slowing raises questions about how the loans will perform in coming quarters and whether banks are taking appropriate steps to minimize potential problems.

Rapid Commercial Real Estate Loan Growth Is Prevalent

Among several of the largest metropolitan statistical areas (MSAs) in the Region, signs of imbalance between the supply and demand of commercial space are appearing. For example, vacancy rates for industrial space in **Detroit** and **Columbus** have climbed from lows a few years ago. **Indianapolis'** vacancy rate for suburban office space has risen by roughly 200 basis points in the past year or two, and rates in other MSAs are edging up. Similar data for smaller MSAs, generally available only from localized real estate sources, should be monitored for signs of weakening market conditions.

Table 2

Some Community Banks Report Exposure to CRE Markets			
By Location in FDIC's Chicago Region	Number of Institutions	Percent with CRE Concentration	Percent with Concentration and Rapid Loan Growth
All Community Banks	1987	46	18
Select MSAs			
Grand Rapids-Muskegon-Holland MI	18	94	56
Madison WI	22	82	18
Minneapolis-St. Paul MN-WI	11	82	55
Appleton-Oshkosh-Neenah WI	19	68	26
Milwaukee-Waukesha WI	47	68	30
Chicago IL	289	67	26
Wausau WI	14	64	14
Detroit MI	27	63	26
Indianapolis IN	26	62	27
Gary IN	15	60	13
Cleveland-Loraine-Elyria OH	24	50	21
Peoria-Pekin IL	27	48	19
Columbus OH	21	48	19
Cincinnati OH-KY-IN	58	47	12
St. Louis MO-IL	38	39	26
Other Metro Areas	352	48	20
Non-Metro Areas	979	34	13

Notes: Rapid growth means 20% or higher over four quarters ending 1998:Q3. Community banks have assets of $1 billion or less. Bank data by MSA reflect only counties in the FDIC's Chicago Region.
Source: Bank and Thrift Call Reports

Vacancy rates today generally reflect the interaction of previous periods' construction decisions and current demand. In some markets, concern arises because commercial real estate projects now under way may add large amounts of space when the cyclical expansion and demand for new space are fading. To the extent that a significant amount of space in current construction projects is not pre-leased, the potential repercussions of a weakening economy on cash flows and thus owners' repayment abilities are magnified.

Against this background, concern arises because more than a third of the community banks in the Region grew their construction and commercial real estate portfolios by 20 percent or more in the year ending September 30, 1998, as shown in Table 1. When community banks with both high concentration and rapid growth are considered, about 18 percent have sufficiently high exposure to warrant close monitoring (see Table 2). (Commercial real estate (CRE) loans are defined as construction and development loans plus loans secured by commercial real estate. High concentration is defined as CRE loans totaling 100 percent or more of Tier 1 capital.)

Community banks' exposures show considerable variance among MSAs, as illustrated in Table 2. For example, most banks in the **Grand Rapids-Muskegon-Holland** MSA have high CRE concentration, and slightly more than half of these also are experiencing rapid CRE loan growth. In contrast, concentration is high in the **Madison** MSA, but only 18 percent of institutions there are growing their CRE loan portfolios rapidly.

In each case, high concentration and rapid growth may reflect considerably different strengths in CRE markets in these MSAs as well as differing business strategies among lenders. However, historical experience suggests that concentration of high-risk credits such as CRE increases an institution's vulnerability to credit risks if economic conditions weaken. In addition, rapid growth by itself deserves attention and careful monitoring because it may result from weakened underwriting standards or it may strain management resources.

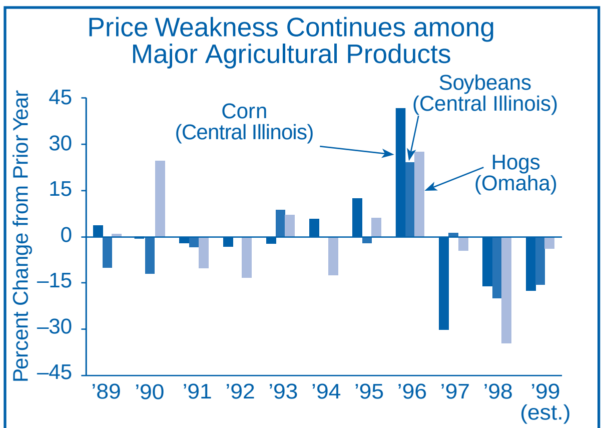
Financial Market Turmoil Highlights Risk Management Practices

Significant price weakness has persisted in the major commodity markets over the past two years, and the ***U.S. Department of Agriculture*** (USDA) projects additional declines ahead (see Chart 2). Largely because of lower prices, cash receipts nationwide are expected to fall by $10.7 billion (or about 5 percent) in 1998, according to the USDA's late-November estimates. About 70 percent of the decline is associated with receipts from crops, the remainder with livestock production.

Two factors—government payments to farmers and reduced production expenses resulting from lower prices of inputs—are softening the effect of lower cash receipts on farm incomes. However, because about half of 1998's government payments came from an emergency appropriation that may not be renewed, the effect of low commodity prices on farmers' finances may be felt more keenly in the future than it was in 1998.

Stress among Hog Producers: Although hog farming generates about 15 percent of cash receipts in Indiana and less elsewhere in the Region, the recent dramatic plunge in hog prices raises concerns about the viability of small hog operations that characterize this Region.

CHART 2



Sources: *Wall Street Journal* via Haver Analytics, Inc.; U.S. Department of Agriculture

Because large industrialized hog producers are more likely to have sufficient resources to continue production despite currently low prices, supply may continue to surpass demand for some time. Consequently, prices may not rebound soon, darkening the outlook for many of the Region's small hog operations.

In addition, as some producers adapt to structural changes in the sector by participating in contractual arrangements, they may be incurring relatively new types of risk. With respect to production contracts, some producers have increased their leverage in order to finance the purchase of specialized hog facilities and inputs.

Marketing contracts, under which a packer typically guarantees the producer a price within a preset range, carry different risks. For example, farmers currently receiving the minimum contract price (which exceeds the current market price) may be accumulating liabilities that will have to be liquidated by a cash settlement when the contract expires in several years. Although participants are still gaining experience with this relatively new type of contract, several issues deserve attention:

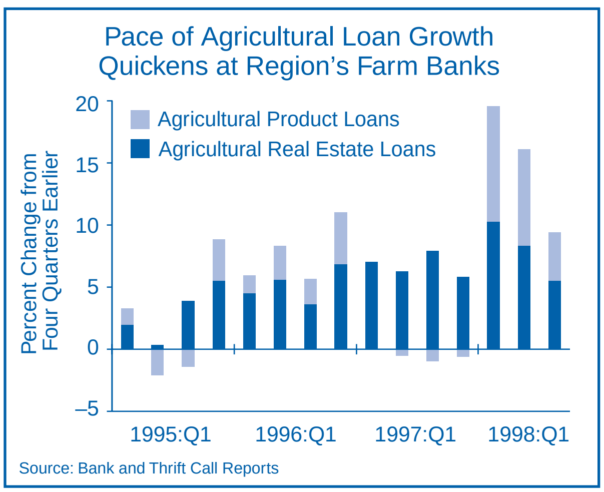
- Are any future liabilities incurred under marketing contracts properly reflected in producers' balance sheets and financial ratios?
- Are lenders pricing their loans appropriately in light of these potential liabilities, and are they considering their lien position with respect to liens that packers may hold?
- Is the financial health of packers being evaluated with respect to their ability to perform when contracts are detrimental to them (i.e., the price they pay is above the market price)?

Farmland Prices Affected: The weakness in commodity prices is affecting farmland prices, which fell on a widespread basis in third quarter 1998 for the first time since 1986. This development was reported in the ***AgLetter,*** published by the ***Chicago Federal Reserve Bank*** in November 1998, which surveyed 390 agricultural bankers in Illinois, Indiana, Michigan, Wisconsin, and Iowa. Over the three months ending October 1, 1998, the value of "good" farmland fell by 3 percent in Indiana and 2 percent in Illinois, held steady in Michigan, and rose by 1 percent in Wisconsin, according to the survey. (Ohio is not included in the survey.) Given the guarded short-term outlook for commodity prices and farm income, lenders may want to reevaluate their assumptions about the value of farmland used as collateral for loans.

Loan Performance: Strain caused by these conditions may be affecting banks. Both agricultural operating loans and loans secured by agricultural real estate held by the 512 farm banks in the Region (those with 100 percent or more of Tier 1 capital exposed to agricultural loans) have grown rapidly in the past three quarters (see Chart 3).

Some of the growth may reflect carryover debt resulting from crop farmers' decisions to hold a higher percentage of recent harvests in anticipation of selling at higher prices in the future. Indeed, bankers in the ***AgLetter*** survey reported a significant rise in loan renewals and extensions, especially in Illinois. The USDA's forecast

CHART 3



for continued slackness in corn and soybean prices casts doubt on whether farmers will be able to sell their stocks at significantly higher prices.

Some of the increase in agricultural loans also reflects deteriorating loan repayment rates, according to the ***AgLetter.*** Forty-three percent of respondents in the survey indicated that loan repayments had weakened over the past year, with the decline most prevalent in Illinois but also noticeable in Indiana and Michigan.

In light of these conditions, consideration should be given to various issues, including the following:

- whether farmers have sufficient financial cushion to withstand more than one year of low prices;
- the fact that the 1998 cushion to farm income from emergency farm legislation may not be repeated;
- whether lenders are continuing to carefully monitor cash flows and avoid overreliance on land collateral values;
- whether lenders might benefit by helping farmers develop, implement, and monitor risk management strategies, where appropriate; and
- what the wider economic impact will be on farm communities that are heavily dependent on commodities experiencing sustained price weakness.

Sustained commodity price weakness and excess supply could heighten farm banks' challenges should farmers encounter significant financial problems as 1999 unfolds. Although most farm banks were well capitalized on September 30, 1998, a third of institutions in the lowest earnings quartile (with ROA of 0.91 or less) also had loan loss reserve coverage of gross loans below 1 percent, which may leave them vulnerable to adverse developments.

The Chicago Region Staff

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