
◆ Regional Outlook ◆

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◆ *Falling Prices in Commodities and Manufacturing Pose Continuing Risks to Credit Quality*—Falling prices are causing problems for a wide range of *commodity industries*—a collection of agricultural, mining, and manufacturing industries that produce standardized products and face global competition, mostly on the basis of price. Firms in these industries have experienced slow or negative profit growth even as they reduce payrolls to cut costs. There are signs that these trends are contributing to higher credit risk for insured institutions. The effects of these problems on local economies and community banks could grow if low prices persist. *See page 3.*

By Richard A. Brown and Alan Deaton

◆ *Shifting Funding Trends Pose Challenges for Community Banks*—Several long-term trends are making it more difficult for some institutions to economically fund asset growth with deposits in today's marketplace. As a result, traditional measures of liquidity and liability composition for commercial banks reflected record-low levels of deposit funding at year-end 1998. The need to augment lagging deposit growth to meet loan demand has led many community banks to seek more wholesale funding sources, particularly borrowings. If the trend toward greater reliance on nondeposit funding continues, liability management may become more important and more challenging for community banks that have historically relied upon deposits for funding and net interest revenues for profitability. *See page 11.*

By Allen Puwalski and Brian Kenner

Regional Perspectives

◆ *Economic and Banking Conditions*—Although the economy remains healthy, growth has slowed in the past year. The slowdown reflects a low unemployment rate, the loss of manufacturing jobs, and slower hiring in several key sectors. Some indicators suggest that the manufacturing sector's weakness will not intensify in the near term. Banks and thrifts reported healthy conditions in the first quarter despite continued contraction in the net interest margin. *See page 18.*

◆ *Weak Agricultural Conditions Lead to Falling Repayments and Rising Past-Due Levels*—The United States Department of Agriculture projects that low crop prices will lead to a significant decline in net farm income in the Region this year. Insured institutions active in agricultural lending are exposed to risks related to falling repayments, rising past-due loan levels, and increasing carryover debt. *See page 22.*

◆ *Institutions Diversify Funding Sources to Supplement Weak Core Deposit Growth*—With loan growth outpacing deposit growth, many insured institutions have sought alternative funding sources. Although the shift to noncore funding has been more prevalent within larger institutions, smaller institutions also are relying increasingly on noncore funding. The diversity and availability of funding sources have many benefits; however, the rising complexity these resources bring to liability management requires effective policies and measurement tools. *See page 23.*

By the Chicago Region Staff

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Falling Prices in Commodities and Manufacturing Pose Continuing Risks to Credit Quality

- **Prices have fallen sharply across a wide range of commodities and manufactured goods.**
- **Signs of stress are apparent in some industry sectors.**
- **These trends are contributing to rising credit risk for insured institutions.**
- **Effects on local economies and community banks could grow if low prices persist.**

The performance of the U.S. economy during the mid- to late-1990s has been generally positive for banking. Economic activity grew in 1998 at an inflation-adjusted rate of 3.9 percent for the second consecutive year. Continued low inflation has helped to hold interest rates low and extend the expansion into its ninth consecutive year. However, one downside of low inflation has been that firms in certain commodity industries have encountered slow or negative growth in revenues because of the low prices they receive for their products.

Commodity industries are defined in this article as a collection of agricultural, mining, and manufacturing industries that produce standardized products and face global competition, mostly on the basis of price. Since the beginning of 1997, price weakness has extended across a wide range of commodity industries, from agricultural products to oil, chemicals, textiles, paper, semiconductors, steel, and even some segments of the auto industry. While many firms have retooled and restructured to cut costs, clear signs of financial stress have become apparent.

The potential importance of problems in commodity industries to the FDIC was illustrated by the banking problems related to oil and agriculture during the 1980s and early 1990s. As documented in a 1997 study by the *FDIC Division of Research and Statistics*, regional economic dislocations related to declining farmland values and declining oil prices contributed to large increases in credit losses and the eventual failure of hundreds of federally insured banks and thrifts. The analogy to the 1980s is far from perfect—for example, oil and agriculture have not experienced booms comparable to those that preceded their collapse in the

1980s—but exposures to commodity industries remain important for many insured institutions.

This article summarizes recent adverse trends in commodity and manufacturing sectors and discusses why industry-sector problems are important in banking. It takes a high-level approach, emphasizing the economic fundamentals that are driving prices across the economy while ignoring many of the industry-specific factors that are also driving the performance of individual sectors. The goal is to evaluate the effects of these trends on bank credit quality if they persist through 1999 and beyond.

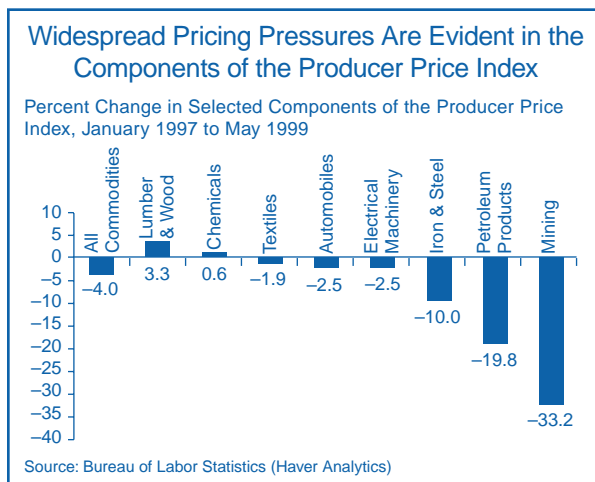
Prices Have Been Declining across a Range of Commodities and Manufactured Goods

Low inflation has been a boon for consumer spending and business investment during the economic expansion of the 1990s. As of March 1999, the Consumer Price Index had risen at an annualized rate of less than 2.0 percent for 8 consecutive quarters and at an annualized rate of less than 4.0 percent for 33 consecutive quarters. The prices of many popular and essential consumer goods—from computers to gasoline—have generally fallen throughout the decade, even as the prices of most services continue to rise steadily. Businesses, too, have benefited from the ability to purchase goods cheaply, as well as from the generally low interest rates that have accompanied low inflation.



The declining average wholesale price of goods is reflected in Chart 1 (next page), which shows changes in the producer price index (PPI) and some of its key components since the beginning of 1997. The PPI focuses on goods, omitting changes in the price of services. The decline of nearly 5 percent in the PPI since the beginning of 1997 has been led by falling prices for mining products, petroleum, and steel. Moreover, economy-wide price declines for wholesale goods have been steady over time, with the PPI registering year-over-year declines for 26 consecutive months through May 1999.

CHART 1



Although they are only indirectly included in the PPI numbers, the prices of several important agricultural commodities have also fallen substantially. Chart 2 shows that the price of wheat has fallen by more than 35 percent since January 1997, with the price of corn, hogs, and cotton also registering double-digit rates of decline. While the price of hogs has rebounded significantly since the end of 1998—more than doubling from its low of less than 15 cents per pound—prices for corn, wheat, and cotton continued to decline through May 1999.

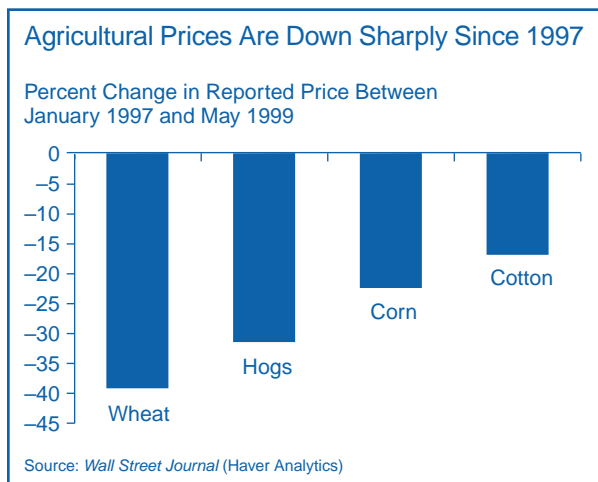
Reasons for Broad-Based Commodity Price Weakness

Pricing trends in disparate industries such as electronics and agriculture, or oil and steel, are driven in part by industry-specific factors. For example, weather patterns heavily influence agricultural prices, while global politics tends to drive world oil price levels. In manufacturing, technological developments can significantly alter the demand for a product or its cost of production, thereby influencing its market price. For example, improvements in semiconductor manufacturing techniques—from shrinking the size of chips to using larger silicon wafers—have significantly increased production yields in that industry during the 1990s.¹

However, the pervasiveness of recent price declines across a wide range of commodities and manufactured

¹ See “Semiconductor Industry Trends,” *Standard and Poor’s Industry Surveys*, May 27, 1999, p. 4.

CHART 2



goods suggests that a number of common factors are driving prices lower:

- **Low inflationary expectations.** Since 1980, inflation rates have gradually declined worldwide as central banks shifted their focus toward price stability. *Disinflation* has profoundly altered the expectations of investors, consumers, and businesses, and in the process has altered the course of events in individual markets and in the economy as a whole. As a result, commodities have lost much of their appeal as a hedge against inflation. This has contributed to a decline of more than 50 percent in the price of gold since 1980. The expectations of many businesses have also changed, because with less pricing power they must continually cut costs to remain competitive.
- **Overcapacity because of large-scale investment.** Global investment in productive capacity accelerated during the early to mid-1990s in a number of commodity and manufacturing industries. Many U.S. firms have implemented new technologies and moved their operations closer to their markets or to areas where low-cost labor is available. For example, major U.S. and foreign automakers have invested billions of dollars in recent years in new production facilities in the emerging markets of Asia and Latin America as part of a “build-where-you-sell” strategy.² Because these additions to capacity largely have not been offset by the closure of existing plants, analysts say that global productive capacity in autos

² Barbara McClellan, “Asia Woes Worsen,” *Ward’s Auto World*, November 1998, pp. 28–31.

could exceed demand by more than 20 million units annually by 2000.³ A similar situation has developed in the semiconductor industry, where capital investment in chipmaking equipment tripled between 1993 and 1996, contributing to a glut of memory chips and plunging prices.⁴

- Curtailed global demand in the wake of emerging market crises.** The economic crises that have developed in Asia, Russia, and parts of Latin America since 1997 have crimped global demand for commodities and manufactured goods. For example, demand for new cars in Korea fell by 50 percent in 1998.⁵ Asia received approximately 30 percent of U.S. feed grain exports in 1996, but declining Asian demand since then has contributed to a sharp decline in global grain prices. The slowdown of economic activity in crisis countries and the resulting decline in their demand for imports is only one factor that has hurt the pricing power of U.S. producers. Another problem is the pricing advantage conferred on countries that have experienced currency devaluation. Firms operating in a country that has devalued its currency experience a reduction in the price of their exports in U.S. dollar terms. This process further depresses the pricing power of U.S. farmers and businesses that sell their goods in global markets.

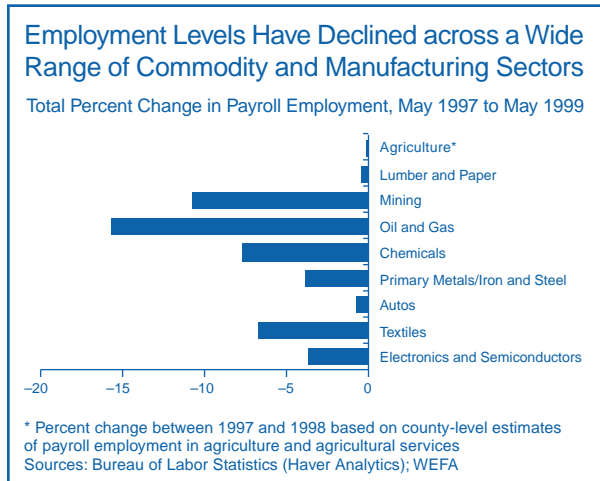
Recently, there have been signs that some hard-hit Asian economies may soon begin to recover. However, the other factors cited above—low inflationary expectations and rapid investment in productive capacity—may well be longer-term trends. In any event, U.S. farmers and businesses that participate in commodity industries must be prepared for the possibility that pricing pressures will not dissipate in the near term.

Signs of Stress Are Showing for Affected Industry Sectors

As commodity prices continue to stagnate, signs of stress are emerging among firms in the commodity industries. A long-term trend toward reduced levels of employment in manufacturing has accelerated in the midst of the current economic expansion. Chart 3 shows that employment levels declined in a wide range of commodity industries in the 24 months ending in May

³ "1997 Automotive Outlook," *Automotive Industries*. This report is available at <http://www.ai-online.com>.
⁴ "Semiconductor Industry Trends" (1999), p. 3.
⁵ Barbara McClellan (1998).

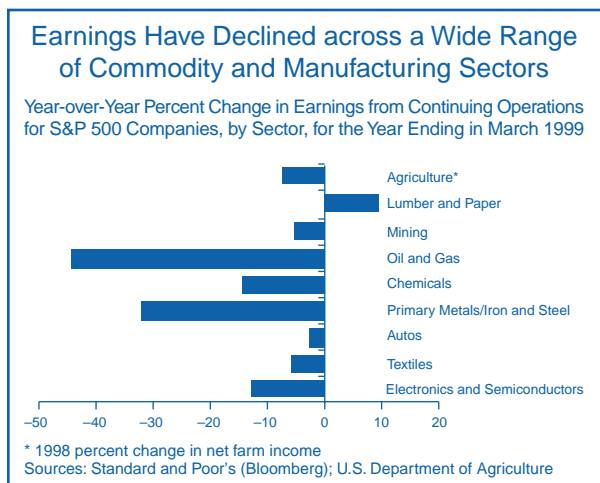
CHART 3



1999. The total manufacturing sector lost more than 420,000 jobs during that period, while another 64,000 jobs were lost in the mining sector, which includes oil and gas extraction. The trend toward lower levels of employment in mining and manufacturing not only reflects pricing pressures but also attempts by firms in these sectors to maintain profitability by investing in labor-saving technologies.

The profit picture has begun to deteriorate as well for firms operating in commodity industries. Four-quarter trailing earnings through March 1999 for oil-sector firms in the Standard & Poor's 500 dropped by more than 44 percent from a year ago (see Chart 4), while the earnings of steel firms fell by almost 32 percent. The losses experienced by firms in some of these industrial sectors extended to the farm sector as well, where net

CHART 4



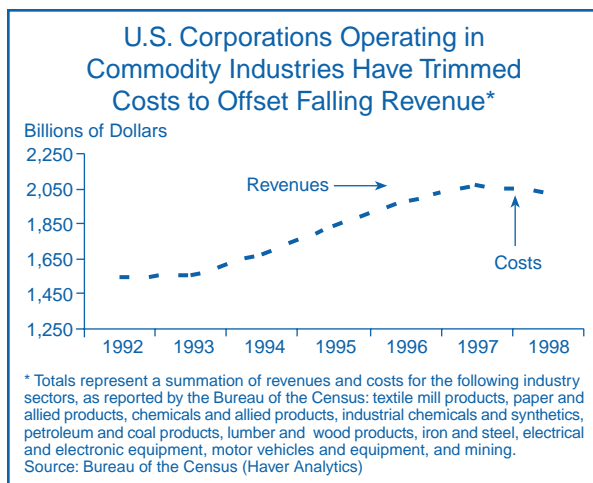
incomes fell by more than 7 percent in 1998, according to the *U.S. Department of Agriculture*.

Affected Industries Have Found Ways to Cope with Pricing Pressures Thus Far

Despite the signs of stress in industries where prices are weak or declining, U.S. farmers and industrial firms have shown themselves to be fairly resilient thus far in their ability to cope with the situation. Agricultural producers have been making greater use of carryover debt to keep their operations running even if they were not able to fully retire their operating loans during the previous crop year. The *FDIC Report on Underwriting Practices* shows that 29 percent of FDIC-supervised agricultural lenders reported at least a moderate increase in carryover debt during the six-month period ending in March 1999, compared with only 10 percent in March 1998. Although the use of carryover debt is not an uncommon practice in agriculture, it indicates that low prices and declining subsidies have contributed to financial stress for farmers.

Many industrial firms have found ways to increase productivity and cut costs to offset declining revenues. Chart 5 follows trends in annual total revenue and costs for U.S. corporations operating in a selected group of commodity industries. It shows that growth in revenue and costs slowed noticeably in 1997. Both revenue and costs in these sectors declined in 1998, illustrating that firms in these sectors have needed to cut costs to preserve profit margins. Cost cutting in the manufacturing sector is further illustrated by a steady decline in the index of unit labor costs for manufacturing, which started from a value of 100 in 1992 and fell to less than 96

CHART 5



by the first quarter of 1999. Falling unit labor costs means that the productivity of manufacturing workers is rising faster than the cost of their services. This trend demonstrates that manufacturing firms have been successful at implementing new technologies and new capital equipment to cut production costs.

Cost savings and industry consolidation have been accomplished in part through mergers. According to *Merger Stat*, the dollar volume of merger and acquisition transactions involving U.S. firms exceeded \$1.2 trillion in 1998, an increase of more than 80 percent from 1997 levels. Both the number and dollar volume of mergers announced in 1998 far exceeded the volumes recorded during the “merger mania” of the 1980s. Some of the largest mergers announced in 1998 involved firms looking for ways to increase market share and cut costs in markets characterized by overcapacity. Examples include the \$39 billion Daimler-Chrysler transaction announced in May 1998 and the \$80 billion Exxon-Mobil transaction announced in December 1998. Furthermore, merger activity recorded in early 1999 suggests that total merger volume for the year could exceed the record pace of a year ago.

Industries plagued by oversupply and weak prices require consolidation to reduce capacity and improve profit margins. Mergers and acquisitions represent a fairly orderly way for firms operating in a troubled industry to consolidate on their own terms. Bankruptcy filings are an alternative means for severely troubled firms to reduce capacity and achieve consolidation within an industry. Regardless of how industry consolidation is achieved, it often results in reductions in employment (such as those documented in Chart 3). However, from a lender’s perspective, an orderly consolidation process through mergers and acquisitions is preferable to a disorderly shakeout of firms through bankruptcies.

Recent favorable capital market conditions have allowed firms in troubled industries to consolidate through mergers. Acquisitions are sometimes financed through corporate borrowings or, more commonly, by swapping equity shares that have been rising in value during the bull market of the 1990s.⁶ Recent consolidation in commodity industries could be depicted as an

⁶ According to Loan Pricing Corporation’s *Gold Sheets*, syndicated and leveraged lending related to mergers and acquisitions reached a record high of \$80 billion in the second quarter of 1998, which represents about 30 percent of the total syndicated and leveraged lending market for that period.

orderly process, associated with record-high merger and acquisition activity, near-record-low business bankruptcy filings, and low credit losses on commercial and industrial (C&I) loans. However, a sudden change in financial market conditions characterized by sharply higher interest rates, lower stock values, or both could inhibit the ability of businesses to restructure and retool on their own. This could lead to a much more disorderly shakeout of firms accompanied by a rise in business bankruptcies and losses to lenders.

Signs Point to Rising Credit Risk in the Commodity Industries

In dollar terms, the largest commercial bank exposures to the commodity industries are in the portfolios of large banks. Chart 6 provides an estimated breakdown of the aggregate exposure of insured institutions to commodity industries based on corporate balance sheet information collected by the Bureau of the Census.⁷ The chart shows that the aggregate exposure of the bank and thrift industries to these sectors is approximately \$206 billion, or 26 percent of the total industry C&I portfolio. The largest single industry exposure is to the chemical industry, which represents approximately 9.5

percent of bank C&I loans. In the syndicated loan market, where large U.S. banks dominate in terms of originations, about 25 percent of all loans made in 1998 were to firms operating in the manufacturing sector.

A rough indicator of recent trends in the credit risk associated with bank loans to commodity industries can be found in expected default frequencies (EDFs) calculated by KMV Corporation. The EDF is an estimate of the probability that a firm will default on its bond obligations within one year.⁸ Chart 7 tracks the median EDF for firms operating in commodity industries compared with the median for all other firms rated by KMV. This chart shows that while the median EDF for commodity industries has consistently exceeded the median for all other firms in the recent past, this difference has widened appreciably since the middle of 1998. Over the past year, the median EDF for commodity industries has more than doubled, rising from 0.8 percent to 1.9 percent, while the median EDF for all other firms has doubled as well, from 0.6 percent to 1.2 percent. These data indicate that the level of credit risk associated with corporate borrowers has been increasing, led by an increased probability of default among firms operating in commodity industries.

⁷ Because of the limitations of the data, bank exposures to corporations engaged in agriculture are not broken out in Chart 6.

⁸ KMV's proprietary calculation for EDF is based on 1) the current market value of the firm, 2) the structure of the firm's current obligations, and 3) the vulnerability of the firm to large changes in market value.

CHART 6

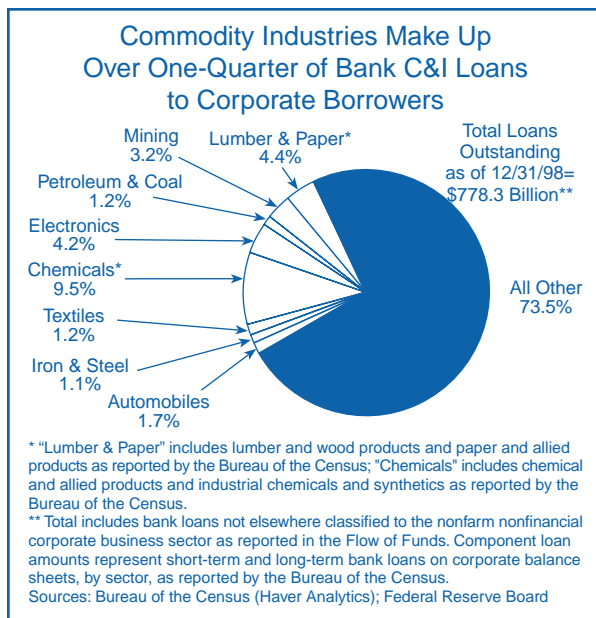
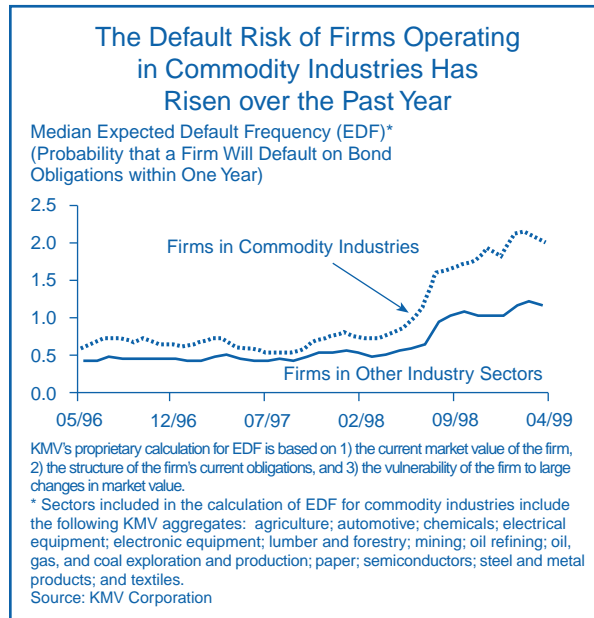


CHART 7



Effects on Local Economies and the Banks That Operate in Them

The economic effects of adversity in commodity industries tend to be most severe in local areas that depend heavily on these sectors for employment and income. In the 1980s, problems in the agricultural and oil sectors kicked off a “rolling recession” that spread through the Plains states and oil-producing regions of the south-central and western states. In agricultural regions, farmland values began to decline around 1981, contributing to the failure of hundreds of FDIC-insured banks between 1984 and 1990.⁹ Similarly, declining oil prices in the mid-1980s contributed to the failure of federally insured banks and thrifts in Texas, Oklahoma, Louisiana, and other states, while the attempts of some institutions to diversify into risky real estate investments resulted in still more failures. The FDIC’s analysis of these episodes emphasizes how industry-sector problems can affect local economies and bank credit quality.¹⁰ Moreover, the study shows that there can be a significant lag between the onset of industry-sector problems and the emergence of performance problems

⁹Federal Deposit Insurance Corporation, Division of Research and Statistics (1997). *History of the Eighties: Lessons for the Future, Vol. 1, An Examination of the Banking Crises of the 1980s and Early 1990s*. pp. 275–276, <http://www.fdic.gov/databank/hist80/index.html>.

¹⁰Federal Deposit Insurance Corporation (1997). See Chapters 8 and 9.

in the banking industry. Although banks with direct credit exposures to a troubled industry are likely to be affected first, virtually all banks that operate in areas that are heavily dependent on a troubled sector will eventually have to contend with the indirect effects on the local economy.

To evaluate the extent of local economic effects that might have resulted from the recent adverse trends in the commodity industries, we have conducted analysis on 1,027 U.S. counties identified as particularly dependent on at least one commodity industry (see Table 1 for a list of the commodity industries studied).¹¹ The purpose of this analysis is not to identify every county that might be affected by these trends; instead, this analysis focuses on the U.S. counties *most concentrated* in the commodity industries and determines if these counties and banks that operate in them are showing any symptoms of widespread distress.

Table 2 compares 1998 average job growth and unemployment rates in these “most concentrated counties” against the average for all U.S. counties. This comparison shows that the concentrated counties tended to have moderately lower job growth and higher unemployment than the U.S. average. However, further analysis shows

¹¹ Counties identified as being highly dependent on one or more commodity industries had an average population of 36,250 in 1998 versus 86,055 for all U.S. counties.

TABLE 1

U.S. COUNTIES MOST CONCENTRATED IN COMMODITY INDUSTRIES BY 1998 PAYROLL EMPLOYMENT			
	PERCENT OF 1998 COUNTY EMPLOYMENT IN THE INDUSTRY	NUMBER OF COUNTIES WITH EMPLOYMENT CONCENTRATION IN 1998	STATES WITH THE MOST DESIGNATED COUNTIES
AGRICULTURE	>30	295	TX, NE, SD, KS, MO
LUMBER AND PAPER	>5	305	GA, AL, MS, AR
OIL AND GAS	>5	83	TX, OK, LA
CHEMICALS	>5	46	TN, IL, NC, TX
STEEL	>5	70	KY, OH, AR, IN
AUTOS	>5	118	MI, IN, OH, KY, TN
TEXTILES	>5	156	GA, NC, SC, VA, AL
ELECTRONICS AND SEMICONDUCTORS	>5	33	TX, NY, IN, IA
ANY COMMODITY INDUSTRY	N/A	1,027	TX, GA, NC, TN, AL
ALL U.S. COUNTIES	N/A	3,142	N/A

SOURCE: WEFA, BASED ON DATA FROM THE BUREAU OF LABOR STATISTICS

TABLE 2

RELATIVE ECONOMIC PERFORMANCE OF COUNTIES MOST CONCENTRATED IN COMMODITY INDUSTRIES		
	1998 AVERAGE EMPLOYMENT GROWTH (%)	1998 AVERAGE UNEMPLOYMENT RATE (%)
AGRICULTURE	1.1	4.8
LUMBER AND PAPER	1.3	6.9
OIL AND GAS	1.4	5.6
CHEMICALS	1.3	6.0
STEEL	1.7	5.6
AUTOS	1.8	4.4
TEXTILES	0.9	5.1
ELECTRONICS AND SEMICONDUCTORS	1.9	3.7
ANY COMMODITY INDUSTRY	1.3	5.5
ALL U.S. COUNTIES	1.6	5.1

SOURCE: BUREAU OF LABOR STATISTICS, HOUSEHOLD SURVEY (HAVER ANALYTICS)

that the current situation is not unusual in that job markets in concentrated counties have tended to consistently underperform other U.S. counties over the past two decades. On the whole, the economic picture did not noticeably deteriorate in 1998 for the concentrated counties. Average unemployment declined in 1998 for every group of concentrated counties except oil counties, and average job growth increased in every group of counties except textile counties. These data indicate that while recent problems in the commodity industries might be having severe effects in specific areas, these problems had not translated into a broader weakening of economic performance through the end of 1998.

The financial performance of insured institutions operating in concentrated counties is evaluated in Table 3 (next page). The table provides average C&I loan performance and profitability ratios for 1,915 banks and thrifts identified as having at least 25 percent of their deposits in at least one of the concentrated counties as of June 1998.¹² The average C&I loan charge-off ratio for concentrated counties overall was higher than the U.S. average, driven largely by higher average charge-

offs in both agricultural and oil and gas counties. Comparisons of past-due and noncurrent C&I loans also indicate that institutions operating in agricultural and oil and gas counties tend to have more problem credits than the U.S. average.¹³ During the 12 months ending in December 1998, the average noncurrent loan ratio jumped from 4.8 percent to 6.1 percent for institutions operating in agricultural counties, while the average ratio rose from 2.7 percent to 3.8 percent for institutions operating in oil and gas counties.

These results indicate that while profitability in 1998 remained solid for the average bank operating in concentrated counties, credit losses appeared to be on the rise in agricultural and oil and gas counties. However, because this analysis relies on annual data that extend only through 1998, it is by design a backward-looking test for the local effects of problems in the commodity industries. There is every reason to expect these credit problems to intensify over time if commodity prices remain low.¹⁴ These considerations suggest that bankers in commodity-dependent counties should continually

¹² This analysis identifies the location of deposits by county through the Summary of Deposits report for June 1998, the most recent report available. The analysis is limited to institutions reporting at least \$1 million in C&I loans as of December 31, 1998. Institutions operating in one or more concentrated counties and meeting all the selection criteria averaged \$195 million in total assets as of December 31, 1998, compared with an average of \$733 million in assets for institutions operating in any U.S. county.

¹³ Past-due loans are defined as loans that have been past due for 30 to 89 days. Noncurrent loans are defined as loans that have been past due for 90 or more days plus loans placed in nonaccrual status.

¹⁴ For more information on how the agricultural outlook could affect FDIC-insured institutions, see the statement of FDIC Chairman Donna Tanoue to the Committee on Agriculture, U.S. House of Representatives, February 12, 1999, <http://www.fdic.gov/publish/speeches/99spchs/spc13apr.html>.

TABLE 3

RELATIVE FINANCIAL PERFORMANCE OF INSURED INSTITUTIONS OPERATING IN COUNTIES MOST CONCENTRATED IN COMMODITY INDUSTRIES					
INCLUDES ONLY INSURED INSTITUTIONS WITH AT LEAST \$1 MILLION IN C&I LOANS	NUMBER OF BANKS WITH AT LEAST 25% OF DEPOSITS IN A DESIGNATED COUNTY	AVERAGE C&I LOANS PAST DUE 30 TO 89 DAYS, AS PERCENT OF LOANS, 12/31/98	AVERAGE NONCURRENT C&I LOANS, AS PERCENT OF LOANS, 12/31/98	AVERAGE NET C&I LOAN CHARGE-OFFS, AS PERCENT OF AVERAGE LOANS, 1998	AVERAGE RETURN ON ASSETS, 1998
AGRICULTURE	416	5.08	6.12	1.58	1.16
LUMBER AND PAPER	465	3.38	1.89	0.78	1.21
OIL AND GAS	163	3.44	3.78	1.18	1.29
CHEMICALS	81	2.47	2.97	0.79	1.18
STEEL	186	2.53	2.06	0.59	1.08
AUTOS	341	2.64	2.05	0.66	1.12
TEXTILES	264	2.91	1.92	0.70	1.10
ELECTRONICS AND SEMICONDUCTORS	107	2.71	2.36	0.68	0.87
ANY COMMODITY INDUSTRY	1,915	3.39	3.03	0.93	1.13
ALL U.S. COUNTIES	8,485	2.91	2.50	0.76	1.05

NONCURRENT LOANS INCLUDE LOANS PAST DUE 90 OR MORE DAYS PLUS LOANS PLACED ON NONACCRUAL STATUS.
 C&I = COMMERCIAL AND INDUSTRIAL.
 SOURCES: SUMMARY OF DEPOSITS, DIVISION OF RESEARCH AND STATISTICS, FDIC; BANK AND THRIFT CALL REPORTS (RESEARCH INFORMATION SYSTEM)

monitor their local economy for signs of stress related to problems in the commodity industries.

Conclusion

Businesses operating in a range of commodity and manufacturing industries continue to grapple with weak or declining prices. This problem is not solely the result of industry-specific factors; it is part of long-term economic trends that may continue for some time. Signs of stress among firms in these industries are apparent in the form of declining levels of employment and slow or negative profit growth. However, there are few signs to date of any disorderly industry shakeouts involving widespread business bankruptcies and losses to lenders. Thus far, most firms have managed to cope with the situation by cutting costs and consolidating operations through mergers. At the same time, more forward-

looking indicators show that the level of credit risk associated with commodity industries may be on the rise. An analysis of the U.S. counties most heavily dependent on these industries showed few signs of a widespread deterioration in the performance of their economies or in the profitability of their local depository institutions through the end of 1998. However, there are signs of rising credit losses among local depository institutions in counties with the highest concentrations of agriculture and oil and gas extraction. A continuation of today's weak pricing picture in these industries has the potential to result in higher credit losses for insured institutions during the next few years.

*Richard A. Brown, Chief,
 Economic and Market Trends Section
 Alan Deaton, Economic Analyst*

Shifting Funding Trends Pose Challenges for Community Banks

- **Several long-term trends are making it more difficult for some institutions to economically fund asset growth with deposits in today's marketplace.**
- **Lagging deposit growth in recent years has resulted in greater reliance on alternative funding sources to meet loan demand.**
- **Liability management may become more important and more challenging for community banks that have historically relied upon deposits for funding and net interest revenues for profitability.**

For the past few years, assets have been expanding faster than deposits at many commercial banks. The result is an increased reliance on equity and borrowings for funding. Since 1992, commercial bank assets have grown at an average annual rate of 6.3 percent compared with a 3.9 percent average annual growth rate for deposits. Traditional measures of liquidity and funding for commercial banks reflected record-low levels of deposit funding at year-end 1998. Large commercial banks have traditionally made greater use of nondeposit funding alternatives. However, many community banks,¹ which have typically relied more on deposit funding, may face liability management challenges as a result of shifting funding trends. This article surveys the factors influencing the ability of banks to fund loan growth with deposits, discusses community bank funding trends, and considers the implications of these trends for community banks.

Factors Influencing Deposit Funding Trends

The percentage of commercial bank assets, particularly loans, funded with deposits has declined steadily in the 1990s. As shown in Chart 1, the industry's ratios of deposits to assets and loans to deposits reflect a longer-term shift away from deposit funding. Although the level of these industry ratios is heavily influenced by larger banks, the trend toward lower deposit funding exists for both large banks and community banks and points to secular factors that are affecting banks' ability to raise deposits in step with asset growth.

¹ Defined here as banks with total assets of \$1 billion or less.

Trends in Household Wealth Accumulation

One factor affecting the ability of banks to attract deposits is the recent trend in the way households are amassing wealth. While the total wealth of U.S. households has soared in recent years because of unrealized capital gains on housing and investments, annual net purchases of new financial assets² by households as a percentage of disposable income have actually trended downward since the mid-1980s (see Chart 2, next page). A falling personal savings rate and fewer purchases of financial assets may suggest that households are more comfortable consuming a higher percentage of current income as long as capital gains are adding to their accumulated wealth. However, because households have been setting aside less of their current income for savings, the pool of new funds available to purchase bank deposits has been growing more slowly.

Higher-Yielding Investment Alternatives

At the same time that households have been setting aside less of their current income for savings, the share of total new household savings flowing into bank deposits has declined in the 1990s as competition from higher-yielding alternatives has increased. During the 1980s, over 30 percent of the cumulative net increase in

² Financial assets are defined as deposits, money market and mutual fund shares, credit market instruments, corporate equities, life insurance reserves, pension fund reserves, and trust reserves.

CHART 1

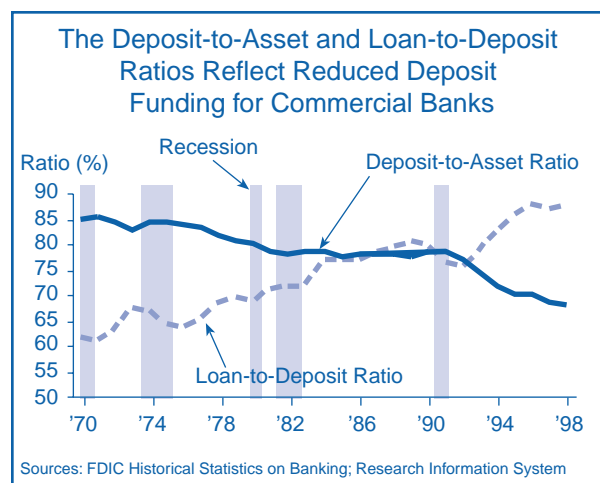
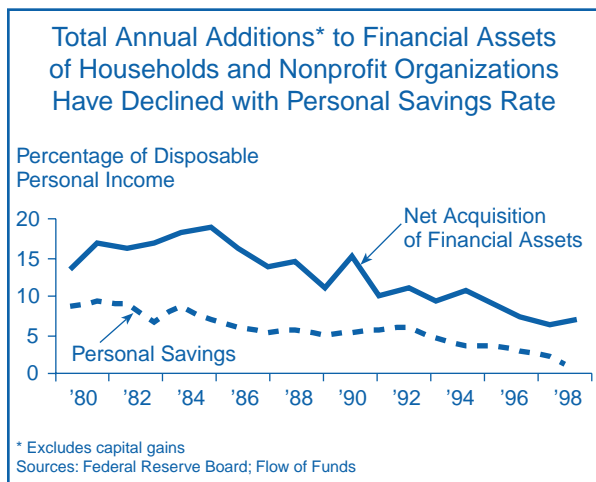


CHART 2



financial assets by households and nonprofit organizations flowed into deposits. In contrast, less than 15 percent of the cumulative net increase in financial assets has flowed into deposits during the 1990s, although an increasing proportion has been allocated to deposits in recent years.

Not only do banks face intensifying competition from other banks and thrifts, as indicated by 66 percent of the respondents in *Grant Thornton's 1999 Sixth Annual Survey of Community Bank Executives*,³ but they also

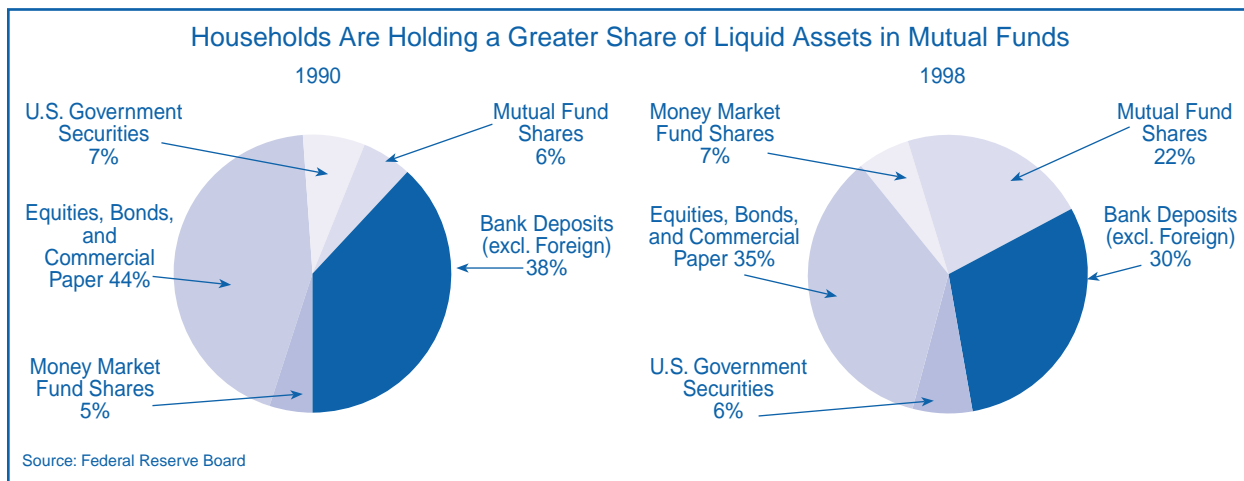
³ Grant Thornton's 1999 Sixth Annual Survey of Community Bank Executives, "Community Banks: A Competitive Force," <http://www.granthornton.com/resources/finance/banksurvey99/survey99w.html>.

face increasing competition from mutual funds and other nonbank financial service providers, such as credit unions.

Mutual Funds. Increasingly, consumers are pursuing higher yields by investing in mutual funds. Beyond yields, however, many mutual fund companies also are competing effectively with banks on the basis of convenience by offering money market accounts that allow check writing, automated teller machine cards, and check cards. Chart 3 shows the changes in the composition of household liquid assets during the 1990s. In 1990, bank deposits constituted 38 percent of households' liquid assets versus 11 percent for mutual funds and money market funds; at year-end 1998, the shares were nearly even. While some of the change in composition can be explained by rising mutual fund share prices, other measures indicate a shifting preference for mutual funds as a savings vehicle. For example, data from the *Investment Company Institute* show that net inflows into mutual funds have exceeded net increases in insured institution deposit accounts in all but three quarters during this economic expansion. Moreover, the first quarter of 1999 marked the seventeenth consecutive quarter that mutual fund inflows outstripped increases in deposits for all FDIC-insured institutions.

Credit Unions. In addition to mutual funds, credit unions also are formidable competitors for consumer savings. Membership in credit unions has increased more than 20 percent over the past decade, while deposits and share accounts have risen by over 90 per-

CHART 3



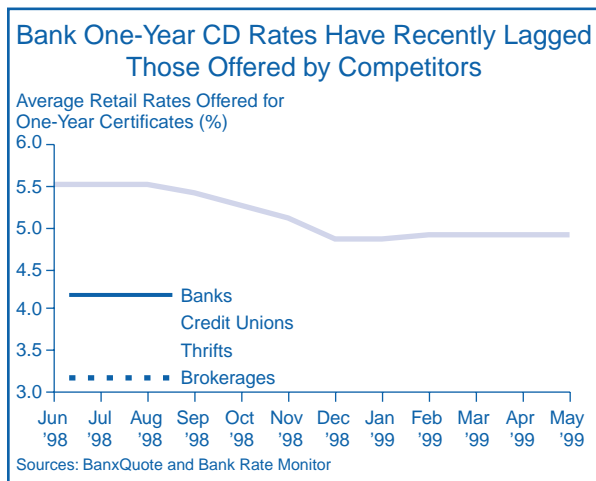
cent.⁴ Credit unions also offer federal insurance on share accounts as well as competitive rates on comparable deposit-type vehicles relative to other types of financial institutions. For example, according to information from the *National Credit Union Association*, on average, credit unions have offered rates on one-year share certificates in excess of one-year bank certificates of deposit in nine of the past ten years. As shown in Chart 4, average rates paid by credit unions on one-year share certificates over the 12 months ending May 1999 were consistently higher than rates offered by banks or thrifts and approached retail rates offered by brokerages.

Demographic Shifts

Some analysts maintain that rural community banks face additional funding challenges as a result of demographic shifts. According to the *Federal Reserve Bank of Kansas City*, rural bankers perceive that sluggish deposit growth is at least partially attributable to the migration of deposits to cities as urban-dwelling heirs of rural depositors relocate funds. While evidence for this deposit migration remains anecdotal, economists at the Federal Reserve Bank of Kansas City indicate that the demographic shift is still in process, and its full effect may not be felt for some time. Further challenging deposit growth for banks, additional evidence suggests that urban dwellers tend to place less of their

⁴ Center for Credit Union Research, "Credit Union FAQ," <http://wiscinfo.doit.wisc.edu/bschool/cu/cufaq.html>.

CHART 4



savings in banks than their rural counterparts do.⁵ This trend poses additional consequences for bank deposits as rural populations migrate to suburban areas.

Community Bank Funding Trends

Community banks traditionally rely more heavily upon core deposit funding than larger banks do. For example, Chart 5 (next page) shows that 72 percent of aggregate community bank assets were funded with core deposits at year-end 1998. In contrast, 43 percent of aggregate large bank assets at year-end 1998 were funded with core deposits. This difference in liability structures reflects large banks' broader use of wholesale funding alternatives and greater access to capital markets instruments.



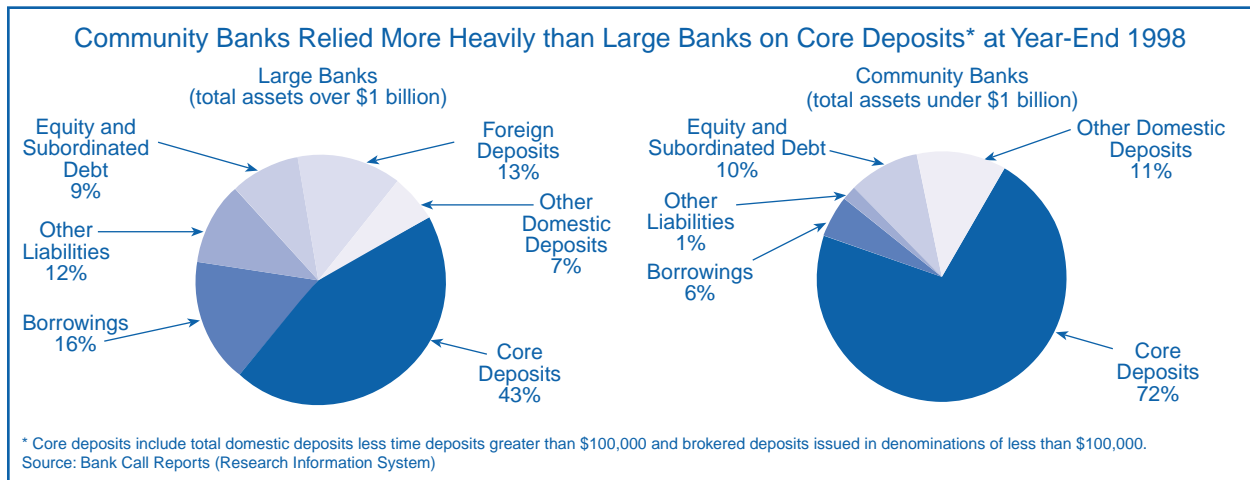
While large banks have responded to factors influencing deposit growth by making greater use of alternative funding sources, funding options for community banks tend to be more limited.

Because of high fixed costs, community banks may find it more difficult than larger institutions to make cost-effective use of capital market instruments such as securitizations or public debt and equity offerings (see *"Industry Consolidation Presents Unique Risks and Challenges for Community Banks," Regional Outlook, Fourth Quarter 1998*, for a discussion of additional non-deposit funding sources for community banks).

The need to augment lagging deposit growth to meet loan demand has led many community banks to acquire more noncore funds. These funds include time deposits greater than \$100,000, borrowings, foreign deposits, brokered deposits, and demand notes. At year-end 1998, nearly 75 percent of community banks held noncore liabilities representing 10 percent or more of total liabilities. As recently as 1993, only 42 percent of community banks exceeded that threshold. Moreover, over the same five-year period, the ratio of core deposits (defined here as total deposits less time deposits greater than \$100,000 and brokered deposits) to total deposits for all community banks declined each quarter.

⁵ William R. Keeton, Federal Reserve Bank of Kansas City. "Are Rural Banks Facing Increased Funding Pressures? Evidence from Tenth District States." *Economic Review*, Second Quarter 1998, p. 56. Also see "Regional Banking," *Regional Outlook, Kansas City Edition*, Second Quarter 1998, p. 24.

CHART 5



As community banks' use of noncore funds has increased, they are relying more on federal funds purchased, repurchase agreements, other borrowings, demand notes, and mortgages (collectively referred to as borrowings). After adjusting for mergers, borrowings funded 12 percent of new community bank asset growth from 1992 through 1998—three times more than the percentage of new asset growth funded by borrowings from 1985 to 1990. Possibly reflecting a shift toward greater acceptance of wholesale funding by community bankers, growth in borrowings has been largely driven by increased use of nonovernight borrowings,⁶ which have become the dominant form of borrowings at community banks. As shown in Chart 6, the proportion of community banks reporting nonovernight borrowings has doubled in the 1990s. This trend coincides with growing community bank membership in the Federal Home Loan Bank (FHLB) system and increasing use of FHLB borrowings.

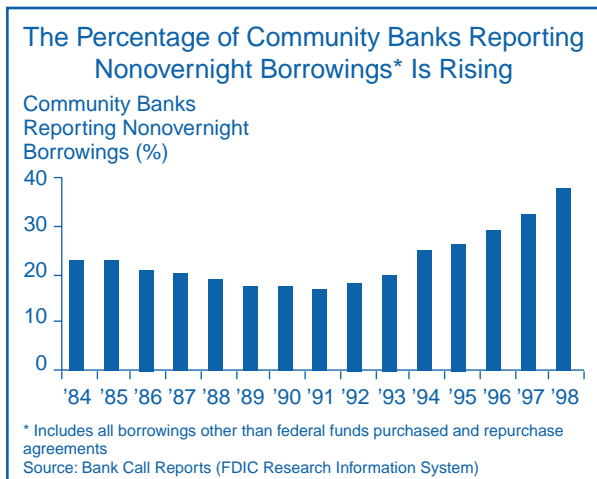
Federal Home Loan Bank Membership

Over the past five years, community banks have substantially increased their membership and participation in the FHLB system. According to data from the *Federal Housing Finance Board*, for the five-year period ending in 1998, the percentage of FDIC-insured community banks that were members of the FHLB more than doubled to 50 percent. Over the same period, FHLB advances outstanding for community banks grew by more than 50 percent to \$47 billion. At year-end 1998,

FHLB advances represented approximately 80 percent of all nonovernight borrowings for community banks.

Analysts have cited a number of reasons why community banks are joining the FHLB system. Community banks are using FHLB advances to meet contingent liquidity needs, manage interest rate risk, fund new asset growth, and leverage capital to maintain or boost returns on equity. Recent surveys indicate that FHLB advances will continue to have a role in community bank liability management. Almost one-half of respondents to *Grant Thornton's 1999 Annual Survey of Community Bank Executives* considered FHLB borrowings an important funding source over the next three years, and 43 percent plan to increase the use of FHLB advances in 1999. Similarly, the *American Bankers Association's 1999 Community Bank Competitiveness*

CHART 6



⁶ Nonovernight borrowings are defined here as all borrowings other than federal funds purchased and repurchase agreements.

*Survey*⁷ reported that FHLB advances are the preferred nontraditional funding product. In addition, legislative changes enacted in third-quarter 1998 have eased membership requirements for banks with assets less than \$500 million, significantly increasing access to FHLB advances for smaller banks in rural areas.

Implications of Funding Trends for Community Banks

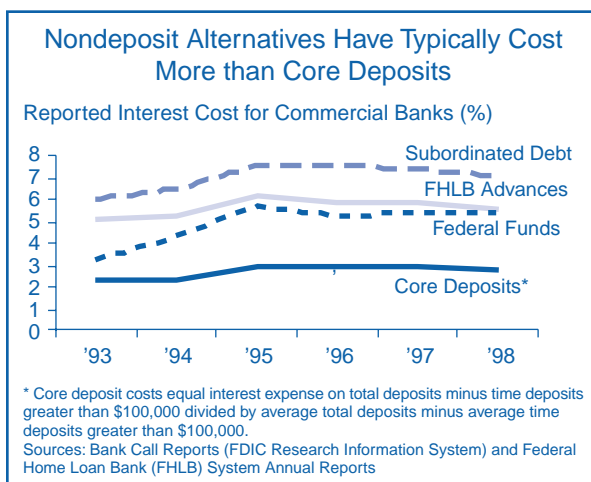
According to community banker opinion surveys, the trend toward greater reliance on noncore or alternative funding sources appears likely to continue. *Grant Thornton's 1999 Annual Survey of Community Bank Executives* found that 75 percent of community bankers expect funding with core deposits to be more difficult in three years than it is today. Moreover, more than 20 percent of community bankers responding to the *American Bankers Association's 1999 Community Bank Competitiveness Survey* do not expect to derive the bulk of their funding from deposits five years from now. Liability management is an important aspect of a bank's operations and a key driver of interest expense. Responses to funding challenges will likely influence strategic business decisions that shape the risk profiles of insured institutions, particularly community banks that historically have relied more heavily upon core deposits to fund asset growth and net interest income for profitability.

A fundamental challenge that confronts bank management is the strategic response to the increased costs associated with wholesale funding sources. As shown in Chart 7, the reported interest costs of nondeposit funding alternatives, such as federal funds purchased and repurchase agreements, subordinated notes, and FHLB advances, have traditionally exceeded the interest cost of core deposits for commercial banks. Therefore, as institutions that have typically relied upon core deposits increase the use of nondeposit sources, funding costs will likely rise relative to asset yields. As a result, net interest margins (NIMs) may be pressured.

To some extent bank managers may be able to offset the higher interest costs of wholesale funding strategy by improving efficiency through greater management of overhead expenses and increases in noninterest income. However, community banks face challenges to their ability to increase noninterest income (see "*Industry Consolidation Presents Unique Risks and Challenges*

⁷ *ABA Banking Journal*, February 1999, p. 30.

CHART 7



for Community Banks," *Regional Outlook*, Fourth Quarter 1998), and there are limits to cost cutting. If banks are unable to fully offset higher funding costs with increases in noninterest income or reductions in noninterest expenses, overall profitability could suffer. Community bankers in the upper Midwest expressed this concern in a 1998 survey conducted by *The Federal Reserve Bank of Minneapolis*, which found that 57 percent of respondents expect the shift away from deposit funding to decrease bank profitability.⁸ As bank managers search for additional ways to offset the relative rise in funding costs, they may be tempted to increase asset yields by pursuing additional portfolio risk, in the form of credit or market risk, to generate higher asset yields.

Funding challenges also could alter the liquidity and interest rate risk positions of community banks. The relative complexity and volatility of some nondeposit sources require greater expertise and attention to asset-liability policies and practices to avoid unexpected liquidity strains or exposures to changing interest rate environments. Strategies that result in the pledging of liquid assets, overreliance on purchased funds, or concentrations in price-sensitive long-term assets could adversely affect a bank's relative liquidity or interest rate risk position. Moreover, interest rate risk management can be further challenged by the complexity of nondeposit funding sources. For instance, some FHLB advances may contain embedded options that required greater expertise and attention to policies and practices that, if not managed properly, could lead to undesirable outcomes if interest rates change adversely.

⁸ *Fedgazette*, July 1998, p. 2.

Differences between Community Banks with High and Low Levels of Core Deposit Funding

To evaluate how a shift from a core deposit funding strategy might change the profile of a community bank,

performance and condition measures for community banks that rely most heavily on core deposits were contrasted with those that are least reliant on core deposit funding. Table 1 compares 1998 funding, earnings, and asset performance measures for these community bank

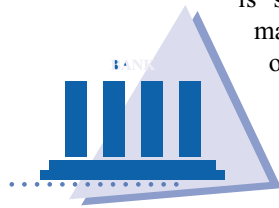
TABLE 1

COMPARISON OF BANKS WITH HIGH AND LOW LEVELS OF CORE DEPOSIT FUNDING						
	ALL COMMUNITY BANKS ¹		COMMUNITY BANK AGRICULTURAL LENDERS ²		COMMUNITY BANK COMMERCIAL LENDERS ³	
	HIGH CORE DEPOSIT FUNDING ⁴	LOW CORE DEPOSIT FUNDING ⁴	HIGH CORE DEPOSIT FUNDING	LOW CORE DEPOSIT FUNDING	HIGH CORE DEPOSIT FUNDING	LOW CORE DEPOSIT FUNDING
SELECTED AGGREGATE MEASURES						
NUMBER OF BANKS IN GROUP	405	405	106	51	126	185
MEDIAN TOTAL ASSETS (\$000s)	46,244	118,358	23,274	58,223	69,479	130,923
MEMBERS OF FHLB (%)	32.10	49.38	17.92	47.06	38.89	50.81
HAVE OUTSTANDING FHLB ADVANCES (%)	7.65	40.25	6.60	45.10	7.14	38.38
SELECTED MEDIAN LIQUIDITY AND FUNDING MEASURES (%)						
1998 GROWTH IN TOTAL ASSETS	9.02	11.16	5.96	6.42	12.75	18.50
1998 GROWTH IN TOTAL DEPOSITS	9.74	8.79	6.40	5.31	13.56	11.93
1998 GROWTH IN BORROWINGS	(50.00)	28.62	(64.49)	31.85	(51.87)	42.87
1998 GROWTH IN TOTAL EQUITY CAPITAL	5.93	7.53	3.46	5.39	9.94	8.85
TOTAL DEPOSITS-TO-TOTAL ASSETS RATIO	91.04	75.68	90.35	80.22	91.23	77.94
CORE DEPOSITS-TO-TOTAL ASSETS RATIO	87.29	53.87	87.10	55.81	87.21	54.03
BORROWINGS TO TOTAL ASSETS RATIO	0	9.58	0	4.15	0	8.55
TOTAL EQUITY CAPITAL TO TOTAL ASSETS RATIO	8.25	10.24	9.00	10.09	7.74	10.16
SELECTED MEDIAN PERFORMANCE RATIOS (%)						
RETURN ON EQUITY	12.65	10.19	11.10	10.93	14.49	9.52
RETURN ON ASSETS	1.07	1.04	1.01	1.19	1.10	0.92
NET INTEREST MARGIN	4.76	4.03	4.51	3.98	5.25	4.22
GROSS EARNING ASSET YIELD ⁵	8.17	8.02	8.24	7.89	8.45	8.26
COST OF FUNDING EARNING ASSETS ⁶	3.33	4.07	3.74	4.05	3.21	4.05
NONINTEREST INCOME TO AVERAGE ASSETS	0.76	0.61	0.59	0.44	1.01	0.64
NONINTEREST EXPENSE TO AVERAGE ASSETS	3.49	2.90	3.23	2.40	3.99	3.12
EFFICIENCY RATIO ⁷	69.01	63.68	68.59	57.48	68.99	67.00
SELECTED MEDIAN CREDIT QUALITY MEASURES (%)						
NONPERFORMING ASSETS TO TOTAL ASSETS RATIO	0.39	0.44	0.40	0.51	0.46	0.61
NONCURRENT LOANS TO TOTAL LOANS RATIO	0.53	0.72	0.53	1.02	0.52	0.77
NET LOAN CHARGE-OFF RATIO	0.11	0.12	0.04	0.15	0.14	0.11
1998 GROWTH IN NONPERFORMING ASSETS	(9.10)	7.50	10.57	11.79	(17.32)	23.97
1998 GROWTH IN NET LOAN LOSSES	6.09	10.24	(3.90)	23.73	9.59	30.64

¹ COMMUNITY BANKS ARE BANKS WITH \$1 BILLION OR LESS IN TOTAL ASSETS.
² AGRICULTURAL LENDERS ARE BANKS WITH 25 PERCENT OR MORE OF ASSETS IN AGRICULTURAL REAL ESTATE LOANS OR AGRICULTURAL PRODUCTION LOANS.
³ COMMERCIAL LENDERS ARE BANKS WITH 25 PERCENT OR MORE OF ASSETS IN COMMERCIAL AND COMMERCIAL REAL ESTATE LOANS.
⁴ HIGH CORE DEPOSIT FUNDING GROUP IS COMPOSED OF COMMUNITY BANKS WITH CORE DEPOSITS-TO-ASSETS RATIOS IN THE TOP 5 PERCENT OF ALL COMMUNITY BANKS, EXCLUDING THOSE WITH EQUITY-TO-ASSETS RATIOS IN EXCESS OF 25 PERCENT. THE LOW CORE DEPOSIT FUNDING GROUP IS COMPOSED OF COMMUNITY BANKS WITH CORE DEPOSITS-TO-ASSETS RATIOS IN THE BOTTOM 5 PERCENT OF ALL COMMUNITY BANKS.
⁵ GROSS EARNING ASSET YIELD EQUALS INTEREST INCOME DIVIDED BY AVERAGE EARNING ASSETS.
⁶ COST OF FUNDING EARNING ASSETS EQUALS INTEREST EXPENSE DIVIDED BY AVERAGE EARNING ASSETS.
⁷ EFFICIENCY RATIO EQUALS NONINTEREST EXPENSE DIVIDED BY THE SUM OF NET INTEREST AND NONINTEREST INCOME.
 FHLB = FEDERAL HOME LOAN BANK
 SOURCES: BANK CALL REPORTS (RESEARCH INFORMATION SYSTEM); FEDERAL HOUSING FINANCE BOARD

groups. High core deposit funders are defined as those community banks with core deposit-to-asset ratios in the top 5 percent of all community banks at year-end 1998. Low core deposit funders are those community banks with a core deposit-to-asset ratio in the bottom 5 percent.⁹ A similar comparison is included for agricultural banks and commercial lending specialists, which combined make up roughly 60 percent of each of the total community bank funding groups.

This comparison reveals several differences. First, a tradeoff between heavy reliance on core funding and asset growth is evident. Median measures for the groups indicate that the typical bank that relies less on core deposit funding is larger and growing faster than the typical bank in the high core funding group. Second, less core deposit funding appears to be associated with a lower NIM, primarily the result of higher funding



costs. However, overall profitability is similar between the groups mainly because of a lower ratio of overhead expenses to average assets for the low core funders. These characteristics are also evident across the agricultural and commercial specialists groups.

Asset quality indicators suggest that the low core funding groups may exhibit greater credit risk. Although higher asset yields resulting from increased portfolio risk are not evident, median measures for each low core funding group reflect higher levels of noncurrent loans and higher growth in nonperforming assets and net loan losses relative to its high core funding group counter-

part. For example, the median growth in nonperforming assets for commercial lending specialists with less reliance upon core deposits was nearly 24 percent in 1998 versus a 17 percent decline for the high core funding group.

Summary and Conclusions

Commercial banks have been experiencing a long-term trend toward lower deposit funding of loans and assets. Increasing competition among banks and from thrifts, nonbanks, and higher-yielding investment alternatives has made it more difficult and expensive for some banks to attract deposits in step with asset growth. While some nondeposit funding alternatives may provide a stable source of funds for insured institutions (especially those located in areas characterized by aggressive competition and slow deposit growth), better matching of asset cash flows, and greater flexibility in asset-liability management, they also may pose certain risks. To some extent community banks may be able to manage noninterest expense and noninterest income to offset the relative increase in interest expense incurred to acquire nondeposit funding sources. However, if overall profitability suffers, banks may be tempted to pursue additional portfolio risk to generate higher offsetting asset yields. As a result, liability management may become more challenging for community banks that have historically relied upon deposits for funding and net interest revenues for profitability. In addition, the complexity of some nondeposit funding sources requires greater expertise and attention to policies and practices to avoid unexpected liquidity strains or exposures to changing interest rate environments.

*Allen Puwalski, Senior Financial Analyst
Brian Kenner, Financial Analyst*

⁹ These groups exclude community banks with equity-to-asset ratios greater than 25 percent.

Regional Perspectives

- The Region's economy remains healthy, although manufacturing employment fell in the past year.
- Banks and thrifts continue to report healthy performances in the first quarter despite continued contraction in net interest margins.
- Falling loan repayments, rising past-due levels, and increasing carryover debt evidence persistent weakness in the agricultural sector.
- With loan growth outpacing deposit growth, many insured institutions, including smaller community institutions, have sought alternative funding sources.

Regional Economic and Banking Conditions

Chicago Region's Economy Remains Healthy Despite Slower Growth

The Chicago Region's economy remains healthy, as illustrated by developments in the first quarter of 1999:

- The Region's unemployment rate returned to 3.7 percent, the record low first reached in the second quarter of 1998. However, not all states participated equally in the reduction (see Table 1).
- The single-family housing sector continued its expansion, with permits 6.6 percent higher than a year earlier.
- Personal bankruptcy filings remained high (51,627), yet were 7.7 percent below the Region's second-quarter 1998 peak.

- Business bankruptcies, which have been below year-earlier levels for the past seven quarters, are down 23 percent from their recent high in mid-1997.

However, some signs of slower economic growth and a shift in monetary policy have emerged:

- Job growth in the Region continues to slow, with first-quarter 1999 employment only 1.3 percent higher than a year earlier. Some employers are finding it difficult to fill positions because of a lack of available workers, while others are undertaking layoffs or hiring cutbacks.
- Growth in the Region's industrial output also slowed, with its 1.1 percent first-quarter gain the smallest in almost three years.

TABLE 1

REGION'S LABOR MARKET SHOWS LOWER UNEMPLOYMENT RATE AND MODERATE JOB GROWTH						
1999:Q1	CHICAGO REGION	IL	IN	MI	OH	WI
UNEMPLOYMENT RATE (%)	3.7	3.9	2.9	3.9	4.1	3.4
% CHANGE FROM 1998:Q1	-0.3	-0.7	-0.4	0.0	-0.1	0.3
EMPLOYMENT GROWTH (% CHANGE FROM 1998:Q1)	1.3	1.6	1.9	1.0	0.8	1.3
MANUFACTURING (%)	-0.7	-0.6	0.4	-1.2	-1.1	-0.5
SERVICES (%)	2.1	3.0	2.3	1.9	1.3	1.8
OTHER (%)	1.6	1.5	2.4	1.4	1.2	1.8
SOURCE: BUREAU OF LABOR STATISTICS, VIA HAVER ANALYTICS, INC.						

Regional Perspectives

- Economic troubles in Asia and elsewhere abroad continue to dampen activity in the Region's manufacturing and farming sectors.
- Some farmers may lack the capacity to withstand another year of low crop prices and falling income.
- The Federal Reserve increased its targeted short-term interest rate by 25 basis points in late June, raising the possibility that recent months' increases in intermediate- and longer-term interest rates may continue.

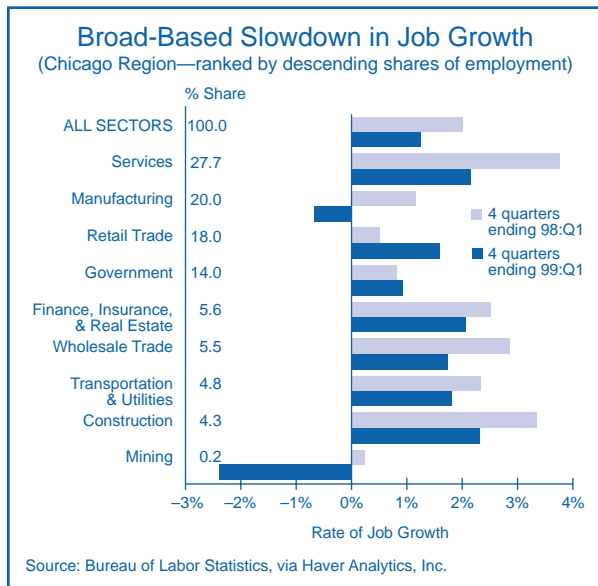
In this environment, economic conditions deserve careful monitoring for signs of further slowing of growth or for new areas of weakness. Indicators that bear watching include:

- The manufacturing sector, where job reductions have accounted for about half the Region's slowdown in employment growth over the past year.
- Manufacturers' new orders and order backlogs, which are determinants of factory employment and production levels for the next 3 to 12 months.
- Active commercial real estate markets, especially where speculative construction is occurring.
- Recent upticks in business bankruptcy filings in **Illinois, Michigan, and Ohio** and a modest increase in personal bankruptcies in Michigan.
- Fewer business starts, which traditionally generate employment opportunities and economic growth.

Manufacturing Sector Is Behind the Recent Slowdown

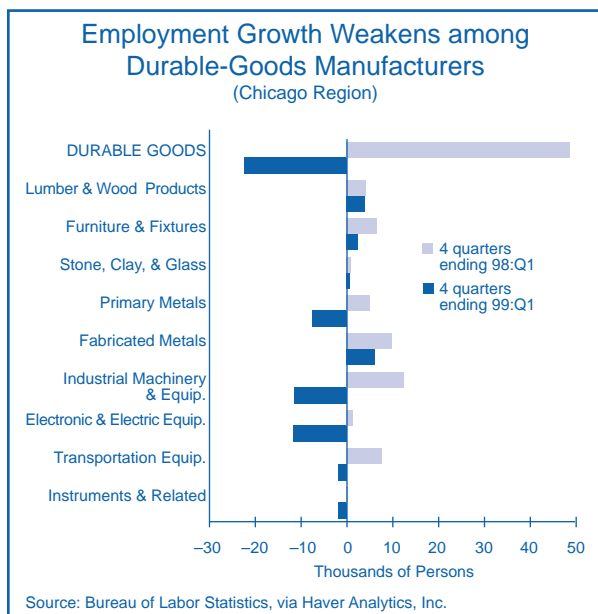
The past year's slowdown in job growth reflects, in part, a lack of available workers because the unemployment rate is at a record low. However, it also reflects layoffs in the manufacturing sector and noticeably slower job growth among firms providing business, health, professional, and other services (see Chart 1). Together, these two sectors account for about 48 percent of employment in the Region.

CHART 1



The Region's producers of durable goods (products, such as cars or industrial machinery, that last three years or longer) trimmed their payrolls by 22,300 workers during the past year (see Chart 2). Specifically, producers of industrial machinery and equipment and of electronic and electrical equipment each reduced employment by approximately 11,500 workers. Meanwhile, manufacturers of primary metals eliminated about 7,600 jobs, with more than 60 percent of this loss

CHART 2

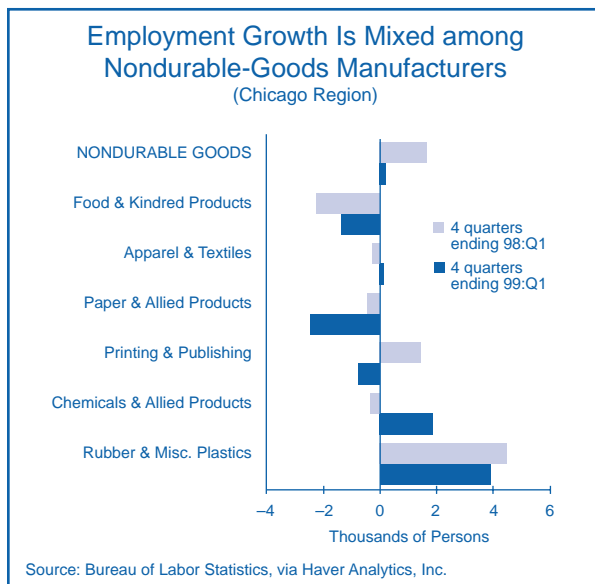


Regional Perspectives

occurring in Ohio and another 25 percent in **Indiana**. In contrast, nondurable-goods manufacturing employment, which tends to be less affected by swings in domestic demand and economic weakness abroad, has downshifted considerably less in the past year (see Chart 3).

Manufacturing is typically a leading indicator of shifts in the Region's economy. Further, more than two-thirds of the Region's manufacturing jobs are associated with the cyclically sensitive durable-goods sector. As a result, sharp downturns in employment by firms making primary metals and certain types of machinery and equipment, along with a general weakening in other manufacturing industries, are causes for concern. In addition, softer manufacturing conditions are triggering cutbacks not only in manufacturers' payrolls but also among contractual workers providing such supporting services as accounting, data processing, temporary help, security, and other functions. This spillover effect reflects that a growing number of manufacturers outsource work not directly related to production line activity. The effects of such events on communities will vary with the degree of diversity in the affected economies. Although the unemployment rate is low for the Region as a whole, laid-off workers may find it difficult to obtain replacement positions locally.

CHART 3

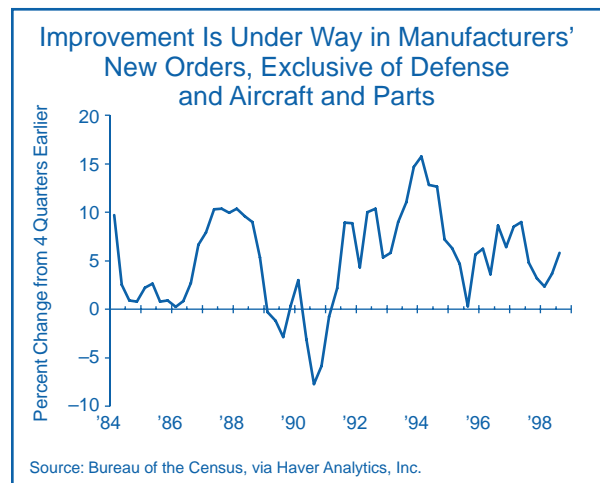


What Lies Ahead for Manufacturers?

Manufacturers' new and unfilled orders provide one indication of future production and employment levels. If inventories keep pace with sales, incoming orders typically shape firms' production workloads for the next 3 to 12 months. In the first quarter of 1999, orders for nondefense goods, exclusive of aircraft and parts,¹ were 5.8 percent above their year-earlier level (see Chart 4). This increase was the greatest since late 1997 and followed four quarters of more modest gains. If this upswing in orders' growth is sustained, jobs among the Region's manufacturers may grow moderately in the near term or, at the very least, not weaken much further.

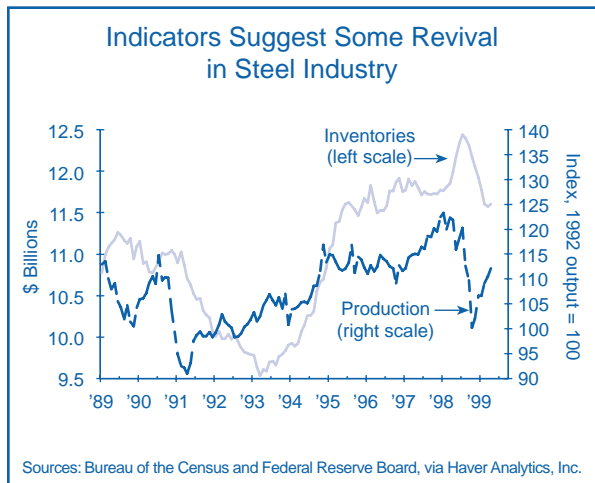
Recent developments in the hard-hit steel industry also support the prospect of a modest improvement in the manufacturing sector. Recently negotiated trade agreements, along with the imposition of some punitive tariffs, should reduce steel imports from Japan, Brazil, and Russia. These factors likely will strengthen the upturn in domestic raw steel production that began in late 1998 (see Chart 5). In addition, a reduction in excess inventories that built up last year and accompanying improvement in the inventory-to-sales ratio could stimulate production in coming months.

CHART 4



¹ Because the defense and aerospace industries play relatively small roles in this Region, new orders received by these industries are excluded.

CHART 5



Outlook Contains Uncertainties

Developments in the manufacturing sector during the first half of 1999 suggest that the past year's slide may not worsen and could improve. Even so, tight labor markets—as measured by low unemployment and a lack of available workers—suggest that the Region lacks the capacity for robust growth in coming quarters. In addition, any revival in the manufacturing sector could be limited, should the recent upturn in new orders' growth not be sustained.

Partly in response to tightness in labor markets nationwide, Federal Reserve officials have expressed concerns about the economy's potential for over-heating, where excess demand relative to supply could spur inflationary pressures. In mid-June, the Federal Reserve Board's Chairman Greenspan said that "...it is useful to preempt forces of imbalances before they threaten economic stability."² Several weeks later, the Federal Open Market Committee (FOMC) followed suit by raising its target short-term interest rate by 25 basis points.

It is unclear whether the FOMC's recent action is a one-time event or the start of a sustained move toward tighter monetary policy and higher interest rates. If the latter, the Region likely would feel negative repercussions in many ways, including lower consumer confidence and spending, reduced residential and commercial construction, and moderating activity

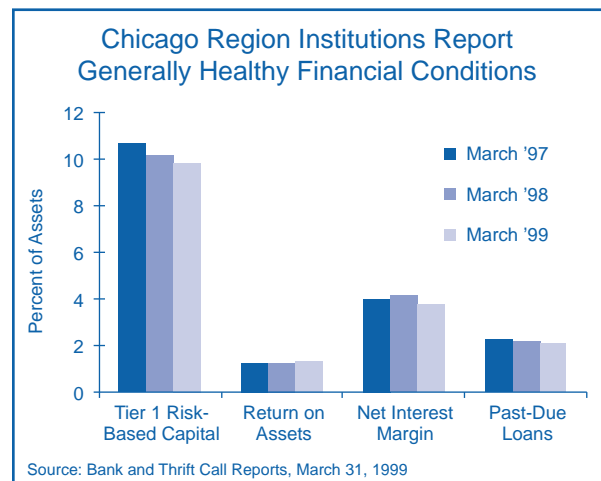
² Testimony of Federal Reserve Board Chairman Alan Greenspan before the Joint Economic Committee, U.S. Congress, June 17, 1999.

among interest-sensitive sectors such as manufacturing. Banks' and thrifts' rate of loan growth and asset quality might be challenged by such developments. In addition, financial institutions might need to continue careful monitoring and adjustment of their asset/liability positions, because a sustained period of rising interest rates would represent a shift from much of the past decade, when falling or stable rates more often were the norm.

Banks and Thrifts Continue to Report Strong Performances in the First Quarter

The Region's banks and thrifts reported generally healthy financial conditions in the first quarter of 1999 (see Chart 6). The Region's banks reported a return on assets (ROA) of 1.36 percent in the first quarter compared with 1.32 percent in the same quarter last year. Stronger performance was realized despite continued contraction in the net interest margin (NIM). The aggregate NIM among the Region's banks fell to 3.87 percent from 4.07 a year earlier, with a decline of 31 basis points in the yield on earning assets more than offsetting a decline of 23 basis points in the cost of funds. Noninterest income (NII) continues to strengthen performance, particularly among the Region's largest banks (institutions with total assets greater than \$1 billion). In addition, reported asset quality remains favorable with total past-due loans of 2.15 percent compared with 2.29 percent a year earlier. Aggregate core deposit growth continues to slow as noncore funding sources play a larger role in liquidity and asset/liability management, particularly among the Region's largest banks.

CHART 6



Regional Perspectives

Performance at the Region's 398 savings institutions improved with a ROA of 1.08 percent in the first quarter compared with 0.98 percent in the same quarter last year. Savings institutions overcame weakness in the mortgage market in the first quarter by increasing NII and controlling overhead expenses. While loans secured by real estate remain the largest loan portfolio segment, total outstandings were virtually unchanged year-over-year.

Loan growth was concentrated in the relatively small consumer portfolio, which increased 41.8 percent over the past four quarters to 11.5 percent of total loans. Reported asset quality remains strong with total past-due loans equaling 1.77 percent of total loans. Aggregate core deposits continue to decline while noncore funding sources, such as borrowings and certificates of deposit greater than \$100,000, post double-digit growth rates.

Weak Agricultural Conditions Cause Falling Loan Repayments and Rising Past-Due Levels

The *United States Department of Agriculture* estimates that net farm income in the Heartland area, which includes **Illinois** and portions of **Indiana** and **Ohio**, will decline by 18 percent in 1999. This decline reflects lower corn, soybean, and hog prices. Net farm income in the Northern Crescent area, which includes Michigan and **Wisconsin**, is expected to decline by 11 percent.

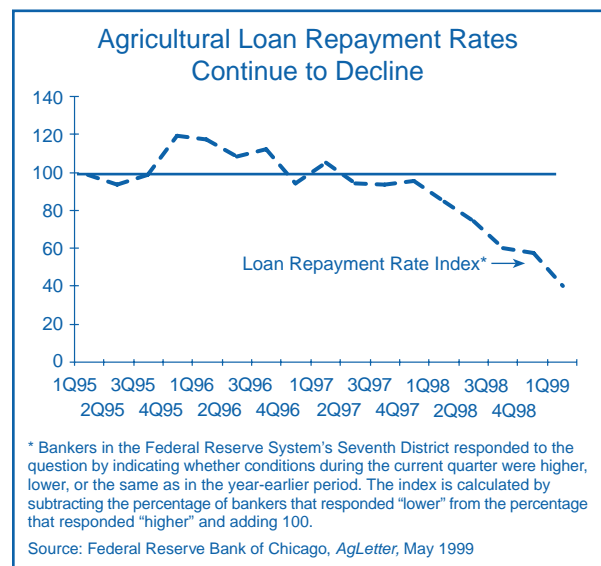
The Federal Reserve Bank of Chicago's *AgLetter* survey of bankers reported that loan repayments continued to decline in first-quarter 1999 (see Chart 7). In Illinois, two-thirds of respondents reported a decline in repayments. Responses from Wisconsin, where the dairy sector is dominant and remains relatively stable, were more favorable but still showed a decline in repayments from a year ago. Further reduction in net farm income this year will likely hinder loan repayments in the coming quarters.

The decline in farm income has led to a significant drop in big-ticket farm equipment sales. Two-thirds of *AgLetter* respondents expect a decrease in the volume of outstanding loans to finance farm equipment. In contrast, production loan demand is reportedly strong, as commodity prices have forced farmers to use more of their borrowing capacity to finance planting needs. In addition, about two-thirds of bankers surveyed reported an increase in the portion of new operating loans used to refinance unpaid carryover debt from last year. This result was mirrored in the FDIC's most recent *Report on Underwriting Practices*. Examiners noted an increase in FDIC-supervised banks' level of carryover debt during the six-month reporting period ending March 1999. Twenty-nine percent of FDIC-supervised banks active in agricultural lending showed a "moderate" increase in the level of carryover debt compared

with 10 percent in the year-earlier period. Three percent showed a "sharp" increase.

The Region's 329 agricultural banks³ held \$4.0 billion in agricultural loans as of March 31, 1999. As a group, agricultural banks continue to report high capital levels and solid earnings. However, reported asset quality measurements show some deterioration. Total past-due loan levels rose to 2.75 percent from 2.47 percent a year earlier, marking the highest level of past-due loans in the past 12 quarters. Net loan charge-offs, while remaining low, nearly doubled to 0.12 percent from 0.07 percent on March 31, 1998.

CHART 7



³ An agricultural bank is defined as an insured institution in which the sum of agricultural production loans and loans secured by farmland exceeds 25 percent of total loans.

Institutions Diversify Funding Sources to Supplement Weak Deposit Growth

Loan growth in the Region has outpaced core deposit growth over the past decade, prompting many institutions to seek alternative funding sources. The shift toward noncore funding has led to increasing loan-to-deposit ratios in the Region (see Chart 8).

The two most rapidly growing sources of funding have been borrowings and large time deposits. On average, half the increase in noncore funding in the Region since 1988 has resulted from borrowings. The increase is largely attributable to the use of borrowings from the Federal Home Loan Bank (FHLB) system (see Chart 9). Flexible loan terms and the relatively lower costs of FHLB advances compared with other noncore sources have likely driven FHLB advances higher. In addition, FHLB borrowings allow institutions to obtain funds without adversely affecting their deposit base. For example, if an institution offered a temporary deposit promotion featuring high interest rates, it likely would attract new depositors. However, many existing depositors in no- or low-cost deposit products may roll over into the promotional product as well, increasing the bank's overall cost of funds.

Approximately 40 percent of insured institutions in the Region held FHLB borrowings as of year-end 1998. Commercial⁴ and residential real estate⁵ institutions have been the primary FHLB borrowers, likely because of strong commercial loan growth and ample real estate collateral to fund borrowings, respectively. On average, a Chicago Region FHLB borrower has 8 percent of assets funded by FHLB advances, up from 5 percent in 1991. Of FHLB borrowers, residential real estate institutions fund the highest percentage on average at 12 percent of assets.

Noncore Funding Has Increased at Community Banks and Thrifts in the Region

Although the shift to noncore funding has been more prevalent in larger institutions, smaller institutions also

are using significantly more noncore funding. In 1998, community banks (banks and thrifts with assets less than \$500 million) totaled 1,856, roughly 91 percent of the number of insured institutions in the Region. Core deposits as a percentage of total liabilities among community banks fell 6 percentage points to 81 percent over the past decade. During this same period, community banks offset the decline in core deposit levels with increases in large time deposits and other borrowings. In 1998, large time deposits comprised 11 percent of total liabilities compared with 8 percent in 1988. Other borrowings grew to 5 percent of total liabilities in 1998 from 2 percent a decade earlier (see Chart 10, next page).

CHART 8

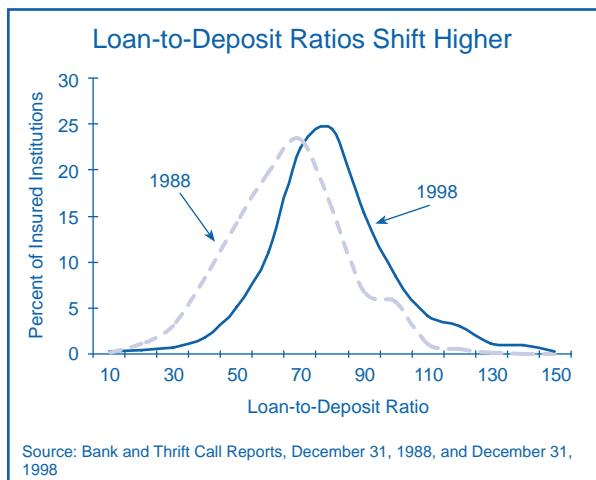
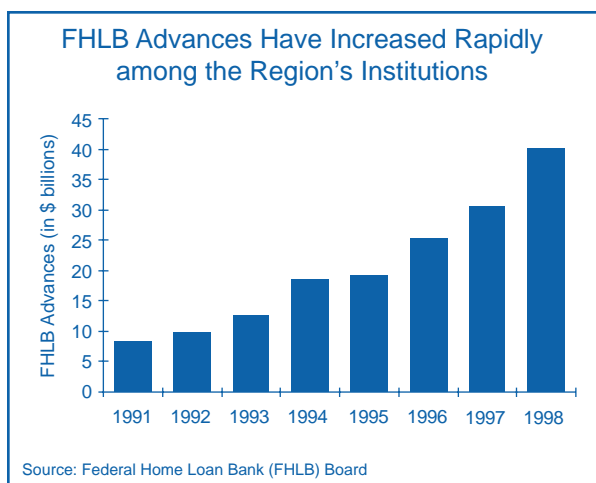


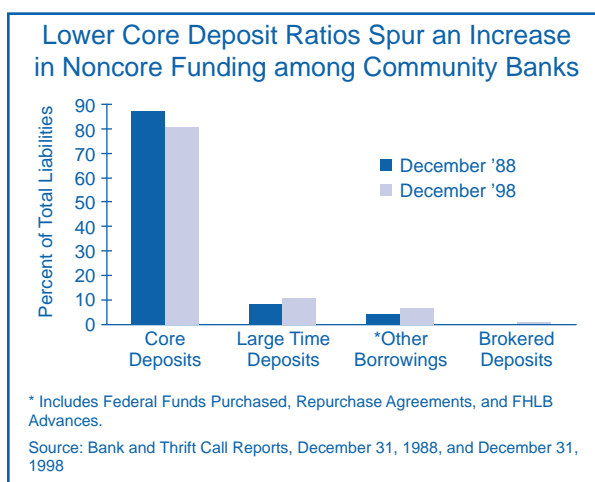
CHART 9



⁴ A commercial institution is typically defined as any institution where the sum of commercial real estate loans and other commercial loans exceeds 25 percent of assets.

⁵ A residential real estate institution is typically defined as any institution where the sum of one- to four-family mortgages and mortgage-backed securities exceeds 50 percent of assets.

CHART 10



Although interest costs associated with noncore funding methods are typically higher than the costs of traditional deposits, performance measures among community banks with high noncore funding compare favorably with the institutions that have maintained substantial core deposits (see Table 2). While the disparity in funding costs between the two groups has remained constant over the past ten years (60 basis points higher for the users of noncore funds), the divergence in the net interest margin (NIM) has diminished. At the end of the past decade, core funders (those institutions with a core-funding-to-total-liabilities ratio greater than 70 percent) had an NIM 59 basis points above that of the noncore funders (those institutions with a core-funding-to-total-liabilities ratio less than 70 percent). However, ten years later, the spread diminished to 43 basis points partly because loan-to-asset ratios are increasing more for noncore funders than for core funders. Also, noncore funders may be seeking

higher yields to offset higher funding costs. Despite a stable loan mix for noncore funders, their yield on earning assets has not declined as much as the yield on earning assets for core funders.

Growth in noninterest income (NII) also has helped to sustain profitability among community bank noncore funders. NII for noncore funders has grown twice as rapidly as that for core funders, up 113 basis points from 1988 to 1.74 percent of average assets in 1998. NII for core funders represented 1.27 percent of average assets in 1998 compared with only 0.76 percent a decade earlier. This income source is relatively untested for many of the Region's institutions during a period of economic contraction; therefore, the stability of this income source is uncertain. A reduction in this income source could be detrimental to community banks that are considered high users of noncore funds. For example, if NII for noncore funders is held constant with that of core funders at 1.27 percent, return on assets drops to 0.71 percent, a reduction of 40 percent.

Institutions with the Highest Growth in Noncore Funding Have Offset the Associated Higher Costs

Institutions that experienced significant growth in noncore funding over the past decade have performed well. Some insights may be gained by studying these institutions. Over the past decade, the ratio of noncore funding to total liabilities increased over 20 percentage points at 187 institutions. Strong loan growth at these institutions increased loan-to-deposit ratios by 33 percentage points on average. Noncore funding to total liabilities increased 30 percentage points, with borrowings

TABLE 2

NONCORE FUNDING MAY LEAD TO COMPRESSED MARGINS BUT OVERALL RETURN REMAINS STRONG		
	CORE FUNDING TO TOTAL LIABILITIES	
	< 70%	> 70%
NUMBER OF COMMUNITY BANKS	173	1,707
YIELD ON EARNING ASSETS	8.13	7.96
COST OF FUNDING EARNING ASSETS	4.43	3.83
NET INTEREST MARGIN	3.70	4.13
NONINTEREST INCOME TO AVG. ASSETS	1.74	1.27
RETURN ON ASSETS	1.19	1.22

SOURCE: BANK AND THRIFT CALL REPORTS, DECEMBER 31, 1998

(up 17 percentage points) and large time deposits (up 9 percentage points) being the primary drivers.

Such a significant change in funding composition might be expected to strain operating performance or asset quality; however, this has not been the case. In fact, the sample group currently has a higher return on assets than the other banks in the Region in spite of an NIM that is 34 basis points lower. Two factors contributed to this strong performance during a period of rising funding costs. First, increasing capital levels have reduced these institutions' funding base as a percentage of assets, thereby reducing the cost of funding earning assets. Second, large increases in the level of NII at these institutions have more than offset the declining NIM. NII increased from 0.79 percent to 2.14 percent of average assets over the past decade. Further, these institutions do not appear to have sacrificed asset quality. Past-due levels at the sample institutions are slightly higher than average but still manageable at 2.62 percent, indicating that reported asset quality has not declined significantly.

Because the current economic expansion has been long-lived, it is uncertain how institutions with an increased reliance on noncore funding will fare in an economic downturn. Institutions with considerable increases in noncore funding have offset those costs through increased NII and rising capital levels. NII may prove difficult to sustain and capital levels may fall during an economic contraction. Institutions that fail to generate more NII and bolster capital may see significant adverse effects from the use of more noncore funding.

Funds Management Has Become More Complex

The diversity of funding sources now available to small institutions has many benefits, but underscores the need for heightened management expertise because the traditional measures of liquidity may no longer be as relevant. Brokered deposits; large time and foreign deposits; and other borrowings, including federal funds purchased, repurchase agreements, and FHLB advances, have traditionally been viewed as noncore funding. However, in certain circumstances, these sources may present relatively stable funding for banks. In contrast, traditional core deposits may be more volatile. Many institutions may now find that smaller depositors are more sensitive to interest rates and some larger depositors or borrowings are actually very stable. In addition, some alternative funding sources are very complex. For example, the FHLB advances offer a number of features that may include prepayment penalties and embedded options. Institutions should ensure that policies are in place to evaluate the benefits and risks of all funding sources and establish appropriate limits.

Chicago Region Staff

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