◈ Regional Outlook ◈

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FDIC
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In Focus This Quarter

◆ ***Gain-on-Sale Accounting Can Result in Unstable Capital Ratios and Volatile Earnings*—The accounting for transferring and servicing financial assets causes asset sellers, particularly high-growth lenders, to recognize significant noncash income related to retained economic interests in the sold assets. This is true whether a company securitizes its own assets or sells its assets as a conduit to another securitizer. Values are often driven by management assumptions about future performance of the sold assets. Major writedowns of gain-on-sale assets by some finance and mortgage companies underscore the importance of careful scrutiny of these assumptions by banks and their supervisors.** *See page 3.*

By Allen Puwalski

◆ ***How Will the Expansion End?*—Analysts are now focusing on when and how the current expansion will end. Although no one can accurately predict when a recession will begin, two possible scenarios have emerged. Each scenario has important implications for lenders as they prepare for the possibility of slower economic growth or recession.** *See page 7.*

By Paul C. Bishop

◆ ***Trends Affecting the Allowance for Loan and Lease Losses*—In today's environment, in which loan availability is abundant, growth is strong, and competition is fierce, some industry leaders and regulators have expressed concern about the loosening of underwriting standards and greater risk in bank loan portfolios. At the same time, the allowance for loan and lease losses (ALLL) relative to total loans at many insured institutions is declining. As the economic expansion reaches an advanced age, an important question for insured institutions is whether their ALLLs adequately reflect the risks associated with changing industry practices.** *See page 11.*

By Andrea Bazemore

Regular Features

◆ ***Regional Economy*—The Chicago Region's economy is healthy…however, the aging cyclical expansion and possible repercussions from conditions in Asia create the potential for a simultaneous weakening in its manufacturing and agricultural sectors…such a development would expose a number of insured institutions throughout the Region to changing economic conditions in the communities they serve.** *See page 16.*

By the Chicago Region Staff

◆ ***Regional Banking*—Chicago Region institutions continue to deal with significant changes and maintain strong operating performance…this strong performance notwithstanding, analysts have identified a number of emerging risks and trends that bank managers, examiners, and auditors likely will have to contend with in 1998…while some of these issues are unique, such as Year 2000 concerns, most revolve around traditional bank lending, funding, and sales operations.** *See page 20.*

By the Chicago Region Staff

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Gain-on-Sale Accounting Can Result in Unstable Capital Ratios and Volatile Earnings

- **Gains generated from asset sales under SFAS 125 rely on management assumptions about the lifetime performance of the assets sold and may not materialize in cash if the assumptions prove incorrect.**

- **Gain-on-sale accounting has been most significant to securitizers, but nonsecuritizers can and do retain economic interests that give rise to significant gain-on-sale assets.**

- **Finance companies seeking to shift attention from gain-on-sale assumptions may find willing bank correspondents.**

- **The rating services have modified capital and earnings analysis in order to lessen what they consider distortions caused by SFAS 125.**

Statement of Financial Accounting Standards No. 125 (SFAS 125), Accounting for Transfers and Servicing of Financial Assets and Extinguishing of Liabilities, causes asset sellers, particularly high-growth lenders, to recognize significant noncash income. Applying SFAS 125, which became effective on January 1, 1997, can give rise to significant noncash gains and related assets if an economic interest is retained in assets sold. The value of retained interests in assets sold is quantified on the basis of management's assumptions about future charge-off rates, repayment rates, and the rate used to discount the expected cash flows from the loans sold. Because the value of these assets changes when actual performance deviates from the assumptions, the quality of earnings, capital, and liquidity for a lender that relies significantly on gains on sale must be considered carefully.

The recent writedowns of interest-only (IO) assets by a few major finance companies have led to a higher level of scrutiny of companies whose financial statements are influenced significantly by gain-on-sale accounting. The Securities and Exchange Commission has recently increased its scrutiny of publicly traded companies that use gain-on-sale accounting, and it may soon require assumptions regarding defaults, prepayments, and discount rates to be disclosed in financial statements. The same companies that enjoyed soaring stock performance thanks to high earnings growth caused by gain-on-sale accounting have seen their stock values tumble as they have had to write down their gain-on-sale-related assets.

Several major credit rating companies have recognized the significant effect of gain-on-sale accounting under SFAS 125 on interpreting financial statements. These companies have issued comments or reports dealing with SFAS 125's effect on the quality of earnings and capital of the companies they rate and how they adjust their analysis as a result. The consensus of these papers is that gain-on-sale accounting for companies that securitize often results in significantly higher reported earnings and equity compared to balance sheet lenders—without, in many cases, materially changing the underlying economics or credit risk to the originator of the assets.[1] Generally, the rating services have modified capital and earnings analysis in order to lessen what they consider distortions caused by SFAS 125.

There Are Risks Associated with Gain-on-Sale Accounting

The asset booked in connection with an SFAS 125 loan sale is an IO strip that represents the present value of future excess spread cash flows generated by the transferred assets. Generally, asset-backed securitizations, including some classified as mortgage-backed securities, are structured so that each month the expected cash flows from the underlying assets will be sufficient to pay the investor coupon, the trust expenses, the servicing fee, and net charge-offs. The cash flow that the underlying assets will generate each month cannot be known with certainty because the underlying asset may allow for variable principal payments (e.g., credit card accounts), or the borrowers may default. Securitizations are structured so that there is enough cushion between the *expected* cash flows and the required payments and

[1] Duff & Phelps Credit Rating Company, "Securitization and Corporate Credit Risk." *Special Report Financial Services Industry,* July 1997; T. E. Foley and M. R. Foley. "Alternative Financial Ratios for the Effects of Securitization Tools for Analysis." *Moody's Special Comment,* September 1997; H. L. Moehlman, R. W. Merrit, and N. E. Stroker. "Capital Implications of Securitization and Effect of SFAS 125." *Fitch Research*, September 16, 1997.

expected charge-offs to absorb fluctuations in *actual* cash flows and *actual* charge-offs. This cushion is excess spread. As actual cash flows vary from projections, so does the excess spread generated.

According to SFAS 125, when a company sells assets and retains the right to future excess spread cash flows, the calculation of the gain on the sale includes the capitalization of this right. In many transactions, the gain on sale consists entirely of the fair value of the IO strip that represents this right—none of which is necessarily received in cash. In addition, with many transactions, cash receipt is further delayed while cash flows go to fund the spread account, which is analogous to an internal loan loss reserve.

SFAS 125 states that quoted market prices in active markets are the best evidence of fair value and should be used whenever available. Although there have been some sales of these IO strips, the number of sales is not yet sufficient to constitute an active market. When market prices are not available, SFAS 125 states that the estimate of fair value should be based on the best information available. In practice, fair value of the excess spread is determined by present valuing the expected cash flows using a discounted cash flow model.

The value of the right to future cash flows is determined on the basis of management's assumptions about the charge-off rate, the average life of loans, and the rate used to discount the cash flows. *These input assumptions drive the model results and, therefore, the magnitude of the gain.* The stability of the value of the IO will depend greatly on the extent to which the input assumptions accurately describe the pool performance over the life of the transferred assets. Changes in economic or market conditions that were not anticipated in the initial cash-flow assumptions will likely cause the pool of loans to perform differently than initially projected.

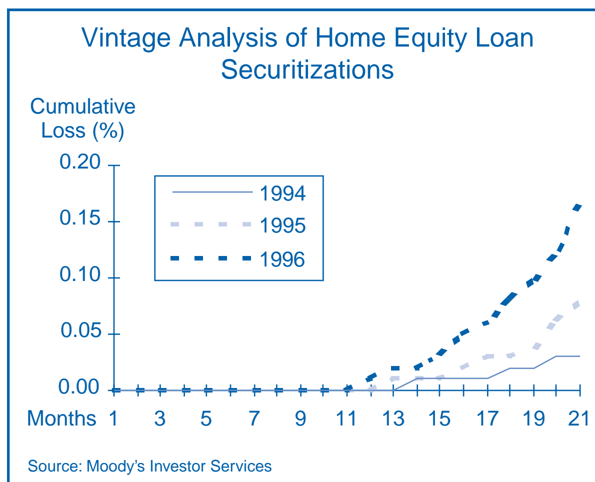
Gain-on-sale accounting is significant to securitizers. To illustrate the significance of the IO account to a securitizer's reported income, consider one major subprime lender. During fiscal year 1997, this company's IO asset grew by over $141 million. Despite a $28 million writedown of the IO asset, the net growth of the asset constituted over half of total revenue and over eight times net income. The revaluation of the IO was necessitated by higher-than-expected prepayment rates.

Current market conditions were not anticipated by many companies that benefited from high earnings related to gain-on-sale accounting. Several other major securitizers have reduced the carrying value of their IO assets in the face of either rising charge-off rates or higher prepayment rates. Writing down an IO strip largely represents a company's admission that it will not generate on a cash basis income that was booked previously.

Chart 1 displays the cumulative charge-off rates by vintage for ***Moody's*** index of home equity loan securitizations. The index consists mostly of prime mortgages, so the loss rates are still low. However, the rising trend in losses is noteworthy and reflects the growing influence of subprime securitizations on the index and the related decline in underwriting standards as competition has increased in this market. Loans originated in 1995 and 1996 are causing progressively larger and earlier losses. After 21 months of seasoning, the cumulative loss rate on loans originated in 1996 is .17 percent—almost six times the loss rate experienced by the 1994-originated cohort at the same age. Despite the continued low loss rates for the home equity market in general, subprime lenders are experiencing accelerated loss rates that are eroding the value of their interests in excess spreads.

There may be a tendency for management to base assumptions about expected loss rates on loans sold solely on past experience with similar loans. Such an approach may not capture changes in market conditions and trends. For example, the Moody's data demonstrate that loss rates on home equity loans, including first liens, have been trending upward rapidly. This trend implies that when estimating loss rates, management should consider the potential for changes in market con-

CHART 1



Source: Moody's Investor Services

ditions over the life of the sold assets as well as the past performance of similar assets.

Like loss rates, prepayment rates have risen substantially in the subprime mortgage market. Several factors have contributed to the rise. One factor is the trend toward higher loan-to-value (LTV) loans in the mortgage market, which has allowed borrowers to obtain additional cash from their homes without waiting to pay down principal. Mortgage bankers report the tendency of some subprime borrowers, often debt consolidators, to maintain outstanding balances at the highest possible LTV. With maximum LTV ceilings rising, debt consolidators can refinance home equity loans without having to amortize existing debt.

Another important factor contributing to rising prepayment rates is competition among lenders for volume growth. To continue to grow volume, lenders have been sacrificing margins on loans to offer a better rate to borrowers. When estimating prepayment rates for subprime borrowers, it has been normal to expect that they would need to improve their credit rating, or "credit cure," before they would find it economical to refinance. Stiff competition for volume has allowed borrowers to find better rates without credit curing and has stimulated them to refinance prior to the time estimated at origination. Falling interest rates and a relatively flat yield curve are likely to increase prepayment rates.

In standard finance theory, uncertainty about the future level of losses and prepayment rates is compensated for by discounting the cash flows at a higher rate. Some analysts advocate using a discount rate similar to the required rate of return for equity investments. Faced with changing conditions, one large finance company that specializes in high LTV lending announced in December 1997 that it was increasing the discount rate it uses to value new IO strips from 12.5 percent to 33 percent.

The IO Strip Asset Is Growing at Insured Depository Institutions

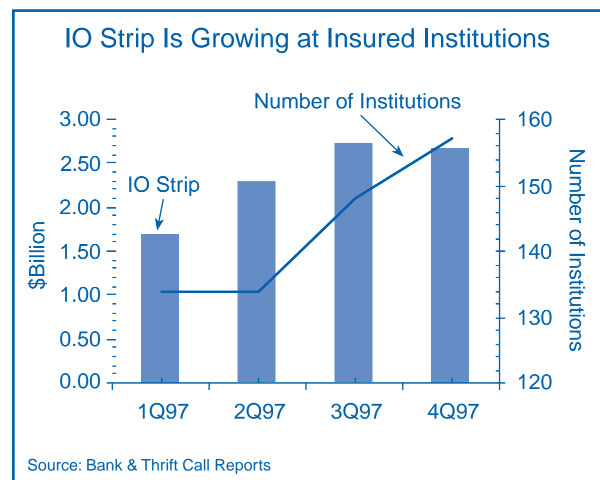
As of December 31, 1997, only 30 institutions reported this IO asset at more than 5 percent of tier 1 capital. However, some institutions have booked gains that should have given rise to a call-reportable IO strip but did not properly report the assets. Therefore, the current reporting may understate the prevalence of the asset.

Furthermore, the recent attention to gain-on-sale accounting from the public equity markets has at least a few large finance and mortgage companies seeking business strategies that shed IO strip-related volatility from their financial statements. One such strategy already in use is to leave the economic interest in excess spread with the correspondents that originate the loans. This is done as follows: The correspondent originates loans for purchase by a finance company. The finance company pays par for the loans, and instead of being paid an origination fee or a premium for the loans, the *seller* retains the right to excess spread generated over the life of the loan. The seller books a gain and an IO asset that capitalizes this right to receive future cash flows. The nature of the IO asset is exactly the same whether it arises directly from a securitization or from a sale of loans to a securitizer. *If this strategy is used widely by finance and mortgage companies, then IO strips are likely to grow among institutions that originate loans for sale to these companies* (see Chart 2).

For insured depository institutions, the capital effects of SFAS 125 need to be evaluated carefully. Analysis of the financial statements and leverage ratios of insured institutions should consider fully issues related to the quality of earnings and the stability of capital posed by the volatility of the IO strip. Insured institutions that engage in significant asset sales while retaining economic interests that give rise to SFAS 125–related assets are subject to distortions similar to those of nonbank financial companies.

The activity of originating and selling loans and booking associated gains can lead to capital ratios that

CHART 2



appear high by traditional bank standards. For several reasons, the leverage ratio can appear particularly high. First, although the asset may be more volatile than mortgage serving rights, there is no limit to the amount of IO strip that a bank can include in tier 1 capital. Second, the amount of IO strip booked increases capital by a gain on the net of the tax effect. The extent to which the amount remains in capital depends, of course, on the institution's dividend policy. Third, the denominator of the leverage ratio is reduced by the sale because the loans are no longer assets of the bank. The cumulative result can be a significant boost to the leverage ratio.

Several insured institutions report an IO strip at greater than 25 percent of tier 1 capital. For an institution whose primary line of business is originating and selling subprime mortgages, the asset can quickly reach a level exceeding tier 1 capital. In a little more than a year of originating and selling subprime mortgages to a major securitizer, one institution has amassed IO assets that it has valued at more than 150 percent of tier 1 capital.

The institutions that have concentrations of 25 percent or more of tier 1 capital in IO assets have a median leverage ratio of about 11 percent. In contrast, the median equity capital ratio for nonbank mortgage securitizers tracked by ***SNL DataSource*** is about 30 percent. Public debt markets or banks that lend to these finance companies appear to require significantly higher capital levels than regulatory minimums required for banks.

The potential for growth of the IO strip asset at insured institutions seems strong. In some circumstances, minimum capital standards for banks may require significantly less capital for IO asset exposure than the public equity markets. Perhaps more important, the quick rise of the significance of gain-on-sale accounting to the mortgage and consumer credit markets exemplifies the speed with which exposure to risk can be acquired through the securitization market. Strong demand for asset-backed securities coupled with changing accounting emphases, which in this case favor asset sellers, can lead quickly to substantial exposures.

Allen Puwalski, Senior Financial Analyst

Risk-Based Capital (RBC) Treatment of the Gain-on-Sale–Related IO Asset

If the IO asset derives from excess spread that absorbs charge-offs from the sold assets, then the IO strip constitutes recourse from the sold assets for RBC purposes. RBC standards require capital to be held against this exposure. In general, the capital requirement for this exposure is the amount of capital that would have been required for the assets had they not been sold. If the sold assets are one- to four-family residential mortgages, they may receive a 50 percent risk weighting. Subprime mortgages are not necessarily precluded from receiving this weighting.

In order to apply the 50 percent risk weighting, the capital standards require that one- to four-family residential mortgages be fully secured and prudently underwritten. The "fully secured" requirement precludes high-LTV loans with LTV ratios of greater than 100 percent from receiving reduced capital requirements, but the language of the RBC regulations does not necessarily preclude subprime mortgages in general from receiving the reduced risk weighting. Although the capital standards require that mortgages be prudently underwritten to qualify for the 50 percent risk weighting, it is not entirely clear how the term "prudently underwritten" applies to subprime mortgages. A higher expected loss rate alone may be insufficient cause for presuming that the mortgages are not prudently underwritten.

The rationale for reducing the capital requirement for traditional one- to four-family mortgage lending is related to the maturity of the market and consistently low loss rates. As noted above, the subprime mortgage market is changing rapidly, and loss rates can be much higher than in traditional mortgage lending. Accordingly, bank managements need to be aware of the potential volatility and risks associated with gain-on-sale assets associated with subprime mortgages.

How Will the Expansion End?

- **Despite a very low unemployment rate and high industry capacity utilization, inflation has been unusually subdued during this expansion, with price declines in some sectors.**

- **After seven years of expansion, most analysts expect the economy's growth to slow in the coming months.**

- **The last seven expansions have ended with an inflation-driven increase in short-term interest rates; in contrast, some analysts believe that the next recession will be caused by a period of falling prices for commodities, finished goods, and perhaps wages.**

- **Insured institutions that base lending and strategic decisions on assumptions of continued robust economic growth should scrutinize and test those decisions against possible adverse change in economic conditions.**

The current economic expansion is the third longest on record since World War II. Since mid-1991, when the expansion began, more than 15 million new jobs have been created and inflation-adjusted gross domestic product (GDP) has increased by nearly 20 percent. In fact, the unemployment rate reached a 24-year low when it fell to 4.6 percent in November 1997 and again in February 1998. At the same time, inflation has remained unusually low, at only 2.3 percent during 1997.

Analysts are now focusing on when and under what circumstances the current expansion will end. While no one can accurately predict *when* the expansion will end, two related but competing theories about *how* it will end have emerged in recent months. The first and more familiar scenario occurs when the Federal Reserve increases short-term interest rates to prevent a rapid increase in inflation caused by an overheating economy. The second scenario, a deflation-induced contraction, is less familiar in the context of recent recessions. This scenario posits a period of falling prices for commodities, finished goods, and, under the most severe circumstances, even wages.

Whatever the cause of the next downturn, its effects are likely to be important for the performance of lenders. During the 1990–91 recession, for example, the widespread deterioration of economic conditions was reflected in a number of indicators: Inflation-adjusted GDP fell by 2 percent; the number of business failures rose by nearly 40 percent; unemployment increased by more than 40 percent to 9.8 million; the unemployment rate peaked at more than 7 percent; single-family housing starts fell by almost 22 percent; and the bank card delinquency rate increased from 2.4 percent to 3.3 percent. This experience suggests that no matter what triggers the next downturn, dramatic adverse changes in the drivers of bank performance will likely result.

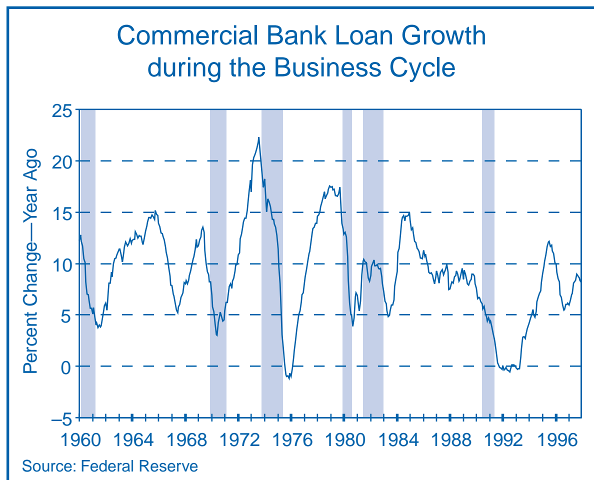
How Have Economic Expansions Usually Ended?

Although to some extent each business cycle is unique, virtually all of the post–World War II expansions have shown a similar characteristic: Toward the end of the expansion, inflation has accelerated. As the economy expands, the prices of inputs, including the wages of workers, are bid up as firms compete for resources to meet demand. The overall inflation rate will rise if prices increase across a large number of industries. Left unchecked, an increase in the overall price level may itself feed back into the labor market through demands for higher wages.

By raising short-term interest rates, the Federal Reserve can limit what might otherwise lead to a rapid increase in both wages and prices. Higher interest rates will reduce sales of capital goods, housing, and consumer durables, the demand for which is very sensitive to the level of interest rates. One reflection of this sensitivity is the changing pattern of loan growth over the business cycle. During periods of expansion, the demand for loans grows rapidly as businesses and households borrow to finance purchases of capital goods and consumer durables. If short-term interest rates are increased in response to inflationary pressures, loan growth will slow as businesses and consumers reduce their demand for loans. If interest rates continue to increase, loan growth may decline as it has done before and during each recession. The cyclical movement of loan growth (with vertical bars indicating periods of recession) is shown in Chart 1 (next page).

Looking more closely at short-term interest rates, Chart 2 (next page) illustrates the federal funds rate during the

CHART 1



last seven business cycles. While an increase in short-term interest rates has preceded each recession, it should be noted that an increase in rates is not sufficient to induce a recession. An increase in rates in 1984 was followed by a period of rapid growth that lasted until 1990. More recently, the increase in rates during 1994 was accompanied by a slowdown in the economy, but not a recession.

What Is Different about Inflation during This Expansion?

With history as a guide, one would expect inflation to rise as the current expansion matures. Chart 3 illustrates consumer price inflation during the four longest post-war expansions, including the current one. The chart shows the inflation rate at various points after the expansion began. During the expansion between 1975 and 1980, for example, the inflation rate was nearly 12 percent at the start of the expansion but fell to just over 6 percent after four quarters. Inflation remained at approximately 6 percent until the twelfth quarter of the expansion, after which it accelerated to more than 12 percent by the end of the 20-quarter expansion.

The current inflation trend differs from previous expansions in two ways. First, by the later stages of previous expansions, inflation was accelerating (see Chart 3). In contrast, there are few signs of accelerating consumer price inflation during the current expansion. In fact, it appears that the rate of inflation is declining; the United States has experienced disinflation.[1] Second, among expansions that have lasted more than 20 quarters, the current rate of inflation is one of the lowest since World War II. Consumer inflation is both decreasing and low by historical standards.

What Are the Two Views about Future Inflation?

Two views have developed about how the current expansion will end. The debate, couched in terms of the expected rate of future inflation, is of more than academic concern. The Federal Reserve's decision about

[1] In popular discussions of inflation rates and the price level, terminology is sometimes used loosely. To clarify, a declining rate of inflation, properly described as disinflation, means that prices are increasing at a progressively slower rate over time. Deflation is defined as a generally falling price level or, equivalently, a negative inflation rate.

CHART 2

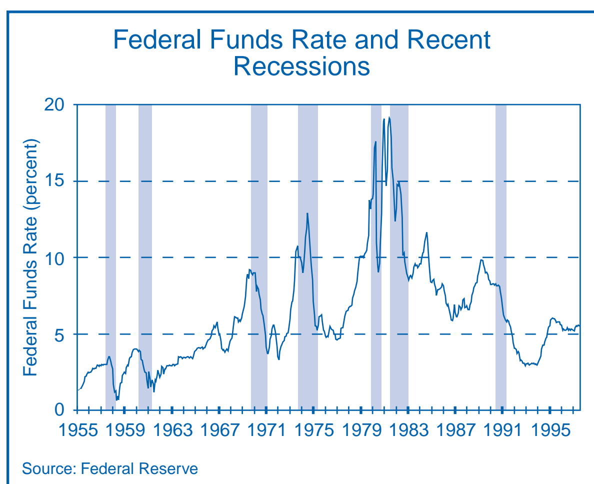
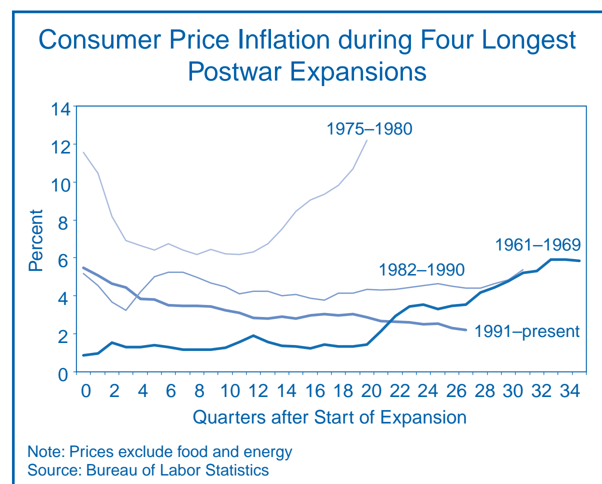


CHART 3



whether to change short-term interest rates may be influenced by arguments on either side of the debate.

The Traditional View

Although inflation has been tame during this expansion, adherents of the traditional view believe that impending inflation still poses a danger to the longevity of the expansion. Evidence cited to support this view includes a very low unemployment rate and rising inflation-adjusted wages. The reasons for the low inflation rate include low energy prices, inexpensive imports, and brisk domestic and international competition. These factors have delayed the onset of inflationary pressures, but they will not remain favorable indefinitely. The underlying dynamics have not changed significantly from those that led to rising inflation during every other recent economic expansion. This is also the view of the Federal Reserve Open Market Committee, as stated in the minutes of its November 12, 1997, meeting:

> *The reasons for the relative quiescence of inflation were not fully understood, but they undoubtedly included a number of special factors…the risks remained in the direction of rising price inflation though the extent and timing of that outcome were subject to considerable debate.*
>
> ***—Federal Reserve Bulletin, February 1998, p. 104***

The Deflation View

Alternatively, some analysts suggest that a recession may be brought about by a period of deflation. Advocates of this scenario base their view on the unusually low and falling inflation rate in the United States, even after seven years of economic expansion. They also suggest that the national economy of the 1990s is markedly different from that of the 1970s and 1980s. Intense global competition is now the norm and not the exception. Worker productivity growth is believed to be higher than the official data show, meaning that wage growth will not translate as readily as before into price increases. The U.S. economy is more prone to a period of falling prices than at any time in the recent past, especially in view of decreasing rates of inflation and deflationary forces originating from the ongoing Asian financial crisis.

What Does the Evidence Show?

Because determining economic policy is necessarily a forward-looking process, policymakers look at many indicators to determine the likely future course of inflation. A brief review of some of the more popular indicators reveals contradictory readings that can support either the inflation or deflation scenario.

Wage Growth

The national unemployment rate is currently very low, signaling that labor markets are near capacity in terms of their ability to create new jobs. The nation's unemployment rate was below 5 percent for nine months during 1997. This rate has been well below what many analysts thought possible without a sharp rise in inflation. As labor market conditions have tightened, wage growth has increased. Since 1993 the rate of growth has been on a steady upward trend, from a low of just over 2 percent to about 4 percent in the first quarter of 1998.

Capacity Utilization

Capacity utilization, the percentage of industrial capacity that is currently in use, has risen since early 1997. Utilization has been around 83 percent since mid-1997, a threshold rate that has traditionally signaled impending inflationary pressures at factories, mines, and utilities.

Commodity Prices

Many commodities, such as metals, crude oil, and unprocessed food products, have exhibited weak prices during the past several months. Between mid-1996 and early 1998, the ***Knight-Ridder Commodity Research Board Price Index*** fell by more than 15 percent. Key to the decline was a 35 percent decrease in crude oil prices.

Finished Goods Prices

Since the data show that both labor and physical capital are at high rates of utilization, the traditional inflation scenario suggests that there will be increasing price pressures. In the manufacturing sector, such price pressures would likely show up first in the prices of goods as they leave the factory. The price of finished goods rose by only 0.4 percent during 1997, however. On a monthly basis, prices declined during eight months in 1997.

Service Sector Prices

The service sector accounts for a growing portion of all output and employment in the U.S. economy. Labor costs generally account for a much higher percentage of input costs in the service sector than in the manufactur-

ing industries. Additionally, many service industries operate in local markets and are insulated from national or global competition. Consequently, inflation rates in the service sector are generally higher than in the goods sector. Service sector inflation has, however, been on a downward trend, falling from 5.5 percent in 1990 to 3.1 percent in 1997.

Import Prices

Since early 1996, import prices have fallen precipitously. The decline is due in part to the rising value of the dollar, which has reduced the cost of imports. Non-petroleum import prices have fallen by 5 percent since early 1996. Within that group, capital goods prices have decreased by 12 percent over the same period.

One factor that will continue to put downward pressure on prices is the turmoil in Asian markets. Asian exporters are now much more competitive with the rest of the world, following the drop in the value of their currencies. Consequently, U.S. firms that compete with Asian producers will be under greater pressure to cut prices. At the same time, reduced Asian demand for U.S. exports could lead to a ballooning trade deficit and a softening of export prices. In January 1998, for example, the United States reported a record-breaking trade deficit of $12 billion, caused in part by slower export growth.

From this brief review, it is apparent that signs of impending inflation are at best mixed. Clearly, U.S. labor markets are at or near full effective capacity, and the utilization of factories and physical capital is also very high. There is little evidence that these factors are causing an increase in prices at either the producer or consumer levels.

How Will the Expansion End?

Although no one can accurately determine when the expansion will end, most analysts are predicting slower economic growth in the second half of 1998. Indicators such as the unemployment rate suggest that growth will be limited by the availability of labor needed to produce an increasing supply of goods and services. Weak or declining output prices in some sectors could act as a further constraint on economic growth.

Among economists, the traditional view that the expansion will end following a rise in inflation and an increase in short-term interest rates appears to be the more prevalent view. Nevertheless, the possibility that the next economic downturn might be triggered by the ripple effects of declining output prices should not be dismissed, especially in light of the potentially adverse and less familiar risks associated with deflation. What is clear for insured institutions is that at this stage of the economic expansion, lending and strategic decisions predicated on an assumption of continued robust economic growth should be carefully scrutinized and considered in light of a possible deterioration of economic conditions.

Paul C. Bishop, Economist

Why Might Deflation Be a Concern?

The most significant difference between the inflation and deflation scenarios is reflected in the response of financial markets. One of the consequences of inflation is that a dollar in the future is of less value than today's dollar. In a deflationary environment, the opposite is true—a dollar in the future will buy more goods and services than a dollar today.

In a deflation scenario, debtors would see the real value of their financial obligations rise and might therefore be hesitant to borrow. A fixed monthly mortgage payment, for example, would be paid back with increasingly valuable dollars over time. Asset values could fall, especially since the purchase of an asset, such as a house, would require inflation-adjusted debt repayments that increase through time. Likewise, consumer credit debt obligations, such as payments on outstanding credit card balances, would become increasingly onerous. For households already experiencing credit problems, the prospect of a period of sustained deflation would worsen their financial position. At the very least, deterioration in credit quality would be expected, along with an increase in the number of business and personal bankruptcies.

Trends Affecting the Allowance for Loan and Lease Losses

- **Allowance for loan and lease loss (ALLL) levels are declining relative to total loans.**
- **Some industry leaders and regulators have expressed concern about the loosening of underwriting standards and greater risk in bank loan portfolios.**
- **Significant growth in riskier loan types calls attention to the need to scrutinize closely the adequacy of the allowance.**

Weakening underwriting standards and significant growth in riskier loan types have increased the risk exposures of some insured institutions to an economic downturn. Meanwhile, the ALLL relative to total loans has declined in recent years. This article provides information on trends in the ALLL over time and by loan type and discusses the factors analysts consider when evaluating the adequacy of the ALLL. Special attention is given to issues related to the volatility of loan losses and the composition of the loan portfolio.

Historical Perspective on the Allowance for Loan and Lease Losses

The nation is currently witnessing one of the longest economic expansions since World War II. It is to be expected that some institutions will reduce their ALLL coverage during periods of improved economic conditions. However, in the current environment—in which loan availability is abundant, growth is strong, and competition is fierce—some industry leaders and regulators have expressed concern about the loosening of underwriting standards and greater risk in bank loan portfolios. At the same time, the ALLL relative to total loans for commercial banks has declined to the lowest point in a decade (see Chart 1). This allowance ratio has diminished because commercial banks' loan loss provisions have not kept pace with new loan growth. In some cases, banks have determined that their allowances are higher than necessary and have taken negative loan loss provisions, which are credited back to income.

This decline in reserve coverage has been broad based, with the exception of credit card specialists. Commercial banks with concentrations in commercial lending and large multinational banks have significantly reduced the level of reserves to total loans in recent years. Table 1 (next page) shows that since 1993, ALLL ratios at both commercial lending banks and multinational banks have declined 31 percent. Moreover, commercial lending banks with assets exceeding $10 billion have reduced ALLL ratios by slightly over 37 percent, or 98 basis points, over the same period.

The low level of nonperforming and charged-off loans, coupled with prevailing favorable economic conditions, is doubtless a significant factor in the reduction of

Chart 1

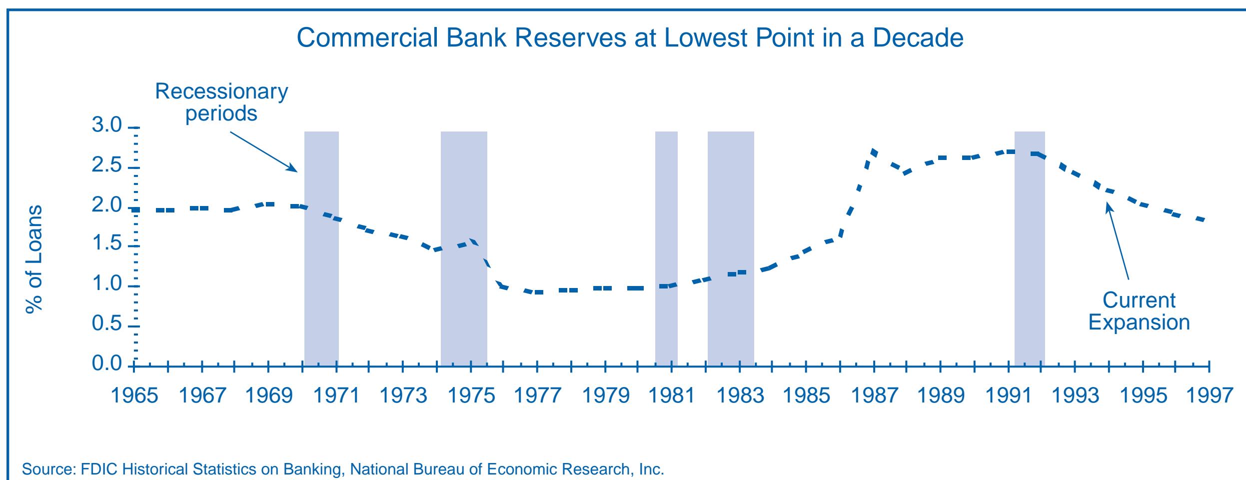


TABLE 1

COMMERCIAL BANK ALLOWANCE FOR LOAN AND LEASE LOSSES TO TOTAL LOANS BY LENDER TYPE

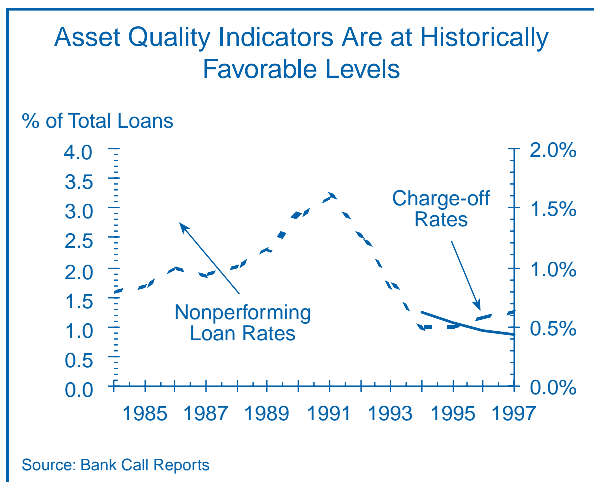
TYPE OF LENDER	NUMBER OF BANKS	ASSETS ($BILLIONS)	1997	1996	1995	1994	1993
MULTINATIONAL	11	$1,383	2.14	2.25	2.55	2.83	3.10
COMMERCIAL	3,207	$1,915	1.63	1.71	1.90	2.16	2.37
CREDIT CARD	67	$202	4.21	3.48	3.21	2.89	3.35
MORTGAGE	286	$120	1.26	1.45	1.45	1.69	1.87
AGRICULTURAL	2,373	$120	1.53	1.66	1.69	1.75	1.83

DEFINITIONS FOR LENDER TYPES BY ORDER OF PRIORITY: MULTINATIONAL—ASSETS >$10 BILLION AND FOREIGN ASSETS >25% OF ASSETS; COMMERCIAL—C&I PLUS CRE LOANS >50% OF ASSETS; CREDIT CARD—CREDIT CARD LOANS >50% OF ASSETS; MORTGAGE—1- TO 4-FAMILY MORTGAGES AND MORTGAGE-BACKED SECURITIES >50% OF ASSETS; AGRICULTURAL—AGRICULTURAL PRODUCTION AND AGRICULTURAL REAL-ESTATE LOANS >25% OF TOTAL LOANS.
SOURCE: BANK CALL REPORTS

ALLL levels. Asset quality indicators such as nonperforming loans and loan loss rates are at historically favorable levels. At year-end 1997, the banking industry's nonperforming loans were just under 1 percent of total loans, the lowest in 13 years. The industry's loan charge-off rates (with the exception of consumer loans) are also at historical lows. (See the ***Regional Outlook,*** first quarter 1997, for a detailed discussion of consumer loan losses.) However, even with the problems in consumer lending, the banking industry's aggregate loan loss rate is down significantly from levels in the early 1990s (see Chart 2).

As the economic expansion reaches an advanced age, an important question for insured institutions is whether their ALLLs adequately reflect the risks associated with changing industry practices. Insured institutions could experience strains on profitability and capital if allowance levels are inadequate. Given changing underwriting trends and loan delinquency patterns, a related question is whether reliance on past loss experience in setting the allowance will be an adequate measure for current losses.

CHART 2



Trends in Underwriting Prompt Regulatory Cautions

Over the past year, various underwriting and lending practices surveys by the FDIC, the Office of the Comptroller of the Currency (OCC), and the Federal Reserve have noted easing of terms and weakening underwriting standards on loans, especially in commercial loan portfolios. *It is important to note that, in 1997, nearly two-thirds of the commercial banking industry's loan growth was centered in the commercial real estate (CRE) and commercial and industrial (C&I) loan categories* (Chart 3).

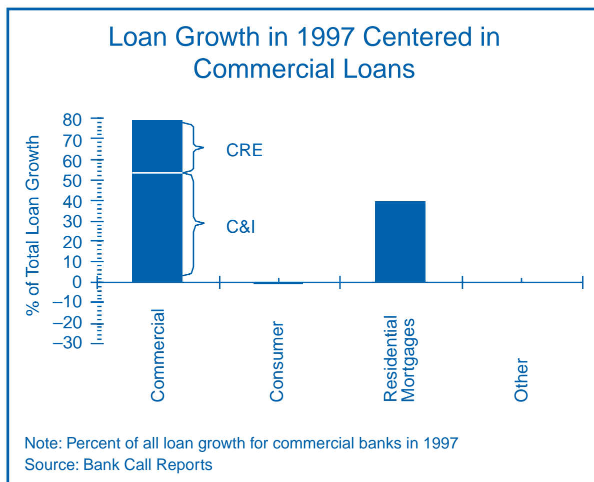
In the FDIC's ***Report on Underwriting Practices*** for April 1997 through September 1997, examiners noted "above-average" risk in current underwriting practices for new loans at almost 10 percent of the 1,233 FDIC-supervised institutions examined. Of the institutions with above-average risk, 12 percent did not adjust pricing for loan risk. Examiners noted that several of the 852 institutions examined that were making business loans had poor underwriting standards, including lack of documentation of the borrower's financial strength

(21 percent) and poor and unpredictable loan repayment sources (14 percent). Also, of the 571 institutions specifically involved in asset-based business lending, 20 percent often failed to monitor collateral. Furthermore, 20 percent of the 398 institutions examined that were actively engaged in construction lending repeatedly failed to consider alternative repayment sources, and 29 percent often funded speculative projects. In contrast, just one year earlier, in the ***Report on Underwriting Practices*** for April 1996 through September 1996, examiners reported that only 11 percent of the institutions examined that were actively engaged in construction lending often funded speculative projects.

The Federal Reserve's ***Senior Loan Officer Opinion Survey*** for November 1997 and February 1998 both indicated some easing of commercial business lending terms and standards. Also, the OCC's ***1997 Survey of Credit Underwriting Practices*** stated that the level of inherent credit risk continues to increase for components of both commercial and consumer loan portfolios. These underwriting trends have resulted in increased risk profiles for some insured institutions, while ALLL ratios at some institutions continue to decline.

In August 1997, the OCC issued an Advisory Letter voicing its concern about declining allowance levels in commercial banks. The OCC cited as primary concerns the apparent increases in credit risk reported by examiners, such as weakening underwriting trends in the syndicated loan market, easing of other commercial underwriting standards, and consumer lending delinquency and charge-off trends. Moreover, the OCC found that some banks were using flawed reserve methodologies for estimating loan loss rates, including an overreliance on historical loss rates.

CHART 3



Factors Affecting Adequacy of the ALLL

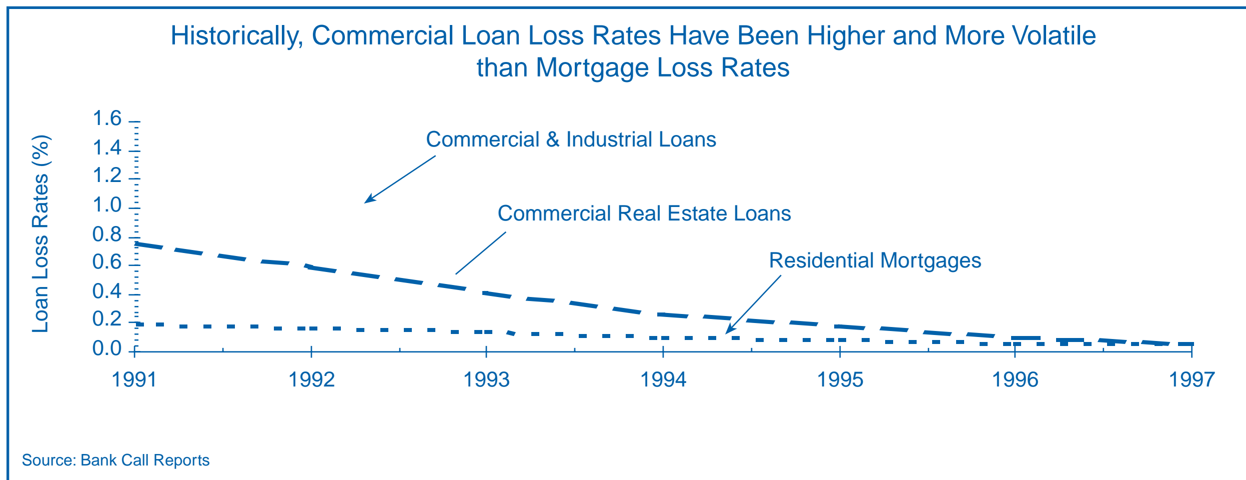
In using offsite data to assess allowance adequacy, analysts consider financial ratios such as the allowance to total loans, reserve coverage (allowance to nonperforming loans), loan loss provisions to charge-offs, and loan delinquency levels. These ratios are evaluated against historical benchmarks. At the same time, however, analysts supplement the analysis with consideration of the potential effects of current industry trends. For example, the banking industry is currently witnessing higher than normal losses in consumer lending spurred by increased bankruptcy filings and the migration of loans from current to charged off without intervening delinquencies. An institution that has a sizable consumer loan portfolio may therefore need to attach more weight to recent loan loss data in setting the allowance, since historical trends may not adequately reflect reserving needs.

Insured institutions exhibit different management and portfolio characteristics that significantly influence the level of the allowance. These characteristics include the diversification of a loan portfolio (diversification by borrower, loan type, geography, or industry), the history and recent trends of credit losses, management's practices in the recognition of losses, trends in past-due and nonperforming loans, underwriting practices, and economic conditions.

New techniques continue to be developed to improve the reliability of allowance estimates. Management information systems, which enable the collection of more refined historical data, coupled with the application of statistical techniques, are helping some institutions formulate more statistically reasoned allowance estimates. Loan management tools such as credit scoring systems, risk rating systems, and consideration of economic cycles in the review of historical loss and delinquency data all are aiding bankers in the reserving process. While these new techniques provide more analytically defensible estimates, they do not diminish the role of judgment in assessing ALLL adequacy.

The role of judgment in setting the ALLL is underscored by the volatility of loan losses over time.

CHART 4



"Volatility" in this context refers to the degree to which loan losses have diverged or might diverge from the long-run averages. Volatility in loan losses can result from changes in the business cycle, local economic events, and major one-time events. For example, a bank relying on a historic average loan loss calculation to derive its reserve level could find itself underreserved if it does not adjust its historical loss rates for deteriorating economic conditions and suddenly incurs greater loan losses than it had anticipated simply on the basis of past performance.

Generally, different types of loans experience varying loan loss rates because of the inherently different risks and varying levels of volatility within each type. Chart 4 shows that commercial loans, such as commercial and industrial loans and commercial real estate, historically have had greater losses than residential loans. Furthermore, the loss rates on commercial loans have not only been higher, they have been more volatile over the years, while average losses on mortgage loans have varied little.

Volatility in loan losses is determined not only by economic events but also by banks' willingness to take risk. Banks that adopt more liberal underwriting policies and high loan growth objectives may experience greater loan default risk and greater volatility in loan loss rates than suggested by their own past experience. For example, Chart 4 shows that mortgage lending has had low and stable loss rates on average. The recent growth in subprime and high loan-to-value mortgage lending, however, may result in increased volatility and losses for some lenders going forward.

All of these factors suggest that ALLLs would be expected to vary considerably both over time and across loan types. Table 2 shows that this has been the case. The ALLL is reported as a single line item on the Call Report. This makes it difficult to estimate how much of the ALLL is attributable to a particular loan type or to compare allowance levels for banks with significantly different loan portfolios. Table 2 shows the results of a statistical regression estimation of commercial bank allowance allocations across the various loan types for

TABLE 2

ALLL ALLOCATIONS HAVE VARIED OVER TIME AND BY LOAN TYPE (COMMERCIAL BANKS UNDER $1 BILLION)*

LOAN TYPE	1997 (%)	1996 (%)	1995 (%)	1994 (%)	1993 (%)	1992 (%)	1991 (%)
C&I	1.71	1.85	1.87	2.06	2.14	2.29	2.45
CRE	1.44	1.54	1.77	1.83	1.97	2.02	1.99
MORTGAGES	0.92	1.00	1.05	1.19	1.22	1.07	0.91
CREDIT CARDS	4.47	4.42	3.32	3.11	3.20	3.29	3.59

* ESTIMATED REGRESSION RESULTS
SOURCE: BANK CALL REPORTS

1991 through 1997 for commercial banks with under $1 billion in assets. Not surprisingly, CRE and C&I loans received relatively higher allowance allocations than residential mortgage loans, indicating that banks saw greater risk in these loan types. Also, credit card loans consistently received higher allocations than the other loan categories, and the allocations have increased in recent years owing to the increased delinquencies and charge-offs in this area.

Conclusions

The adequacy of the ALLL is measured not only relative to historical loan loss experience but also relative to current conditions that may cause losses to differ from past experience. Increased losses could result from adverse economic developments, from changes in banks' appetite for taking risk, or both. In this regard, reported weakening in underwriting standards is increasing some banks' risk exposure to an economic downturn. Institutions with high concentrations in riskier loans, significant growth in riskier loans, or weaknesses in underwriting may be most at risk. Especially for such institutions, the adequacy of the ALLL and its methodologies merits close scrutiny.

Andrea Bazemore, Banking Analyst

Asian Situation Adds to Region's Vulnerabilities and Challenges

- **The Chicago Region's economy is currently quite healthy. However, cyclical conditions and the potential effects of the Asian situation suggest that manufacturers' near-term ability to grow rapidly and maintain their profit margins may face increasing challenges.**

- **The agricultural sector also may face stiff winds on a number of fronts, including expectations of lower crop prices, reduced export demand from Asia, and structural change.**

- **Thus, the potential exists for both the Region's manufacturing and agriculture sectors to weaken simultaneously. Such a development would expose a large number of insured institutions throughout the Region to changing economic conditions in the communities they serve.**

Overview: Current Conditions and Vulnerabilities

The Chicago Region's economy is quite healthy, but, as we have stated before, it continues to show some conditions and vulnerabilities typically experienced in the later stages of cyclical expansions. Recent developments in Asia add to the downside risks facing the Region's important manufacturing and agricultural sectors. At best, the Region's economy could continue operating at its currently high level—but moderate growth pace—for some time. Or, on the downside, both these sectors could falter simultaneously. Should this occur, the combined deterioration in two major but geographically dispersed parts of the Region's economy might create widespread challenges and difficulties for its banks.

Labor Markets

The unemployment rate of 4.0 percent in early 1998 was 1.5 percentage points below its lowest point of the past two decades. Overall employment growth remained moderate, with varying strength among individual sectors (see Table 1). Construction posted the fastest growth (4.8 percent), although it slowed from the 1996 pace. The services sector (e.g., health care, business, personal, legal, and other services) added jobs at the same, fairly rapid, 3.5 percent rate of the prior two years. New hiring in the finance-insurance-real estate (FIRE) sector was less rapid but held about steady relative to 1996. A revival in manufacturing job growth offset the prior years' weakness and contributed to sustained hiring in the wholesale trade sector. Meanwhile, the retail trade and transportation-public utility sectors extended their recent trends of moderating growth; government hiring remained modest; and job losses in the mining sector continued.

Commercial Real Estate Markets

Both new construction and investment remain active. Even so, new construction starts in the Region fell by 9 percent in 1997, with mixed behavior among the states, according to the FDIC's ***Real Estate Report*** of April 1998. Most dramatic were declines of 17 to 18 percent in **Wisconsin** and **Illinois**. Starts in **Ohio** were 11 percent lower than in 1996, while new construction in **Indiana** fell only 5 percent. By contrast, commercial construction starts in **Michigan** rebounded by 7 percent, almost offsetting the prior year's decline. Although

Table 1

Job Growth Strength Varies among Sectors in the Chicago Region (%)

	Q1:96	Q1:97	Q1:98*
Total Payroll Employment	1.5	1.7	1.9
Mining	–7.3	–0.8	–1.4
Construction	2.3	6.2	4.8
Manufacturing	–0.3	–0.2	1.0
Transportation, Public Utilities	1.5	1.8	1.1
Wholesale Trade	0.7	2.0	2.1
Retail Trade	2.1	1.0	0.8
FIRE	1.3	2.7	2.4
Services	3.4	3.5	3.5
Government	0.7	0.4	0.6

Note: Growth calculated as percent change from the same period a year earlier
* Q1:98 reflects January–February average.
Source: Bureau of Labor Statistics via Haver Analytics, Inc.

the estimated 88.8 million square feet of starts in 1997 represent continuation of a slowing trend from 1995's peak of 98.2 million square feet, recent activity still represents a considerable amount of space either just completed or yet to become available.

Plans for future construction of commercial space in the Region are mixed. Millions of square feet of new office space are reportedly in the early planning stage for **Chicago, Grand Rapids,** and **Indianapolis,** while plans for retail space picked up in **Cleveland** and **Youngstown.**[1] By contrast, according to the same source, late 1997 saw plans for significant amounts of new commercial space canceled in **Columbus** and **Detroit.** To date, absorption rates remain fairly high and vacancy rates are low or trending down in most of the Region's metropolitan areas. Even so, clusters of speculative projects in some submarkets and the traditional slowing of economic growth late in a cyclical expansion suggest the need for caution ahead.

Residential Construction

Residential construction remains fairly high, although last year's 9 percent drop in permits for single-family homes and 7.5 percent decline in multifamily building permits suggest that the peak in residential construction for this expansion may have passed. The Region's resale market (sales of existing single-family homes, condos, and co-ops) posted a lackluster advance, expanding by only 2 percent despite favorable employment conditions and mortgage rates.

Ahead: Mixed growth outlooks for the Region's manufacturers, potentially lower agricultural incomes, and the impact of the past year's developments in Asia are expected to influence the Region's economic health as the year unfolds. Because the Region's composition and cyclical sensitivity have been discussed in previous Chicago Region editions of ***Regional Outlook***, the rest of this article highlights the possible drag on the Region's manufacturing and agricultural sectors that could arise from the past year's financial and economic turmoil in a number of Asian countries.

"Asian Contagion" May Affect the Manufacturing Sector

The Region's manufacturers are unlikely to escape repercussions from developments in Asia. Since mid-1997, eight Asian countries have experienced moderate to significant currency depreciations (see Table 2). Consequently, the U.S. dollar prices of goods produced there have the potential to fall sharply, while slumping economic growth in many Asian nations has curtailed their demand for goods imported from the United States and elsewhere. Almost 16 percent of this Region's

[1] FDIC, *The Real Estate Report,* January 1998.

Table 2

Some Asian Countries Experienced Moderate to Significant Currency Depreciations

	Units of Foreign Currency per U.S. Dollar		Percent Change: June 97 through March 98
	June 97	March 98	
Indonesia (Rupiah)	2427.83	9722.05	300
Thailand (Baht)	24.91	41.58	67
South Korea (Won)	892.50	1472.16	65
Malaysia (Ringgit)	2.52	3.74	49
Philippines (Peso)	26.37	39.08	48
Taiwan (Taiwan $)	27.88	32.72	17
Singapore (Singapore $)	1.43	1.62	13
Japan (Yen)	114.30	129.09	13
Hong Kong (Hong Kong $)	7.74	7.75	0
People's Republic of China (Yuan)	8.30	8.28	0

Source: Générale de Banque, New York, via Haver Analytics, Inc.

exports last year went to the ten Asian countries shown in Table 2 (previous page).

Regional firms that either purchase inputs from the affected countries or have production facilities there are expected to benefit from both the realigned exchange rates and the drop in labor and production costs abroad. Other firms, whose sales depend on the vigor of Asian economies or that compete with Asian producers in both domestic and overseas markets, are expected to fare less well.

While the net impact of the Asian situation on Chicago Region manufacturers is expected to be negative, its magnitude is hard to gauge. Consensus forecasts suggest that 1998 real gross domestic product growth for the nation will be reduced by 0.5 to 1.0 percentage points from what it would have been in the absence of the Asian crisis. That is, forecasts of 3.5 percent growth were revised to the 2.5 to 3.0 percent range. It is reasonable to assume that the reduction in this Region's growth because of Asian developments will be about the same magnitude.

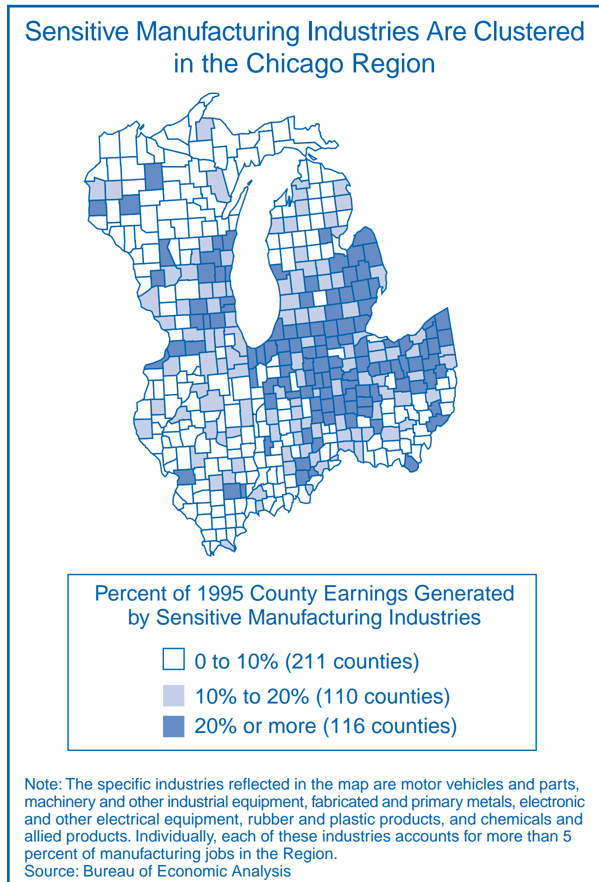
Specific industries and even individual companies may be affected quite differently, depending on their mix of products, input sources, and customer bases. *Even though we cannot pinpoint specific firms or communities likely to experience significant negative repercussions from the Asian situation, we can highlight counties in this Region heavily exposed to the manufacturing sectors thought to be most vulnerable.* Especially susceptible may be producers of:

- motor vehicles and parts;
- steel;
- capital equipment;
- heavy machinery;
- electronic communications equipment;
- chemicals; and
- pharmaceuticals.

Counties with a high share of earnings generated by manufacturing industries sensitive to cyclical and Asian developments are highlighted by dark shading in Chart 1. Although data underlying the map may not be all-inclusive for some counties (because of disclosure restrictions with respect to individual firms), the map shows that communities in northern and western Ohio, south and central Michigan, northern and eastern Indiana, northern Illinois, and southeastern Wisconsin are particularly vulnerable.

Implications: About 23 percent of this Region's 1,954 banks and thrifts with assets of $500 million or less are headquartered in the counties with the darkest shading in the map. These banks service communities where 20 percent or more of household earnings comes from manufacturing industries sensitive to both the aging expansion and repercussions from Asia. Another 36 percent of the Region's small and midsized banks are headquartered in counties where between 10 and 20 percent of earnings come from the sensitive industries. Anecdotal reports indicate that some community bankers are already taking steps to identify potential exposure and to monitor their loan portfolios for possible ripple effects from Asia on their customer bases and communities.

CHART 1



Sensitive Manufacturing Industries Are Clustered in the Chicago Region

Note: The specific industries reflected in the map are motor vehicles and parts, machinery and other industrial equipment, fabricated and primary metals, electronic and other electrical equipment, rubber and plastic products, and chemicals and allied products. Individually, each of these industries accounts for more than 5 percent of manufacturing jobs in the Region.
Source: Bureau of Economic Analysis

Agricultural Communities Are Also Vulnerable

Asia's woes probably will have a more clear-cut negative influence on parts of the Region's agricultural sector than on manufacturing. Corn and soybean farmers likely will feel the biggest impact, although hog and other agricultural sectors also may be affected.

Corn and Soybeans

Because Asia is a major purchaser of U.S. corn and soybeans, the net impact from recent events there is expected to be clearly negative for this Region's crop farmers. About 60 percent of U.S. corn exports and 42 percent of soybean exports went to Asia last year. This is significant because this Region produces about 32 percent of the nation's corn and 35 percent of its soybeans. Moreover, corn and soybeans (combined) account for almost 46 percent of this Region's agricultural cash receipts.

In addition to the impacts from realigned exchange rates and economic weakness, U.S. corn exports to Asia are being trimmed by aggressive corn sales by the People's Republic of China and by plummeting demand for feed corn from Taiwan, whose hog stock was decimated by disease last season.

Late-spring estimates from the ***U.S. Department of Agriculture*** call for soybean prices this crop year to be around $6.50 a bushel, about 11.5 percent below last year's average price. Corn prices are estimated to fall by roughly 8 percent, but such a decline would follow a 16 percent decrease last year.

While the direct effect of slumping demand for agricultural products will be felt in the farm sector, indirect effects may be felt by manufacturers of farm equipment and supplies if lower farm income cuts into such businesses as sales of tractors and farm equipment.

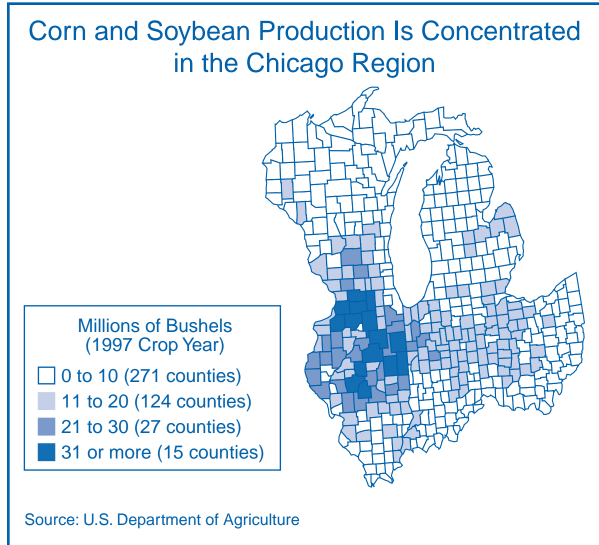
Implications: The potential for reduced near-term vigor in the agricultural sector could affect over one-third of the Region's counties. Because of crop farmers' significant role, counties with large harvests of corn, soybeans, or both are highlighted in Chart 2. Most of these counties are relatively immune to shifts in manufacturing activity, but a few have measurable participation in both the manufacturing and crop farming sectors.

Other Concerns

The potential drag on farm incomes from the Asian situation unfortunately comes at a time when other challenges and uncertainties face the Region's farmers. These include:

- whether the continuing phaseout of subsidies and industry restructuring will prompt some small and marginal producers to leave the industry. This concern is especially relevant to the hog and dairy sectors; the number of hog farms in the Region fell by 11 percent last year and the number of dairy operations fell by 8 percent.
- whether more freedom in planting decisions leads to lower prices or greater price volatility than crop farmers and their lenders have dealt with in recent years.
- whether effects from El Niño will contribute more uncertainty to planting decisions and heighten the risks associated with future price levels and volatility.

CHART 2



In turn, these uncertainties raise issues for banks and lenders to the agricultural sector, including:

- whether crop farmers' income projections and balance sheets have sufficient flexibility to handle lower prices, potentially increased volatility, or both;
- how banks will handle the loss of some long-standing hog and dairy customers as structural change affects their operations; and
- how potentially greater seasonal price fluctuations, loss of some export markets, and longer term structural changes should be considered when valuing farmland as collateral for loans.

More than 500 banks in the Region with direct agricultural loan exposure exceeding 100 percent of tier 1 capital are at risk from these conditions.

Chicago Region Staff

Risks and Trends to Watch in the Chicago Region

- **Institutions in the Chicago Region continue to deal with significant changes in the competitive landscape and maintain strong operating performance, with many institutions posting earnings gains in 1997.**
- **Despite this strong performance, analysts have identified a number of emerging risks and trends over the past several quarters that bank managers, examiners, and auditors likely will have to contend with in 1998.**
- **While some of these issues are unique, such as Year 2000 concerns, most revolve around traditional bank lending, funding, and sales operations.**

Overview

Institutions in the Chicago Region continue to see significant changes in the competitive landscape. For example, 1997 saw:

- an increase in nonbank lending competition, especially in subprime consumer markets;
- ongoing banking company consolidations that have resulted in a net reduction of over 140 independently chartered banks and thrifts in the five-state Chicago Region, while at the same time increasing assets by about $88 billion; and
- increased reliance on technology to perform traditional banking functions, such as the use of small-business credit scoring to underwrite commercial loans.

The vast majority of banks and thrifts in the Chicago Region appear to have adjusted successfully to this changing environment. As Chart 1 shows, over three-quarters had earning gains in 1997 over 1996. This performance is due, at least in part, to favorable economic conditions (see ***Regional Economy: Asian Situation Adds to Region's Vulnerabilities and Challenges***, in this issue). Performance on an aggregate basis was just as impressive, with the Region's institutions:

- maintaining aggregate leverage capital at 7.9 percent of average assets despite a dividend payout ratio of almost 80 percent;
- improving their aggregate return on assets by 11 basis points to 1.22 percent; and
- maintaining good overall asset quality, although many individual institutions are seeing growth in past-due loans.

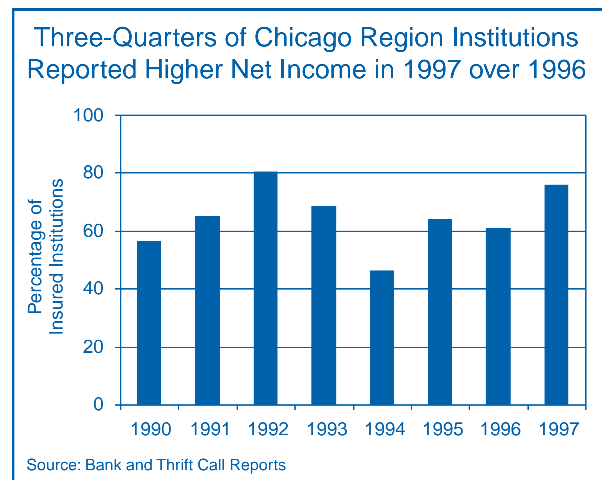
Good conditions notwithstanding, various banking analysts have identified emerging risks and trends that bank managers, examiners, and auditors likely will need to contend with in 1998. Many of these issues have been discussed in this publication in previous quarters. This quarter, we look back on some of these issues with the goal of summarizing and updating the more significant ones.

Technology-Related Risks and Trends to Watch

Year 2000 Conversions

The issue with the highest profile continues to be the potential effect of the Year 2000 on the computer systems of banks and thrifts, their customers, and service providers. The effect on financial institutions is expect-

CHART 1



ed to be especially significant because they make heavy use of computer technology. In addition, bank customers may experience similar problems that could potentially disrupt their ability to conduct business or repay their debt.

Last quarter's ***Regional Outlook*** indicated that addressing Year 2000 (Y2K) issues is becoming ever more costly as the time and resources left to do so disappear. It also indicated that a failure to address Y2K exposures successfully may amount to a gamble backed by the bank franchise itself.

Internet/Electronic Banking

Y2K is not the only technological issue that will have a high profile in the coming quarters. Many insured institutions are expanding their operational capabilities related to electronic/Internet banking. More transaction volume is being handled by telephone and personal computer. Lower transaction costs, expanded geographic reach, and the need to remain competitive with other bank and nonbank delivery systems are cited as reasons for growth in this area.

As the volume of electronic transactions grows, financial institutions will likely expand their geographic markets and encounter more competitors for loan and deposit products. In addition, as banks and thrifts increase electronic commerce capabilities, they will need to ensure that their control systems address increased risks of:

- theft or misappropriation of internal data or external transmissions;
- errors in underwriting of virtual transactions;
- changing technical standards; and
- inadequate or geographically inconsistent regulatory and legal infrastructure.

Traditional Risks and Trends

While technological issues will take a considerable amount of bank management's attention, traditional banking concerns, such as loan quality and funding availability, will also remain important. Several of these issues are discussed below.

Credit Card and Other Consumer Lending

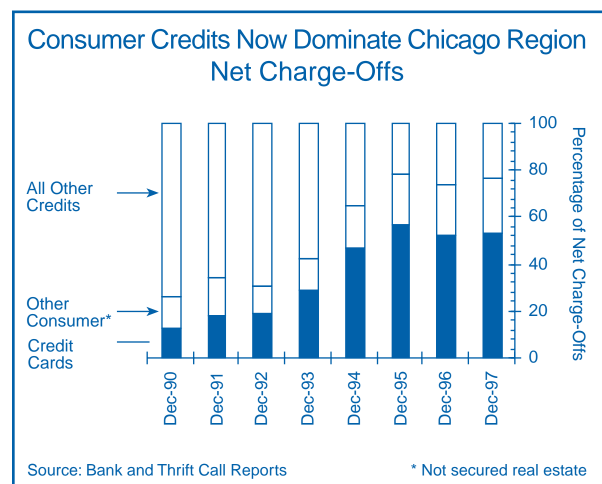
Aggressive underwriting and solicitations, generally high levels of consumer debt, and continuing high rates of consumer bankruptcy have negatively affected consumer loan portfolios in the Region.

Chart 2 shows that most losses to date have been centered in credit card portfolios, which reflected net charge-offs of 6.12 percent of credit card loans outstanding during 1997 and past-due rates at year-end of 5.3 percent. Overall, credit card loans now account for over 50 percent of all charge-offs in this Region. Reportedly, many institutions have taken steps to tighten underwriting standards in this area, but these steps have not yet resulted in a decline in charge-off or past-due rates.

Home equity portfolios also have become an area of interest. These traditionally smaller portfolios increased at a rate of more than 20 percent at about 780 institutions in the Region during 1997. It is believed that some of the recent growth is a result of credit card problems, as bankers attempt to improve their positions by collateralizing some unsecured credits. It also may be caused by some institutions' aggressive attempts to increase or maintain market share by lowering underwriting standards, increasing advance ratios (loan-to-value ratios of 100 percent are not uncommon), or both.

Deserving attention as well are indirect auto loan and lease portfolios. Anecdotal reports indicate that pricing and underwriting terms are becoming more aggressive, and recent surveys indicate that the percentage of past-due indirect loans (by number) have been on the rise.

CHART 2



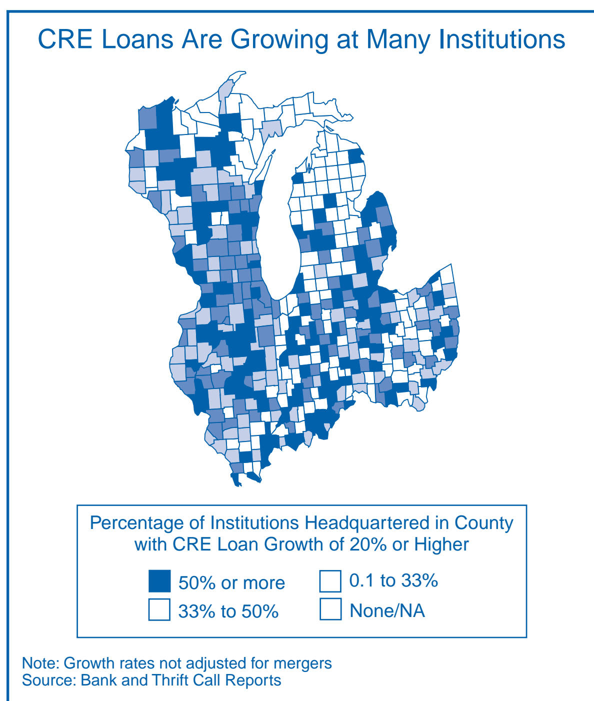
Growth and Concentration of Commercial Real Estate (CRE) Loans

Declining vacancy rates, increasing rental rates, and improving perceptions are combining to increase construction and commercial real estate lending activity throughout the Region. However, loan pricing is reportedly getting thin, as banks, thrifts, insurance companies, real estate investment trusts, and others vie for this business.

It is reported that speculative development is starting in some metropolitan areas. For example, FDIC examiner surveys indicate that a small but significant amount of lending for speculative projects is occurring in Chicago Region institutions.

CRE lending activity as displayed in Chart 3 is especially important in the Chicago Region, as over 1,060 (out of a total of 2,147) institutions have exposures that exceed 100 percent of tier 1 capital, and over 750 had growth rates that exceeded 20 percent over the past year. Ongoing monitoring of the repayment capacity of CRE loans at these banks will be extremely important in 1998. Control systems need to ensure that exposure to loans with marginal debt service ability or overly optimistic cash flow assumptions does not become excessive.

CHART 3



Easing of Commercial Loan Lending Terms

The three federal banking regulators have released surveys that indicate an easing of loan terms and, in some cases, standards. The Federal Reserve recently released the results of its national ***Senior Loan Officer Opinion Survey on Bank Lending Practices.*** The survey did not note a significant easing of lending standards but did note continued easing of terms—primarily interest rates. It also disclosed that, to a much lesser degree, increased competition apparently has led some banks to increase the maximum size of credit lines and adjust loan covenants on commercial and industrial loans during the previous three months.

The Office of the Comptroller of the Currency's national ***1997 Survey of Credit Underwriting Practices*** indicates that there has been a discernable shift in underwriting standards since 1996, and most of the surveyed banks now have moderate or liberal underwriting standards. The survey notes that the trend toward eased standards was most pronounced in middle market loans, syndicated and national credits, and commercial real estate.

The Chicago Region's ***FDIC Examiner Credit Underwriting Survey*** for the fourth quarter of 1997 disclosed that about 17 percent of institutions examined "frequently or commonly" had made business loans that lacked documentation of financial strength.

Eased underwriting terms and poor documentation of commercial loans are always important, but even more so when they occur at this stage of an economic expansion and growth rates for such credits are high. Over 32 percent of all insured institutions in the Chicago Region had growth rates exceeding 20 percent in the commercial lending category during the past year.

Exposure to Recent Changes in the Agricultural Operating Environment

This sector is generally prospering but faces challenges ahead. Plunging Asian demand is one (see ***Regional Economy: Asian Situation Adds to Region's Vulnerabilities and Challenges***, in this issue). Other challenges arise from large harvests, competition by foreign producers, and legislative changes that have altered the subsidies some farmers will receive. Analysts expect that corn and soybean farmers will see prices lower than last year. At the same time, the recent problems of small dairy and hog operators may continue in the face of

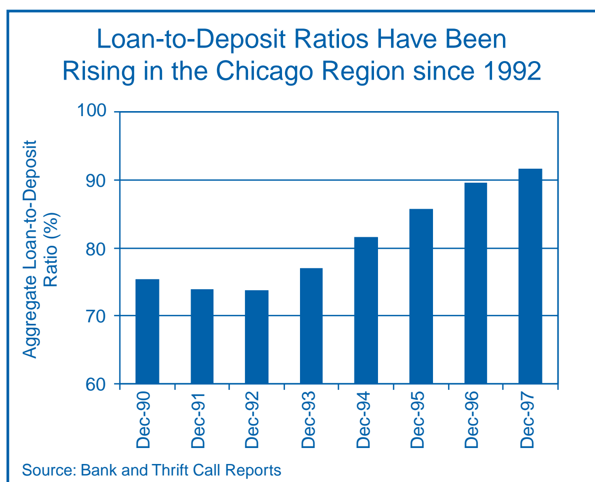
competition from larger and technologically more sophisticated producers.

These factors could lead to increased complexity for the more than 500 banks in the Region that have direct agricultural loan exposures exceeding 100 percent of tier 1 capital.

Changing Funding Strategies

Loan growth and changing funding strategies have resulted in an aggregate loan-to-deposit ratio of over 90 percent for Chicago Region institutions as of December 31, 1997—an all-time high for the decade (see Chart 4). Over half the institutions in the Region reported loan-to-deposit ratios exceeding 75 percent. Loan-to-deposit ratios normally have increased during periods of economic growth because lending tends to pick up. What is unusual is that banks now are relying more on noncore sources to fund this growth. Some of these alternative funding sources are foreign deposits, brokered deposits, short-term debt, and Federal Home Loan Bank borrowings.

CHART 4



It is important that managers recognize changes to funding structures and ensure that procedures are in place to assess and manage liquidity risk adequately, especially if an institution obtains a large portion of funding from limited sources.

Prepayment Increases

Large numbers of Chicago Region institutions have heavy investments in mortgaged-backed securities and mortgage loans. Prepayment rates on mortgage loans have been rising steadily over the past few months. This additional cash flow may result in increased interest rate risk or credit risk, as some institutions may reinvest prepayments in either long-term fixed-rate mortgage products or, possibly, higher credit risk loan types in order to maintain an acceptable spread over their funding costs. In addition, substantial investments in callable agency securities may exacerbate potential risks.

Prudent planning for significant cash inflow from callable loans and securities likely will be important in 1998.

Trend Toward Fee-Related Businesses

In an attempt to mitigate the effect of interest rate risk on total revenues, as well as to diversify revenue streams, insured institutions have focused on increasing noninterest income.

Some of the resulting new business lines, such as insurance sales, mutual funds, and annuities, have unique risks. Increased revenues from these sources must be balanced against potential contingent liability and reputation risks arising from the sale of these products.

Chicago Region Staff

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