Regional Outlook

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In Focus This Quarter

◆ ***Economic Conditions and Emerging Risks in Banking*—This article provides an overview of economic conditions and banking industry trends, with a primary focus on potential risks to insured depository institutions.**

- ***Indicators of Industry Performance*—The reported financial condition of insured banks and thrifts is strong. However, despite projected growth in earnings, bank and thrift stocks underperformed the broader market through October 1999.** *See page 3.*
- ***Economic Conditions*—The economy remains generally strong, and the outlook calls for continued growth. Growth is likely to slow, however, in order to correct financial imbalances that have developed as a result of a rapid creation of household and commercial credit and borrowing from abroad. There is a threat that the adjustment process could be a volatile one.** *See page 4.*
- ***Emerging Risks in Banking*—Rising indebtedness on the part of businesses and households raises concerns about future loan performance. Industry responses to intense competition have created greater credit, market, and operational risks.** *See page 8.*

  ***Consumer Lending*—Banks and thrifts are becoming increasingly involved in subprime consumer lending, which has raised some supervisory concerns.** *See page 8.*

  ***Commercial and Industrial Lending*—Signs of deterioration in corporate credit quality can be found in rising loss rates, slower profit growth, and rising corporate bond defaults. At the same time, banks are expanding their lending to heavily indebted companies in the syndicated loan market.** *See page 11.*

  ***Commercial Real Estate and Construction Lending*—Loans for real estate construction and development are growing rapidly. Despite an uptick in commercial vacancy rates, loan losses remain low.** *See page 12.*

  ***Agricultural Lending*—Low commodity prices are hurting farm operating incomes, but widespread effects on farm banks have yet to materialize.** *See page 13.*

  ***Funding and Interest Rate Risk*—Lagging deposit growth has led to a greater reliance on more volatile, market-based funding, and some institutions are taking on greater interest rate risk to maintain loan growth.** *See page 14.*

By the Analysis Branch Staff

Regional Perspectives

◆ ***Economic and Banking Conditions*—Although the economy remains healthy, tight labor markets and weak demand have led to a slowdown in industrial output growth. Factors continuing to support the expansion include high levels of new construction, low inflation, and rapidly appreciating consumers' net worth. A sudden drop in the value of consumer assets, should one occur, could trigger a sharp and swift decline in households' discretionary spending. Sharply lower stock prices also could limit businesses' access to capital markets. The growing use of noninterest income and a changing asset mix during the first half of 1999 contributed to solid profitability levels and earnings performance at insured institutions.** *See page 18.*

◆ ***Depressed Crop Prices Lead to a Decline in Farm Cash Receipts and Farmland Values*—As farm cash receipts and farmland values decline, agricultural banks' asset quality measures are beginning to show signs of deterioration. A decline in the reserve coverage ratio could suggest that commercial banks have not made sufficient provisions for loan losses, which may affect the quality of future earnings.** *See page 22.*

◆ ***Heightened Levels of New Bank Formation This Late in an Expansion Could Be Cause for Concern*—The banking industry's record profitability during the 1990s has led to an increase in new bank charters. However, risky lending practices combined with declining earnings and growing use of noncore funding could be problematic for new institutions during an economic downturn.** *See page 23.*

By the Chicago Region Staff

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Economic Conditions and Emerging Risks in Banking

The Division of Insurance periodically assesses conditions in the economy and the banking industry to identify and evaluate trends that could adversely affect the performance of insured depository institutions. Overall, conditions in the economy and banking industry are favorable at this time. However, signs point to vulnerability in the economy and in the banking industry that may make the years ahead much more challenging. Three broad themes emerge from this assessment:

- *Households' and businesses' debt levels are on the rise.* Spending by households and businesses is growing faster than cash income, resulting in rapidly increasing indebtedness. Consumer spending has been driven, in part, by large increases in the net worth associated with stock holdings and home equity. Businesses are restructuring and investing in new technologies to raise productivity and cut costs. Both consumer and business spending has been assisted by ready access to financing. Rising interest rates or slower economic growth could make debt service more difficult for borrowers.

- *Intense competition in banking is driving business strategies.* Competitive pressures have affected nearly every facet of the banking business. These pressures are evident in net interest margins, which have suffered from tighter loan pricing and higher funding costs. To maintain profits, some institutions are lending to less creditworthy borrowers, expanding into new or higher-yielding activities, creating more complex balance sheet structures, or cutting costs. These strategies may lead to greater credit, market, and operational risks.

- *The currently benign economic environment is vulnerable to rapid deterioration in the event of financial market instability.* During the 1990s, we have witnessed recurring, and perhaps more frequent, episodes of financial market turbulence. Recent episodes have arisen mainly overseas and have had little adverse effect on U.S. economic activity. However, the current economic expansion is closely tied to the ready availability of market-based financing for households and businesses and to wealth generated with the help of rising stock prices and falling interest rates. For this reason, the currently strong economic outlook may be subject to sudden deterioration in the event of market shocks that sharply raise interest rates or lower stock prices.

The analysis that follows explores these themes in more detail in the following sections: 1) indicators of industry performance, 2) economic conditions, and 3) emerging risks in banking.

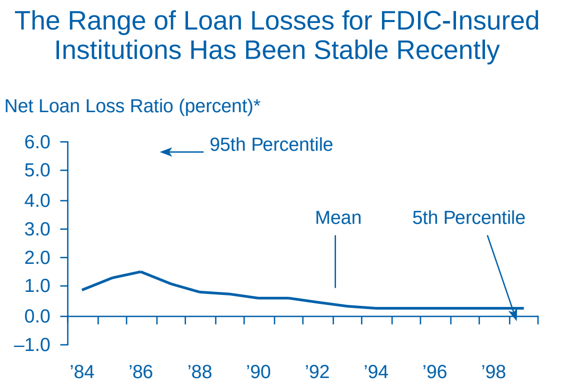
Indicators of Industry Performance

Industry Financial Performance Is Strong

According to reported financial information, the banking and thrift industries are performing well. As summarized in the ***FDIC Quarterly Banking Profile,*** second quarter 1999, both the commercial banking and thrift industries report near-record earnings, strong capital levels, and manageable volumes of problem assets and loan losses. Return on assets (ROA) for all insured institutions in the second quarter was 1.21 percent and return on equity (ROE) was 14.07 percent. ROA and ROE were down slightly from the first quarter despite improvement in the industry net interest margin (NIM) and a decline in provision expense. However, the majority of the decline in net earnings resulted from a $1.5 billion loss posted by one large bank.

The low overall level of net loan losses has been a key contributor to strong industry performance. Chart 1 (next page) shows that the average net loan loss ratio for the industry has been low and stable in recent years. Similarly, the range between the worst and best 5 percent of net loan loss ratios has narrowed considerably since the early 1990s. More than 95 percent of insured institutions reported a net loan loss ratio of less than 1 percent in 1998, continuing a five-year trend.

CHART 1



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

Bank Stocks Underperform Despite Projected Earnings Growth

Analysts expect continued earnings growth for banks and thrifts in 1999 and 2000. Median growth in earnings per share is projected to be 16.9 percent for publicly traded banks and 19.4 percent for publicly traded thrifts for 1999.[1] Ratings agencies also view the industry positively. The ratio of upgrades to downgrades for ratings issued by ***Moody's Investors Service*** improved in the second quarter, with nine companies receiving upgrades versus four receiving downgrades.

Nonetheless, bank and thrift stocks have underperformed the broader market in the first three quarters of 1999. The ***SNL Securities Bank Stock Index,*** which tracks more than 450 publicly traded commercial banks, declined 6.7 percent between January 1 and September 30, 1999. The ***SNL Securities Thrift Stock Index,*** which tracks the performance of about 350 publicly traded thrifts, fell 13.7 percent during the same period. By contrast, the ***Standard & Poor's (S&P) 500*** index gained 4.6 percent. Analysts cite rising interest rates, concerns about problems with corporate credit quality, and a decline in bank merger activity as reasons for the recent performance of bank and thrift stocks.

Economic Conditions

Overview

The U.S. economy has remained generally strong during 1999, the ninth year of the current economic expansion. If growth continues through February 2000—as most analysts expect—this expansion will become the longest in U.S. history. What is also remarkable about this business cycle expansion is the fact that the highest rates of growth have occurred during the past two years, 1997 and 1998. Even as growth has accelerated with unemployment declining to 4.2 percent, wage and price inflation has remained unusually subdued. While low inflation has helped prolong the expansion, it has imposed intense price competition on a wide range of industries. The currently positive economic outlook is subject to possible sudden deterioration in the event of financial market shocks that could raise financing costs, reduce the availability of financing, or destroy investor wealth.

Commodity Industries Have Faced Pricing Pressures

One disadvantage of low inflation during this expansion has been that firms in certain commodity industries have suffered from falling prices. Profit margins have declined in agriculture, mining, and some manufacturing sectors because of weak or negative revenue growth during 1997 and 1998.[2] Firms operating in these industries have aggressively cut costs to preserve profit margins. Nonetheless, profit growth has been flat or negative for a large proportion of ***S&P 500*** firms in the mining, textiles, chemicals, iron and steel, and oil and gas sectors since 1997. In response, some firms in these industries have chosen to consolidate through mergers. According to ***Mergerstat,*** the dollar volume of merger and acquisition transactions involving U.S. firms was a record $1.2 trillion in 1998, more than 80 percent above 1997 levels.

Business Investment Is Outpacing Cash Flow

Analysts recently have become concerned about increasing levels of debt on corporate balance sheets.

[1] Based on estimates as of November 4, 1999, for 98 commercial banks and 33 thrifts that have at least five analyst estimates.
[2] Richard A. Brown and Alan Deaton, "Falling Prices in Commodities and Manufacturing Pose Continuing Risks to Credit Quality," ***Regional Outlook,*** Third Quarter 1999 (http://www.fdic.gov/bank/analytical/regional/ro19993q/na/t3q1999.pdf).

Chart 2 tracks the steady growth of fixed investment by U.S. corporations during the current expansion. It also shows, however, that growth in cash flow available to finance investment has slowed in recent years. This "financing gap" has grown steadily, reaching a record $86 billion in 1998.

As a result, corporations must finance an increasing portion of investment spending by issuing either net new equity or net new debt. In recent years, firms have overwhelmingly chosen debt financing. Net issuance of corporate debt was $219 billion in 1998, while corporations repurchased equity shares on net for the sixth straight year. Corporate borrowing has also continued at a brisk pace; domestic commercial and industrial (C&I) lending rose by 12.5 percent in the year ending June 1999.

A widening financing gap and increasing debt levels could pose future problems if there are adverse changes in the financial environment. For example, a sharp rise in interest rates would increase the debt burden of businesses, hurt their profitability, and impair their creditworthiness. Under such a scenario, firms might decide to curtail their capital expenditures, which would tend to reduce the rate of growth in the rest of the economy.

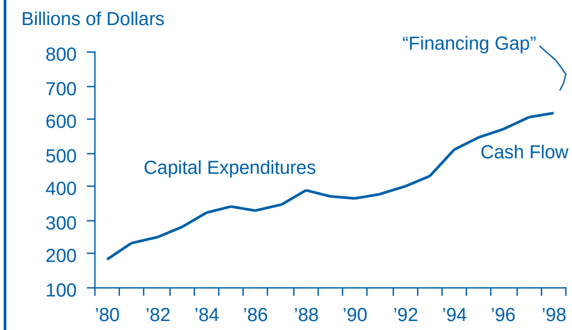
Consumer Spending Continues to Grow

Strong growth in consumer spending continues to propel the economic expansion. Spending has accelerated in recent quarters, in contrast to previous expansions when the strongest growth in consumer spending occurred early in the recovery. One factor supporting the robust pace of spending is housing activity. Single-family housing starts rose to an annualized rate of more than 1.3 million units in fourth quarter 1998 and have remained near that level through third quarter 1999. Existing home sales also have maintained a record pace of 5.3 million units on an annualized basis during the second and third quarters. Low mortgage interest rates and real income gains have combined to push housing affordability to its highest level in many years.[3]

[3] The housing affordability index published by the ***National Association of Realtors*** equals 100 when the median family income qualifies for an 80 percent mortgage on a median-priced existing single-family home. The value of the index as of the third quarter of 1999 was 127.1.

CHART 2

The Financing Gap Has Widened for Nonfinancial Corporations



Source: Federal Reserve Board (Haver Analytics)

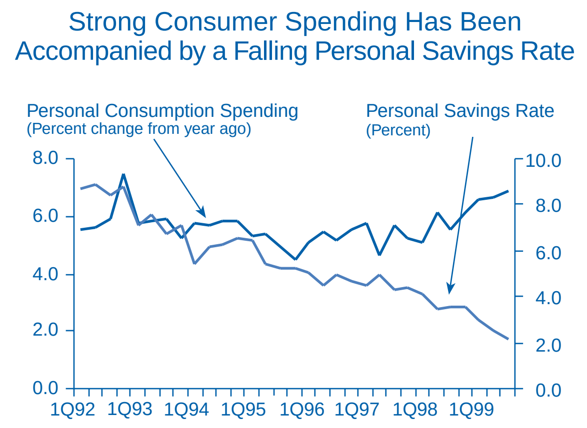
Rapid growth in consumer spending also warrants attention. Despite the highest rates of real income growth in nine years, consumer spending has grown more quickly than disposable personal income. The divergence in growth has resulted in a falling personal savings rate, which reached a record low in 1999.[4] The recent decline in the personal savings rate continues a trend that has been under way for more than a decade (see Chart 3, next page).[5]

Analysts cannot fully explain the reasons for the falling savings rate, although the "wealth effect" associated with the accumulation of capital gains by households is believed to be a significant factor. Since 1995, the total value of equities, mutual funds, and pension funds owned by households has risen by $6.8 trillion, while the value of owner-occupied housing net of mortgage debt has increased by $812 billion. This accumulation of wealth apparently has emboldened consumers to spend, as evidenced by data that show aggregate spend-

[4] *Personal savings* is calculated as the difference between *disposable personal income* (DPI, or total income net of taxes) and *consumption expenditures.* The *personal savings rate* is equal to personal savings divided by DPI. It should be noted that capital gains, even when realized, are not included as income in this calculation, although taxes paid on capital gains are deducted from DPI. Consequently, large-scale realization of capital gains by households will tend to push down the personal savings rate.

[5] The ***Bureau of Economic Analysis,*** which tabulates the personal savings rate, has recently revised its methodology, leading to a large revision in the savings rate data. Earlier estimates reported the personal savings rate to be around negative 1 percent, suggesting that households were spending more than their disposable (after-tax) income. Revised estimates show that the savings rate for the third quarter of 1999 was 2.1 percent. Although higher than previously reported, the revised personal savings rate data continue to show a downward trend similar to earlier savings rate estimates.

CHART 3



Source: Bureau of Economic Analysis (Haver Analytics)

ing growth exceeding income growth. For the most part, when consumers have chosen to convert capital gains to spendable cash, they have done so by borrowing—often against the equity in their homes or their 401(k) accounts.

The increasing indebtedness of consumers could substantially raise the costs of debt service relative to income, especially if interest rates rise or income growth slows. Moreover, analysts express concerns about a reversal of the wealth effect if there is a significant and sustained decline in equity prices. Any resulting decline in consumer confidence could substantially slow the pace of consumer spending, leading to a reduced pace of economic growth.

The Growing Private Deficit Raises Concerns

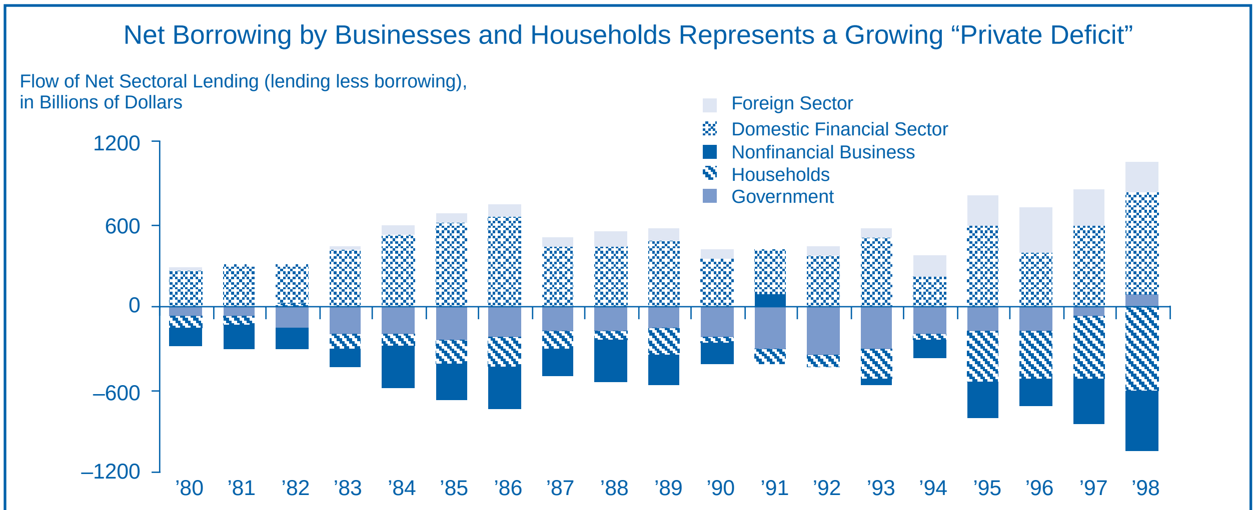
Taken together, the sum of annual net borrowing by businesses and households has been referred to as the "private deficit." During the late 1990s, as the combined budget of federal, state, and local governments moved from deficit to surplus, the private deficit rose sharply; between 1996 and 1998, it nearly doubled from $550 billion to $1.02 trillion (see Chart 4).

The private deficit was financed from three sources in 1998. One source was the $73 billion surplus in the government sector, the first surplus in 28 years. The largest portion of the 1998 private deficit was financed by the creation of credit by the domestic financial sector and by an inflow of foreign capital. The rapid creation of credit raises concerns about credit quality, an issue that is explored in more detail under *Emerging Risks in Banking,* below. Dependence on foreign capital raises questions about what might happen if the foreign sector becomes less willing to export capital to the United States.

Recovery Abroad Is Changing the Terms of Trade

During the past three years, the U.S. economy has experienced consistently strong growth with low inflation, while the economies of some of its major trading partners have grown more slowly or not at all. Japan was mired in its worst recession in decades, while a number of countries in Asia, Latin America, and Eastern Europe

CHART 4



Note: "Nonfinancial business" includes farm and nonfarm, corporate and noncorporate businesses.
Source: Federal Reserve Board (Haver Analytics)

have experienced the harsh fallout resulting from financial market and exchange rate crises. The euro-zone economies, Germany and France in particular, have grown slowly following the imposition of tight fiscal and monetary policies in advance of the introduction of the euro on January 1, 1999.

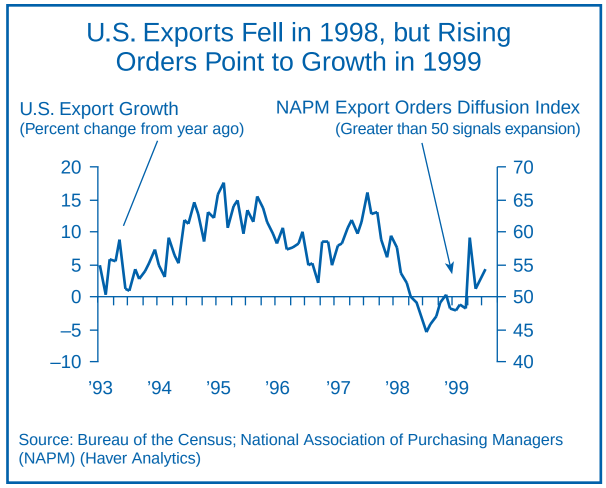
The net effect of this disparity in growth rates has been a growing U.S. trade deficit. The deficit rose by 57 percent in 1998 to $164.3 billion, reflecting a small decline in exports and a 5 percent increase in imports. The adverse effects of the trade deficit on the U.S. economy have been felt primarily by the commodity industries—farming, mining, and basic manufacturing. In addition, the large trade deficit has resulted in the transfer of billions of dollars to foreign investors. During 1997 and 1998, many foreign investors used their excess dollars to purchase dollar-denominated stocks and bonds. This inflow of capital helped keep U.S. equity and bond prices high, while pushing up the value of the dollar.

A global economic recovery during the first three quarters of 1999 has led to higher demand for investment capital outside the United States. The ***International Monetary Fund*** estimates that growth in the global economy will increase from 2.5 percent in 1998 to 3.0 percent in 1999 and 3.5 percent in 2000.[6] Foreign investors, in anticipation of stronger growth and greater investment opportunities abroad, have started to convert excess dollar holdings to other currencies, including the yen and euro. This change in investment strategy has put downward pressure on the value of the dollar. Between July and September 1999, the dollar lost approximately 10 percent of its value against the yen.

A falling dollar will likely contribute to a recovery of U.S. exports in coming months. The index of export orders compiled by the ***National Association of Purchasing Managers*** points to future growth in shipments abroad. The index has signaled growing export orders for nine months through October 1999. As Chart 5 shows, increasing export orders tend to lead the actual rise in exports by several months.

A lower dollar could also place upward pressure on U.S. inflation and interest rates. A steady decline in the dollar would make foreign goods more expensive, while higher export demand would raise manufacturing output at a time when U.S. labor markets are very tight. The prices of several important industrial commodities have

CHART 5



risen in dollar terms during 1999, led by a doubling in the price of oil during the first nine months of 1999. Domestically, the producer price index has risen by approximately 4 percent since the beginning of the year following a two-year decline, reflecting an increase in oil and intermediate goods prices.

Interest rates have risen in step with renewed concerns about inflation. The constant maturity yield on 10-year Treasury bonds increased by approximately 140 basis points in the year ending October 1999, while the Federal Reserve instituted two 25-basis point increases in short-term rates during the summer of 1999.

The Economic Outlook Calls for Continued Growth

One scenario for the year ahead is that the U.S. economy will continue to grow at much the same rate as it has during the past few years. As discussed above, however, continued rapid growth would lead to even greater imbalances in the domestic economy and in the foreign sector. For this reason, most economists do not believe that rapid growth can continue indefinitely. Instead, analysts suggest two possible scenarios for the economy.

The ***Blue Chip Economic Indicators*** consensus outlook for the U.S. economy calls for a "soft landing." Gross domestic product is projected to grow at a rate of 3.8 percent in 1999 with somewhat slower growth of 2.8 percent in 2000.[7] Rising wage pressures, reflecting tight

[6] International Monetary Fund, ***World Economic Outlook,*** October 1999.

[7] *Blue Chip Economic Indicators,* Aspen Publishing, October 10, 1999.

labor markets across the nation, and economic recovery abroad are expected to increase the risks of higher U.S. inflation. Improving growth prospects in the global economy may also lead to a stabilization of commodity prices, reversing a trend of falling prices that has until recently contributed to lower U.S. inflation. In response to expectations of higher inflation, medium-term interest rates are also expected to rise modestly. Slower U.S. growth and faster expansion abroad would result in a rebalancing of global growth that should narrow the U.S. trade deficit and reduce downward pressure on the dollar.

Although the consensus forecast calls for continued expansion, an alternative scenario suggests the possibility of a steep decline in economic growth leading to a "hard landing." Sharply higher interest rates, in response to a weak dollar and an unexpected acceleration of U.S. inflation, could lead to declining capital investment and reduced consumer spending. Rising interest rates would increase the debt burden for households and businesses even as measures of indebtedness are rising. A significant and sustained decline in equity prices may occur if investors become pessimistic as the economy slows. The response of the world economy to a U.S. recession is difficult to assess. As the past several months have shown, growth in the U.S. economy has been an important factor in supporting growth abroad. If the U.S. economy were to enter a recession, overall global growth could also slow, depending on the extent to which recoveries in Europe, Asia, and Latin America offset any shortfall in U.S. growth.

Emerging Risks in Banking

Overview

Favorable economic conditions continue to support strong loan growth and healthy loan performance among insured institutions. Net loss rates remain low relative to the early 1990s for almost every major loan category except consumer loans. Loss rates in domestic commercial loans, previously at low levels, rose modestly during the first half of 1999. Agricultural loan loss rates appear likely to rise in the future due to the effects of weak commodity prices on farm incomes. Strong loan growth and low loan losses have helped banks achieve record and near-record high quarterly profits. However, rising indebtedness on the part of businesses and households raises concerns about future loan performance, particularly if economic conditions were to deteriorate or if interest rates were to rise.

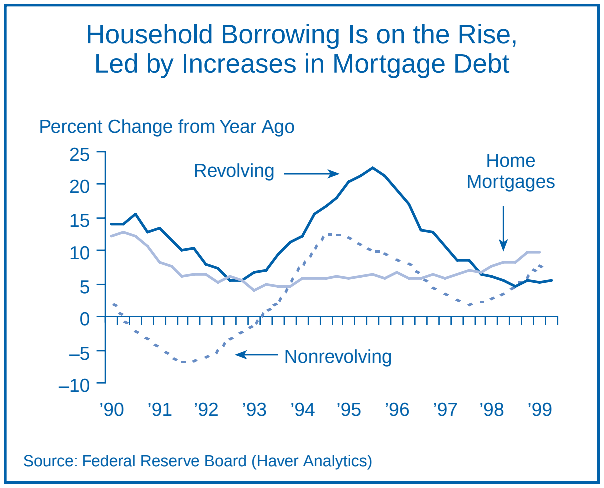
Strategic responses to competitive pressures point to greater credit, market, and operational risks for the industry. Intense competition has pressured NIMs and has encouraged many lenders to seek higher returns by lending to less creditworthy borrowers. In order to maintain and grow profits, some insured institutions are expanding into activities such as subprime consumer lending, high loan-to-value mortgage lending, and lending with minimal or no documentation requirements. Rapid growth in syndicated lending to leveraged companies also indicates that large commercial lenders have increased their tolerance for risk. Competition has made funding with deposits more difficult. As a result, some institutions are relying increasingly on securitizations and more expensive, market-based sources of funds, which can alter an institution's liquidity position, interest rate risk profile, and operational needs. Institutions have also responded to competitive pressures by cutting costs or merging in an attempt to achieve greater efficiencies. In some cases, deep reductions in operating costs support profits at the expense of less effective operational controls.

Consumer Lending

Household Borrowing Is on the Rise

Household borrowing is growing rapidly, consistent with high reported levels of consumer confidence and strong consumer spending. Mortgage debt, which grew by 10.4 percent in the second quarter from year-ago levels, is the fastest-growing segment of household debt (see Chart 6). Mortgage loan growth has been particularly strong, in part because of rising homeownership, the availability of more low-down-payment loans, and the use of mortgage loans to consolidate revolving debt balances. Nonrevolving debt grew by 7.3 percent in the year ending June 1999, largely because of strong sales of new cars. In contrast, credit card and other revolving debt increased by only 5.7 percent during the same period—a much slower rate of growth than during the mid-1990s.

CHART 6



A Mortgage Refinancing Boom Has Helped Consumers Consolidate Debt

A key component of the recent shift by consumers from credit card debt to mortgage debt has been a surge in mortgage refinancing in 1998 and early 1999. The ***Mortgage Bankers Association's Refinancing Index*** peaked at over 4,300 in October 1998, compared with an average monthly index value of 527 during 1997.[8]

Many households have refinanced their mortgages to obtain cash to pay down credit card and other high-cost consumer debt, thereby lowering their monthly financial obligations. According to a ***Freddie Mac*** survey of 1998 refinancing transactions, more than 3 million homeowners, or 51 percent of all mortgage-refinance borrowers, generated net cash proceeds when they refinanced their loans.[9] On average, these borrowers cashed out 11 percent of the equity in their homes. On the basis of this survey, ***Bank One Corporation*** estimated that cash out refinancing added about $60 billion in cash flow to consumer pocketbooks last year. This extra cash flow could help explain recent quarterly declines in personal bankruptcy filings, mortgage delinquencies, and consumer credit charge-offs.[10] Rising interest rates appear to have ended this mortgage refinancing boom. The lower volume of mortgage refinancings raises questions about whether consumers again will increase their use of credit cards to finance purchases. If so, there may be negative consequences for future consumer debt service burdens and consumer credit quality.

Credit Card Lenders Face Declining Returns

After several years of rapid growth in the mid-1990s, the credit card industry has become characterized by overcapacity and declining margins. At the same time, the high level of mortgage refinancings and rising household incomes have reduced the dependence of consumers on credit card debt. Consequently, credit card lenders are struggling to maintain volume as consumers pay off their credit card balances more quickly.

Overcapacity and declining margins have led lenders to search aggressively for new ways to increase revenues. One method they have adopted is to charge new fees that are triggered by cardholder behavior. Lenders are now charging fees for inactive accounts, fees to close accounts, and even customer service fees. In addition, they are reducing grace periods, curtailing leniency periods, and imposing higher penalty interest rates. According to ***RAM Research,*** banks' income from credit card fees has grown 79 percent over the past two years, while card interest income rose only 10 percent.[11]

Shrinking margins have also prompted consolidation in the credit card industry. Today, the top five issuers control about 60 percent of the total managed assets in the credit card sector, up from just 35 percent in 1990.[12] Amid this changing competitive landscape, credit quality has improved. Credit card charge-off levels at insured commercial banks hit an all-time high of 5.5 percent in the third quarter of 1997 but have declined steadily to a level of 4.1 percent in the second quarter of 1999. This decline has been attributed to tighter underwriting standards, more aggressive collection efforts, and extra household cash flow generated through mortgage refinancings.

[8] Index is seasonally adjusted where the week of March 16, 1990 = 100.

[9] Survey cited in a study by the Joint Center for Housing Studies at Harvard University, "The State of the Nation's Housing: 1999."

[10] Tristan Mabry, "This Boom, Some Say, Is on the House," ***The Wall Street Journal,*** July 6, 1999.

[11] Miriam Kreinan Souccar, "Consumer Groups Up in Arms Over Card Penalties," ***American Banker,*** February 26, 1999.

[12] James C. Allen, "Tarnished Platinum," ***SNL Securities Bank Mergers & Acquisitions,*** June 1999.

Subprime Lenders Have Riskier Characteristics than the Industry

Subprime lending to consumers has grown dramatically in recent years. Subprime mortgage originations have grown from 5 percent of the total mortgage market in 1994 to 15 percent in 1997.[13] The percentage of originations fell somewhat in 1998 to 10 percent—not because the volume of subprime mortgage originations fell but because the volume of prime mortgage originations was at a record high. In fact, in terms of dollars, subprime originations grew by 20 percent from 1997 to 1998, to $150 billion. That figure is up significantly from the $35 billion in subprime originations in 1994. Estimates of the size of the subprime automobile loan market vary somewhere between $50 billion and $75 billion, but one source estimates that subprime automobile originations jumped from about 8 percent of all automobile loan originations in 1990 to over 18 percent in 1998.[14] Analysts also have indicated that the subprime credit card market is the fastest-growing segment of credit card lending today. According to ***RAM Research,*** subprime receivables are growing 45 percent annually, compared with 16 percent or less for other segments of credit card lending.[15]

Intense competitive pressure has contributed to the expansion of bank and thrift participation in subprime consumer lending. These loan programs offer higher margins than prime consumer lending products and have become an attractive alternative for banks and thrifts that have experienced shrinking margins in credit cards, mortgage lending, and other consumer product types. Moreover, the shakeout in the subprime specialty finance industry has provided new opportunities for insured depository institutions seeking to enter the subprime lending market. In 1999, several insured depository institutions acquired, or announced plans to acquire, a subprime specialty finance company. Bank and thrift involvement in subprime lending is expected to increase. In fact, some industry analysts predict that insured depository institutions with subprime affiliates will overtake finance companies as leaders in the subprime industry.

Subprime lending poses entirely new challenges in risk management for insured institutions. Not only are expected credit losses higher than for prime consumer lending, but a number of factors suggest that losses are also less predictable:

- *Subprime borrowers are more likely to default than prime borrowers and may be more vulnerable to economic shocks, such as a recession.* Borrowers' previous credit problems suggest that they have limited financial resources to withstand economic difficulties.

- *Credit-scoring and pricing models used to underwrite subprime loans are untested in a recession.* Analysts have noted that credit-scoring models are less effective in predicting the likelihood of default for subprime borrowers than they are for prime borrowers.

- *Operational risks are greater in subprime lending.* Because defaults occur sooner and more often than in prime lending, subprime portfolios require a greater investment in servicing and collections resources. Subprime lenders run a greater risk that these resources could become severely strained if the level of defaults is not correctly anticipated.

- *Liquidity risks are greater in subprime lending.* Some large-volume subprime lenders heavily depend on the ability to securitize and sell loans to the secondary market. But investor demand for paper backed by subprime loans may be volatile, as was demonstrated during the financial market turmoil of late 1998. A number of nonbank subprime lenders experienced a liquidity crunch as a result of that market turmoil, and several opted for—or were forced into—bankruptcy.[16]

- *Reputation, legal, and compliance risks also are important for subprime lenders.* Subprime lenders generally run a greater risk of violating, or being accused of violating, consumer protection laws or regulations. The public perception of subprime

[13] ***The Mortgage Market Statistical Annual for 1999,*** Inside Mortgage Finance Publications, 1999.
[14] Ron Feldman, ***An Introduction to Subprime Auto Lending for Examiners,*** Federal Reserve Bank of Minneapolis, April 1998, and data supplied by CNW Marketing and Research.
[15] Lisa Fickenscher, "Credit Card Issuers Panning for Gold Among Tarnished Credit Histories," *American Banker,* October 22, 1998.
[16] Dominic DiNapoli and Ron Greenspan, "The Next Industry Crisis Could Be Even Bigger," *American Banker,* June 15, 1999.

lenders could be tarnished if a recession were to result in substantially higher default rates.

The growing involvement by insured depository institutions in subprime lending has raised significant concerns for bank and thrift supervisors. To address those concerns, FDIC Chairman Donna Tanoue recently announced that the FDIC will propose to the other federal financial institution regulators that insured depository institutions with concentrations in subprime lending be held to higher minimum capital requirements than the current rules dictate.[17] The FDIC proposal includes a common supervisory definition of subprime lending and ties capital adequacy to the types and levels of risks that individual subprime lenders have in their portfolios. This proposal will be shared with other federal regulators to refine a final approach.

Commercial and Industrial Lending

Commercial and Industrial Loan Losses Have Been on the Rise

Insured institutions continue to accommodate the credit needs of business borrowers. Domestic C&I loans grew almost 12.5 percent during the year ending in June 1999 and accounted for 40 percent of all net new loans booked during that period.

Although commercial loan losses are low, there are signs that credit quality in C&I portfolios is deteriorating. Net domestic C&I charge-offs during the first half of 1999 more than doubled from 1998 levels, while noncurrent domestic C&I loans rose by 26 percent. Examiners also have reported increasing problems in commercial portfolios. The ***Office of the Comptroller of the Currency*** recently reported that the dollar volume of classified and special-mention Shared National Credits rose 70 percent during a recent annual review.[18]

Slower profit growth and rising corporate bond defaults also point toward somewhat weaker business credit quality. While corporate profits grew by an average of 15 percent per year between 1993 and 1996, economists polled by *Blue Chip Economic Indicators* project growth of 6.7 percent for all of 1999, followed by growth of only 3.5 percent in 2000.[19] ***Standard & Poor's*** reported that 55 rated issuers defaulted on $20.5 billion in debt during the first six months of 1999.[20] This pace of defaults is already nearly double levels experienced in the first half of 1998 and does not include more recent large defaults such as Iridium and Daewoo Group. Approximately 85 percent of the defaults that occurred during the first half of 1999 were among speculative-grade issuers. According to ***Moody's,*** junk bond defaults rose to 5.8 percent of issues outstanding during the 12 months ending in September 1999, the highest level since 1991.

Rising Losses May Be Attributable to Loose Underwriting

Analysts attribute the recent deterioration in commercial credit quality to weak underwriting standards in the corporate debt markets during 1997 and early 1998.[21] Bank underwriting was reported to be particularly accommodating at that time. The ***Federal Reserve Board*** reported in its May 1998 *Senior Loan Officer Opinion Survey on Bank Lending Practices* that domestic banks were "generally eager to make loans to businesses" and that during early 1998 "a large percentage cut their spreads on such loans." Subsequently, the November 1998 *Survey* reported a "broad tightening of business lending practices" associated with the financial market turmoil in progress at that time. However, regulators have continued to express concern about the assumptions underlying bank lending decisions. A Supervision and Regulation Letter sent by the ***Federal Reserve Board of Governors*** to its examiners in September 1999 noted the recent tightening of standards, but stated that "certain deeper issues remain," which relate mainly to overoptimistic assumptions about the future repayment capacity of business borrowers.[22]

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[17] FDIC Chairman Donna Tanoue in a speech before America's Community Bankers, Orlando, Florida, November 2, 1999 (http://www.fdic.gov/news/news/speeches/chairman/sp02Nov99.html).

[18] "OCC Says Big Commercial Loans Suffering from Lax Underwriting," *American Banker,* October 6, 1999, p. 1. The shared national credit program is a cooperative interagency program to review large credits held at several institutions. Loans subject to review include commitments in excess of $20 million that are shared among three or more participating lenders.

[19] *Blue Chip Economic Indicators,* Aspen Publishing, October 10, 1999.

[20] "Defaults Soar in First Half 1999," *Standard & Poor's,* August 12, 1999.

[21] See, for example, "Under Boom Economy, Strain Over Debt," *The Wall Street Journal,* August 18, 1999, Section C, p. 1.

[22] SR 99-23, September 28, 1999. "Recent Trends in Bank Lending Standards for Commercial Loans" (http://www.federalreserve.gov/boarddocs/SRLETTERS/1999/SR9923.HTM).

Leveraged Lending Has Been the Predominant Type of Syndicated Lending

Banks appear to be taking on more risk in the syndicated loan market by expanding their lending to heavily indebted companies. During the first half of 1999, leveraged lending was the fastest-growing segment of syndicated commercial lending.[23] While overall syndicated loan volume was down slightly compared with the first half of 1998, syndicated lending to leveraged companies rose $7 billion, or 5 percent, on the strength of a record volume of "highly leveraged loans."[24] As shown in Chart 7, loans to leveraged companies are making up a growing proportion of syndicated loan originations.

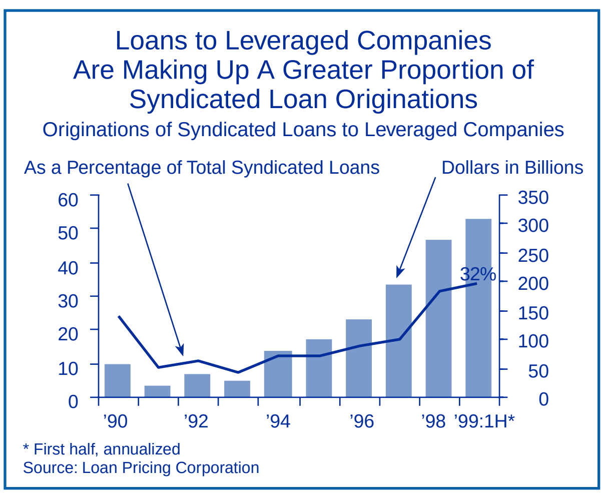
Factors driving growth in leveraged lending include a high volume of corporate mergers and acquisitions, increasing investor demand for higher-yielding loans, and a shift in preference for loans over bonds by high-yield issuers.[25] While bank syndicators pass a large volume of these loans along to nonbank investors, a substantial portion of these credits remains on bank balance sheets. ***Loan Pricing Corporation*** has reported that as much as 64 percent of the value of "highly leveraged" loans originated in the first half of 1999 was retained by banks.[26]

[23] Syndicated loans are credits extended to large or medium-sized corporate borrowers that are originated by a group, or syndicate, of lenders. One type of syndicated lending is leveraged lending, in which the borrower's debt-to-equity ratio is significantly higher than the industry average. Loan Pricing Corporation defines "leveraged loans" as those for which pricing exceeds 125 basis points over LIBOR.

[24] Loan Pricing Corporation defines "highly leveraged loans" as those for which pricing exceeds 225 basis points over LIBOR.

[25] According to ***Mergerstat,*** the value of mergers and acquisitions (M&A) was almost $400 billion during second-quarter 1999. According to ***Loan Pricing Corporation,*** syndicated loans originated in the second quarter to finance M&A activity totaled some $69 billion—a 43 percent increase over issuance in the first quarter.

CHART 7



Commercial Real Estate and Construction Lending

Construction Loan Volume Continues to Rise

Loans for real estate construction and development (C&D) represent one of the fastest-growing segments of bank balance sheets, increasing 24 percent during the year ending June 1999. Compared with construction activity in the mid-1990s, spending on new commercial construction has shifted somewhat away from the industrial and retail markets and toward office and hotel construction. Residential construction growth was also strong during the first half of 1999, with single-family completions increasing 17 percent from a year ago. In the midst of this growth in loan volume, loss rates and past-due ratios for construction and development loans remain very low by historical standards, as indicated in Chart 8.

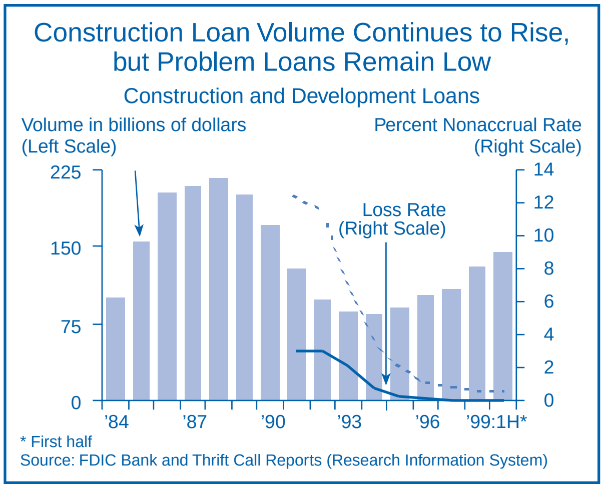
Office Vacancy Rates Are Rising in Many Top Markets

In previously published reports, Division of Insurance analysts identified nine metropolitan real estate markets where rapid development threatened to produce near-term oversupply conditions.[27] These cities were identified based on the pace of current construction activity, commercial space demand indicators, and independent market analysts' projections. Six of the metropolitan areas identified—Atlanta, Phoenix, Orlando, Portland, Dallas, and Nashville—subsequently experienced large increases in office vacancy rates during the first half of 1999. These areas have also experienced reduced employment growth and slowing net in-migration. Higher vacancy rates are often accompanied by slower

[26] "Junk Loan Market Is Feeling the Pinch of Oversupply and Rising Interest Rates," *The Wall Street Journal,* September 13, 1999.

[27] Steven K. Burton, "Commercial Developments Still Hot in Many Major Markets, but Slower Growth May Be Ahead," *Regional Outlook,* First Quarter 1999 (http://www.fdic.gov/bank/analytical/regional/ro19991q/na/infocus2.html) and "Ranking the Risk of Overbuilding in Commercial Real Estate Markets," ***Bank Trends,*** FDIC Division of Insurance, October 1998 (http://www.fdic.gov/bank/analytical/bank/bt9807.html).

CHART 8



Construction Loan Volume Continues to Rise, but Problem Loans Remain Low

Construction and Development Loans

* First half

Source: FDIC Bank and Thrift Call Reports (Research Information System)

rental-rate growth, which may lead to lower real estate values. For example, Atlanta's vacancy rate rose 1.5 percentage points to 10.3 percent, while growth in rental rates slowed noticeably from the pace of the previous three years.[28]

Surveys Suggest Tighter Standards in Commercial Real Estate Lending

Evaluations of bank loan underwriting suggest a recent tightening of lending standards for commercial real estate loans. The August 1999 ***Federal Reserve Board*** *Senior Loan Officer Opinion Survey* reported a net tightening of commercial real estate underwriting standards, continuing a trend begun in late 1998. The ***FDIC's*** March 1999 *Report on Underwriting Practices* also found fewer instances of risky lending practices with respect to commercial real estate and construction lending than in prior reports. The FDIC's September *Report* showed no significant changes in lending standards.

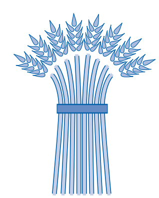
The FDIC also recently published the findings of a targeted evaluation of the underwriting practices of banks operating in three of the fastest-growing metropolitan areas in the country—Atlanta, Dallas, and Las Vegas.[29] Results indicated that competition was generally driving pricing margins down to very low levels, particularly compared with the 1980s. In some instances, lenders have responded to competitive pressures by making structural concessions on loan-to-value, cash equity, and recourse terms, particularly for large borrowers. However, underwriting standards generally have not been as aggressive as practices observed in the 1980s.

Agricultural Lending

Low Commodity Prices Stress the Agriculture Industry

Low prices for wheat, corn, hogs, cotton, and oilseeds are creating financial difficulties for farmers in the nation's midsection. Several consecutive years of high worldwide production have resulted in large inventories of grains and oilseeds, which have depressed prices. Prices not only have fallen from mid-1990s levels, but are also low by historical standards. The ***United States Department of Agriculture (USDA)*** forecasts for 2000 show little likelihood of improvement in prices.[30]

The financial outlook for significant portions of the farm sector has deteriorated. The USDA projects that farm income from operations will decline by around 15 percent in 1999 from year-ago levels. However, total net farm income is projected to decline less than 1 percent. A projected $16.6 billion in government payments is expected to make up most of the difference between operating income and total net income.[31] Legislation passed in October 1998 provides for $8.7 billion in emergency aid to affected farmers.



Farm Banks Continue to Perform Well Overall

Despite the difficulties created by low farm prices, the overall financial condition of the 2,250 FDIC-insured farm banks continues to be strong.[32] Farm banks reported an annualized ROA of 1.21 percent and an equity capital-to-assets ratio of 10.5 percent at mid-year

[28] Vacancy rates and rental growth rates were obtained from ***REIS Reports.***

[29] Steven K. Burton, "Recent Trends in Construction Lending Practices," *Bank Trends,* FDIC Division of Insurance, July 1999 (http://www.fdic.gov/bank/analytical/bank/bt9901.pdf).

[30] "World Agricultural Supply and Demand Estimates," USDA, October 10, 1999.

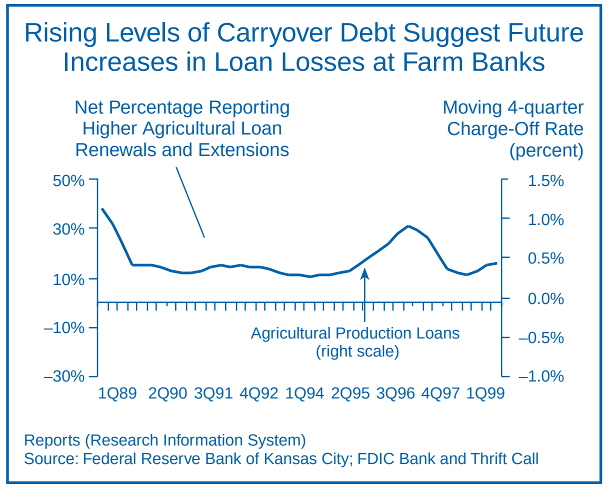
[31] "Potential Impacts of an Agricultural Aid Package," ***Agricultural Outlook,*** USDA, September 1999.

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

1999.[33] Loan loss reserves, which stood at 1.58 percent of total loans in June, remain high compared to historical levels. Loan performance at farm banks also appears to be strong at this time. Total past-due loans made up just 2.66 percent of total loans at farm banks in June, a level that is only 9 basis points higher than a year ago. Moreover, this increase in past-due loans is attributable entirely to nonagricultural loans; the level of past-due farm loans has not risen over the past 12 months. At the same time, higher-than-average nonperforming loan levels have been reported by farm banks in the upper Midwest and the South.

There are reasons to believe, however, that it will take time for financial distress among farm producers to significantly affect loan performance at farm banks. One such reason is the increasing use of carryover debt to restructure and extend operating loans that cannot be fully retired by borrowers during the current crop year. The most recent *Survey of Agricultural Credit Conditions* conducted by the ***Federal Reserve Bank of Kansas City*** indicated an increase in the use of agricultural carryover debt by Tenth District banks.[34] An increase in carryover debt was also noted in the ***FDIC's*** March 1999 *Report on Underwriting Practices,* which indicated that almost one-third of FDIC-supervised farm banks experienced at least a "moderate" increase in agricultural carryover debt during the preceding six-month period.[35] Although the use of carryover debt is not an uncommon practice in agricultural lending, it can be a leading indicator of declining loan performance. Chart 9 shows that increases in carryover debt by Tenth District farm banks in 1995 preceded increased loan losses during 1996.

CHART 9



Funding and Interest Rate Risk

Lagging Deposit Growth Has Led to Greater Reliance on Market-Based Funding

For most of the 1990s, banking industry asset growth has outstripped growth in deposits, creating greater reliance on more expensive and less stable market-based sources of funding. The trend in the loan-to-deposit ratio for commercial banks, which reached a record high of almost 90 percent at June 30, 1999, reflects this shift. Deposit growth has not kept pace with asset growth, in part because of a low rate of personal savings by households and competition for depositor funds from higher-yielding investment alternatives and nonbanks. Lagging deposit growth is particularly important for community banks because these institutions traditionally rely more heavily on deposits to fund assets than do larger banks.[36] Greater dependence on market-based funding can alter the liquidity and interest rate risk positions of institutions and may require heightened attention to, and expertise regarding, asset-liability policies and procedures.

Growth in Securitization Affects Underwriting and the Structure of Bank Balance Sheets

Banks, and nonbanks in particular, continue to employ the securitization market to fund lending activities.

[33] Twenty-three percent of insured farm banks have adopted a Subchapter S designation since 1997, when banks were first allowed to take advantage of the favorable tax treatment available under this section of the Internal Revenue Service code. Because of the effects of this tax treatment on reported profitability, farm bank ROA levels may not be comparable with ratios from prior periods.

[34] *Survey of Agricultural Credit Conditions,* Federal Reserve Bank of Kansas City, June 29, 1999 (http://www.kc.frb.org/PUBLICAT/RED/PDF/2q99AgCrPress.pdf). The Tenth District comprises significant agricultural areas in Colorado, Kansas, Nebraska, Oklahoma, Wyoming, northern New Mexico, and western Missouri.

[35] John M. Anderlik and Jeffrey W. Walser, "Agricultural Sector Under Stress: The 1980s and Today," *Kansas City Regional Outlook,* Third Quarter 1999 (http://www.fdic.gov/bank/analytical/regional/ro19993q/kc/k3q1999.pdf).

[36] Allen Puwalski and Brian Kenner, "Shifting Funding Trends Pose Challenges for Community Banks," *Regional Outlook,* Third Quarter 1999 (http://www.fdic.gov/bank/analytical/regional/ro19993q/na/t3q1999.pdf).

Issuance of asset-backed securities and commercial mortgage-backed securities (CMBS) totaled $223 billion through the first six months of 1999, and is on pace for another record year. Including participation through credit card companies and CMBS conduit programs, bank-related issuance amounted to about 25 percent of total issuance in 1998, a decline from 1997 levels. Although insured institutions are not dominant players, growth in the securitization market can influence loan underwriting practices and the structure of bank balance sheets.

The securitization market competes to originate loans that could be made by insured institutions. This competition may tend to erode underwriting standards if securitizers ease terms to maintain sufficient volume to support lending pipelines. Recent trends indicate that this competition has intensified. For example, market observers note that the subordination levels in the CMBS market have been declining, which allows securitizers to increase lending volume for a given level of capital.[37]

When banks do securitize, it is not always clear how much risk is transferred. The issue of credit risk transference by commonly used securitization structures continues to receive attention from the markets and rating agencies. For example, many analysts agree that revolving structures, such as those used to securitize credit cards, eliminate only the most catastrophic credit risks for issuers.[38] In addition, assets created by gain-on-sale accounting rules when loans are securitized can be volatile and can lead to unstable earnings and capital if not properly controlled and administered.

[37] Securitizations are often structured in tranches such that a subordinated security bears the credit risk for a senior piece. The relative size of the subordinated piece affects not only funding costs for the issuer, but also the amount of effective leverage achievable through securitization.

[38] A common feature of a revolving securitization structure is the provision for an "early amortization." When a triggering event occurs, such as a negative three-month average excess spread, all available cash flows are used to pay off bondholder principal. This event causes receivables related to the deteriorating accounts to remain on the balance sheet of the issuer. Unless the deterioration in account credit quality is very rapid and severe, the bondholders will be repaid completely, and the credit risk will be borne by the issuer.

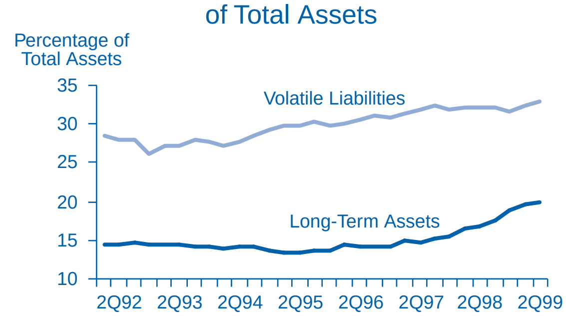
Banks and Thrifts Appear Increasingly Vulnerable to Rising Interest Rates

Potentially volatile liabilities and long-term assets have been growing as a percentage of banking assets. Consistent with reduced deposit funding by insured institutions, more market-based and potentially volatile liabilities have been supporting an increasing proportion of banking assets in recent years (see Chart 10).[39] At the same time, the lengthening maturity of insured institution mortgage portfolios has increased the percentage of total bank assets with maturities or repricing frequencies of greater than five years. This trend in mortgage portfolios is primarily responsible for the thrift industry's increasing interest rate sensitivity. According to the ***Office of Thrift Supervision's*** *Quarterly Review of Interest Rate Risk,* interest rate sensitivity for the median thrift rose in the second quarter of 1999 for the third consecutive quarter.

[39] Volatile liabilities include borrowings, federal funds purchased, repurchase agreements, jumbo certificates of deposit, foreign deposits, and trading liabilities.

CHART 10

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



Note: Long-term assets have a maturity or repricing frequency of greater than five years.
Source: FDIC Bank and Thrift Call Reports (Research Information System)

Operational Risks

Insured banks and thrifts face numerous business- and process-oriented operational risks on a daily basis. At the same time, recent industry developments and bank failures have highlighted the importance of maintaining strong operations. The ***Basle Committee on Banking Supervision*** reported in late 1998 that "awareness of operational risk among bank boards and senior management is increasing."[40]

The competitive environment and shareholder expectations have led many insured institutions to search for greater efficiency by cutting costs. In some cases, deep cuts in overhead expenses may weaken the effectiveness of operating and monitoring systems as well as internal controls. Anecdotal evidence from banking regulators suggests that internal control and recordkeeping weaknesses are on the rise. Moreover, industry consolidation and new business activities are creating bigger, more complex, and more decentralized operating environments, especially for the largest institutions. These issues are important since operational weaknesses may leave institutions more vulnerable to adverse economic conditions, insider abuse, or fraud.

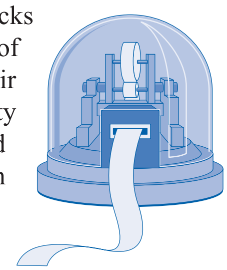
Implications

This article has summarized the generally favorable current condition of the U.S. economy and banking industry. The economy is in the ninth year of a remarkable economic expansion that has been conducive to a high level of financial performance on the part of the banking industry. There are, nonetheless, areas of vulnerability that could contribute to a less favorable economic environment and less robust financial performance for insured institutions in the future.

One issue raised by this report is rising indebtedness on the part of households and businesses, which represents a growing private deficit. Rising interest rates could increase the debt service burden for consumers and businesses, making them more vulnerable to a slowing economy. An increasing private deficit is problematic also because the two major sources of financing—foreign capital inflows and domestic credit creation—have the potential to create problems for the economy and for lenders. Dependence on foreign capital makes U.S. inflation and interest rates highly subject to changes in the decisions of foreign investors and the value of the dollar. The rapid pace of credit creation by the financial sector threatens to impair credit quality. The intuition that loose underwriting standards can lead to credit quality problems is supported by recent signs of rising credit losses in a strong economy.

The second issue that cuts across this report is the effect that competition is having on banking strategies and exposures to credit, market, and operational risks. There has been an increase in lending to less creditworthy borrowers, including subprime consumer borrowers and leveraged corporate borrowers. There is also evidence that institutions are pursuing asset-liability structures with higher levels of interest rate risk to maintain loan growth and meet funding needs. Finally, some of the innovations banks have used to counter competitive pressures may introduce new risks associated with complex accounting valuations, weakening internal controls, and the need for more intensive loan servicing.

The third issue is the increasing potential for financial market instability, which leaves the economy and the banking system vulnerable to sudden shocks. Events from fall 1998 showed some of the more damaging aspects of these crises, as market-based financing went from abundance to scarcity virtually overnight. The financial imbalances associated with the rapid creation of credit and borrowing from abroad not only create the need for the economy to slow down eventually, but also threaten to make that adjustment process a volatile one. Financial market shocks could quickly alter the confidence of consumers and businesses and their access to financing. Such instability could end the current expansion and expose underlying weaknesses in bank risk-management practices.



[40] "Operational Risk Management," Basle Committee on Banking Supervision, September 1998 (http://www.bis.org/publ/bcbs42.pdf).

This article was prepared and coordinated by the staff of the Analysis Branch of the Division of Insurance. Contributions and feedback from analysts across the Division were essential to its completion.

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Regional Perspectives

- **The Region's aggregate economy remains healthy, reflecting some conditions typically experienced in a mature expansion as well as others unique to the current cycle. A slowdown in the manufacturing sector's growth and developments in the agricultural sector, however, warrant monitoring.**

- **The reported aggregate financial condition of the Region's banks and thrifts was favorable in second quarter 1999 as higher noninterest income offset a decline in net interest margin.**

- **An increasing number of new banks and thrifts, which often exhibit high-risk profiles, are being established in the Region.**

Regional Conditions Reflect Expansion's Longevity

Many economic and banking conditions within the Region are in line with those typically experienced after an extended period of expansion. Some, however, differ. The combined effect of these developments is that generally healthy economic conditions in the Chicago Region likely will continue at least through March 2000, the cyclical expansion's ninth anniversary.

Industrial Sector Growth Slows

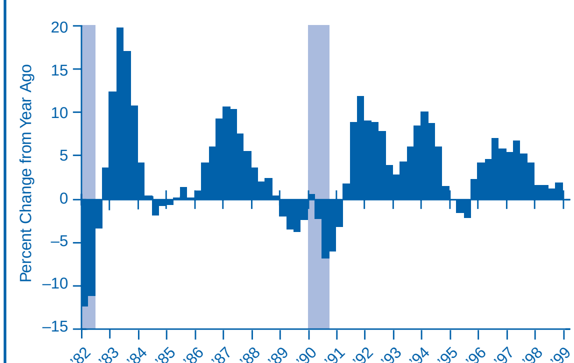
The Region's sustained low unemployment rate—4.1 percent or less since late 1997—reflects tight labor markets. In turn, the lack of readily available workers and the need to attract workers away from other employers are limiting the Region's ability to expand rapidly and triggering higher personnel costs and profit pressures among some firms.

Although demand continues to climb for motor vehicles and some other products important to the Region's manufacturers, combined output growth of 16 of the Region's major manufacturing industries has slowed to between 1 and 2 percent during the past year (see Chart 1). The current pace is the slowest since immediately after the last recession, except for the weakness in 1995 and early 1996, following a year of rising interest rates. Along with tight labor markets and slower domestic demand growth, weak demand from abroad and the loss of some customers to foreign producers are contributing to the slowdown in the Region's industrial output growth.

National capacity utilization rates late in the summer suggest that increased production could be realized from current factories if strong demand conditions warranted it. Manufacturers of both durable and nondurable goods were using between 79 and 80.5 percent of their production capacity recently, somewhat below their annual averages of recent years (see Chart 2). The slowdown in production growth and easing of factory utilization rates have contributed to a 0.5 percent (or 22,000 workers) drop in employment among the Region's manufacturing firms in the year ending August 1999.

CHART 1

Midwest's Industrial Output Growth Slows



Source: Federal Reserve Bank of Chicago, via Haver Analytics, Inc.

CHART 2

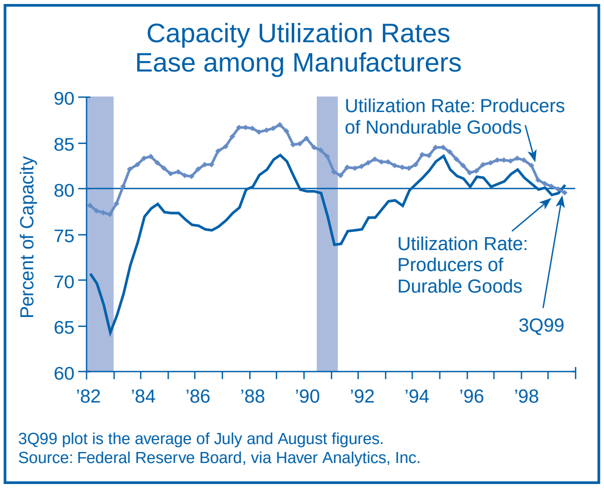
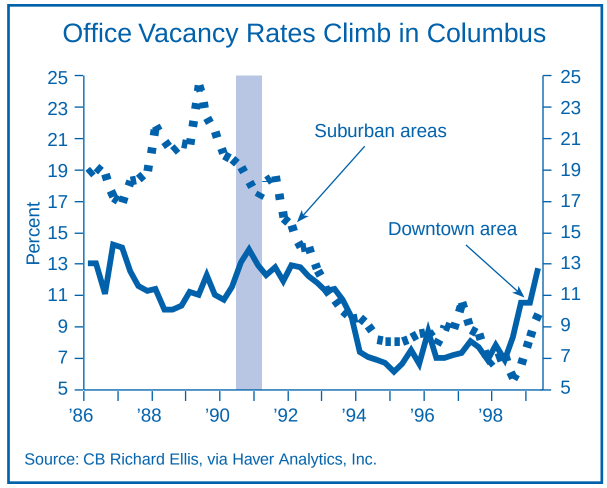


CHART 3



Commercial Real Estate Activity Is Rising

High levels of new construction and rising valuations of existing properties are accompanying the continued expansion. Scattered pockets of "hot" construction activity are reported in a few of the Region's metropolitan markets, typically in suburban areas. Among the Region's largest metropolitan statistical areas (MSAs), only **Columbus, Ohio,** has posted consistent and sizable increases in vacant office space over the past year (see Chart 3), a trend deserving careful evaluation by lenders, builders, and owners in that market.

Overall office vacancy rates in the Region's other major MSAs (**Chicago, Cincinnati, Cleveland, Detroit,** and **Indianapolis**) have not been boosted noticeably by recent construction, at least to date. However, because these MSAs are quite large, favorable aggregate data may obscure submarkets where a number of new projects under way will add new space in coming quarters. Should excess supply develop, cash flows for both existing and new structures could be negatively affected. In addition, some market participants may have been lulled by the favorable levels and stability of financing terms of recent years, which may not hold in coming quarters.

One quarter of the Region's 2,019 insured institutions had 200 percent or more of their Tier One capital exposed to commercial real estate (CRE) loans as of June 30, 1999. Among these institutions, 190 experienced CRE loan growth of 30 percent or more in the past year (based on data adjusted for mergers), with a median percentage increase of 49 percent. Although some loans secured by commercial real estate may, in fact, function as commercial and industrial (C&I) loans because their proceeds are used to finance general business operations, this portfolio segment warrants attention because of concentration, growth, issues related to the proper valuation of collateral properties, and rising interest rates.

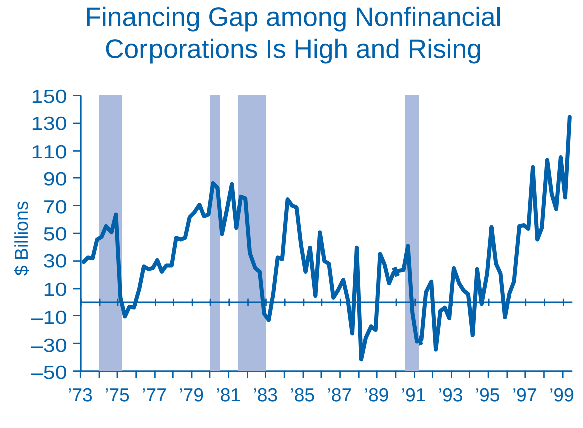
C&I Loans Are Growing Faster than Aggregate Loan Portfolios

Other developments at insured institutions also mirror those typically experienced in a mature expansion. For example, C&I loans are growing faster than total loan portfolios, an indication that businesses are relying more heavily on external sources of financing than earlier in the expansion. This rising reliance on external funding is reflected by increases in what is sometimes referred to as the "financing gap," the difference between capital expenditures and internally generated funds.[1] Among nonfarm corporations outside the financial sector, taken in the aggregate, the financing gap is currently at a record high (see Chart 4, next page).

Call report data for banks and thrifts in the Chicago Region show that, in the year ended June 30, aggregate loans expanded by 8.4 percent and C&I loans grew by

[1] In technical terms, the financing gap equals capital expenditures less the sum of domestic (U.S.) internal funds and inventory valuation adjustment.

CHART 4



Source: Federal Reserve Board, via Haver Analytics, Inc.

13.9 percent, with larger institutions participating more than smaller ones (see Table 1). Among institutions with assets of $500 million or less, C&I loan growth has been stronger among newly formed institutions than among more seasoned ones, as discussed in more detail later in this article.

In addition, aggregate loans and leases relative to total assets have risen during the expansion, which is typical. The 67 percent share in the Region on June 30, 1999, was the highest midyear share in at least 15 years. Meanwhile, a decline in net interest margins (NIMs) also is occurring, which is discussed along with other performance measures in the next section of this article.

TABLE 1

LOAN GROWTH AMONG CHICAGO REGION'S INSTITUTIONS

INSTITUTIONS' ASSET SIZE	MEDIAN GROWTH RATE (%): 1999:Q2 FROM 1998:Q2	
	NET LOANS	C&I LOANS
$500 MILLION OR LESS	7.2	9.2
EXCLUDING INSTITUTIONS ESTABLISHED SINCE 1996:Q2	6.9	8.8
$500 MILLION TO $1 BILLION	12.8	14.2
$1 TO $10 BILLION	9.9	13.2
$10 BILLION AND HIGHER	7.9	16.1

C&I = COMMERCIAL AND INDUSTRIAL
SOURCE: BANK AND THRIFT CALL REPORTS, JUNE 30, 1999

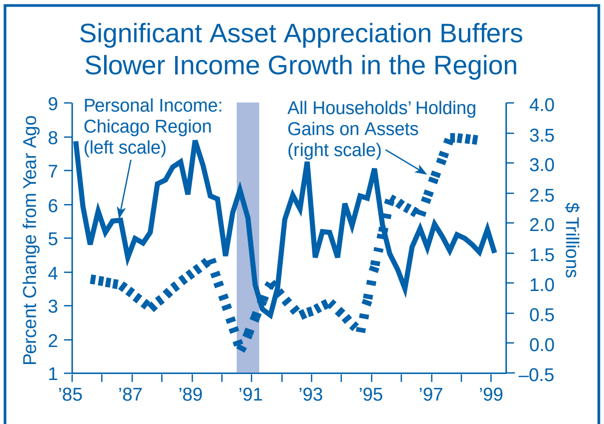
The Current Situation Has Distinguishing Features

Although the economy tends to follow a "normal" pattern, each business cycle has its own special characteristics. The unusually low inflation rate of less than 2.5 percent after many years of this expansion has surprised many analysts. This condition, in turn, is contributing to interest rates that, although rising, at midyear were still among the lowest levels of the cycle.

Recent years' conditions in world financial markets also have contributed to keeping interest rates on U.S. Treasury securities low for this stage of an expansion. In turn, favorable financing rates have supported unusually robust growth in consumer and business spending during the ninth year of an expansion. In the aggregate, the generally low interest rate environment benefited much of the Region's manufacturing sector, as well as financial services, construction, and others. These benefits may have more than countered the negative impact of rising import levels or heightened foreign competition that trimmed—sometimes significantly—output of specific firms in the Region.

Unusually rapid appreciation in asset values is another distinguishing feature of the current economic expansion. The significant appreciation in real estate, equity, and other household assets over the past four years is illustrated in Chart 5. Without the wealth effect generated by their rising net worth, households' spending growth likely would have moderated noticeably by now, in line with their personal income gains (see Chart 5). Had that happened, demand for vehicles, appliances, and other goods produced in the Region likely

CHART 5



Sources: Bureau of Economic Analysis and Federal Reserve Board, via Haver Analytics, Inc.

would have been lower and, in turn, the recent growth in jobs and manufacturing output would have slowed more than it has. Among businesses, recent years' stock market conditions are providing an attractive source of financing for many firms, helping to support their capital modernization and expansion efforts.

The risk ahead is that a sudden drop in real estate or stock values, should one occur, could trigger a sharp and swift decline in households' discretionary spending, with depressing spillover effects on manufacturers and local communities. Business firms could face reduced access to capital. In such an environment, insured institutions could experience increased customer use of unsecured lines of credit, reduced collateral values, and deterioration in the performance of their loan portfolios.

Bank and Thrift Overview: Financial Performance Remains Solid despite Falling Margins

Chicago Region banks and thrifts reported overall healthy financial conditions during the first six months of 1999.

Commercial Banks Report Stable Profitability

Despite a significant decline in the aggregate NIM to 3.86 percent, down 17 basis points from June 1998, profitability of the Region's commercial banks remained fairly stable. On an aggregate basis, return on assets (ROA) was 1.32 percent for the quarter ended June 30, 1999, compared with 1.31 percent a year earlier. This ROA level was heavily dependent on increases in noninterest income (NONII).

Competition from other financial intermediaries and a relatively flat yield curve during the first half of the year led to the continued decline in the NIM. However, the Region's commercial banks are trying to bolster earnings performance through other forms of revenue. These institutions' growing use of NONII has been critical in helping to sustain overall profitability in light of lower margins and rising noninterest expenses (see Chart 6). When taken as a percentage of average assets, NONII for the Region's commercial banks was 2.08 percent, up 26 basis points from June 1998.

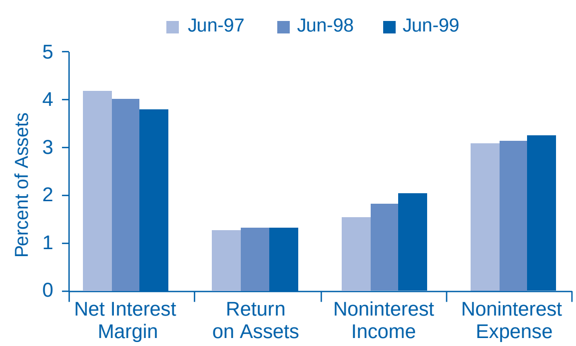
Reported asset quality at the Region's commercial institutions held steady during the first half of 1999 as past-due and nonaccrual loans remained fairly stable from the year-earlier period, at 2.13 percent. However, these institutions reported lower reserve coverage of past-due and nonaccrual loans (coverage ratio) of 180 percent during the first six months of 1999 compared with 196 percent in the prior year's period. The declining coverage ratio could suggest that commercial banks have not made sufficient provisions for loan losses, which may affect the quality of future earnings. While allowance coverage slipped, capital levels remained stable at approximately 7.9 percent.

Savings Institutions' Performance Strengthens

Performance among the Region's 394 savings institutions strengthened by June 1999. NIMs improved 10 basis points to 3.15 percent, resulting in a 1.09 percent ROA, up from 0.97 percent a year earlier. The improved performance of the Region's thrifts can be attributed largely to a shift in asset mix (see Chart 7, next page). The aggregate loan-to-assets ratio grew to roughly 73 percent, its seventh consecutive year-over-year increase since June 1992. This loan growth represents a shift

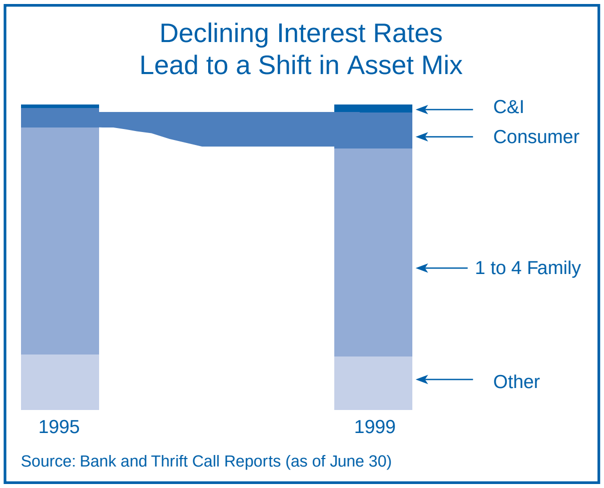
CHART 6

Rising Noninterest Income Helps to Sustain Profitability at Commercial Banks



Source: Bank and Thrift Call Reports, June 30, 1999

CHART 7



from lower-yielding securities and, at the same time, a change in loan mix.

One- to four-family residential mortgages continue to comprise the bulk of assets of the Region's savings institutions. However, the declining interest rate environment, which began early in 1995 and continued into the first quarter of 1999, has led to a migration away from lower yielding residential mortgages toward higher yielding consumer loans and C&I obligations. As a result, one- to four-family obligations now comprise 68 percent of total loans, down 8.5 percent from June 1995. However, the Region's thrifts have experienced an increase in the C&I and consumer loan portfolios to 2.5 percent and 11.9 percent, respectively, up from 1.2 percent and 6.5 percent as of June 30, 1995.

Currently, neither C&I nor consumer loans make up a significant portion of the aggregate assets of the Region's thrifts, but the five-year growth trend has been significant. Given the newness of these loans, asset quality remains solid. As a result, total past-due and nonaccrual loans among the Region's thrifts improved over the past three years to 1.70 percent by June 30, 1999. However, the changing loan composition of these institutions has not been tested during a recession.

Weak Agricultural Conditions Persist

According to ***The Kiplinger Agriculture Letter,***[2] the overall farm economy will remain under stress well into 2000. Abundant supply, sagging demand, and increased competition from abroad will continue to depress crop prices, particularly for the Region's principal crops of soybeans and corn (see Table 2).

Weakness in crop prices continues to affect farmland values. Agricultural bankers in **Illinois,** responding to the Federal Reserve Bank of Chicago's ***AgLetter***[3] survey, reported that the value of "good" farmland was down 7 percent on July 1, 1999, from a year ago. In **Indiana,** agricultural bankers reported farmland values off by 4 percent over the same period.

While agricultural loans represent less than 2 percent of the total loan portfolio held by the Region's insured institutions, a significant portion of agricultural loans are held by small institutions that are highly concentrated in this loan type. The Region's 336 agricultural banks[4] held agricultural loans totaling $4 billion as of June 30, 1999, or 32 percent of all agricultural loans held by the Region's insured institutions. Reported asset

TABLE 2

Regional Producers Concentrate in Corn and Soybeans
Percent of Total U.S. Production
1994–1998 Average

Rank	Corn State	Corn Percent	Soybeans State	Soybeans Percent
1	Iowa	18.5	Iowa	18.0
2	Illinois	16.0	Illinois	16.8
3	Nebraska	12.2	Minnesota	9.8
4	Minnesota	9.6	Indiana	8.6
5	Indiana	7.9	Ohio	6.9
Regional Production		23.9		32.3

Source: United States Department of Agriculture

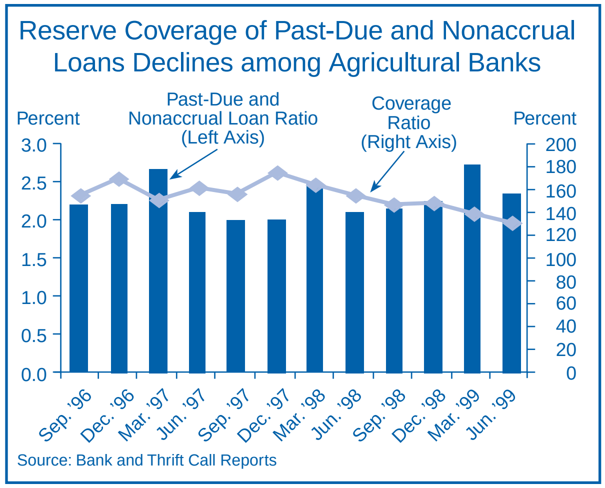
[2] The Kiplinger Washington Editors, Inc., *The Kiplinger Agriculture Letter,* August 13, 1999.

[3] Federal Reserve Bank of Chicago, Farmland Values and Credit Conditions, *AgLetter,* Number 1905, August 1999.

[4] 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.

quality measures at these institutions are showing some deterioration. Total past-due and nonaccrual loans equaled 2.37 percent of total loans as of June 30, 1999, up from 2.12 percent a year ago. According to the *AgLetter,* loan repayments were most problematic in Illinois and Indiana. In addition, the reserve coverage of past-due and nonaccrual loans (coverage ratio) among the Region's agricultural banks declined to 129 percent as of June 30, 1999, from 153 percent a year ago (see Chart 8). As a group, agricultural banks reported high capital levels and healthy earnings performance; however, the declining coverage ratio indicates that earnings are possibly beginning to be overstated as provision expenses have not kept pace with increasing levels of past-due and nonaccrual loans.

CHART 8



New Bank and Thrift Formation Has Accelerated in the Chicago Region

Nationally, new bank[5] creation has steadily increased since 1993 but remains well below levels experienced in the early to mid-1980s. In the Region, however, the level of new bank formation exceeds 1980s levels. During that time, the Region averaged 13 new bank openings annually, compared with 17 annually during the 1990s. Twenty-seven new banks were established in 1998, and 28 more have been established through September 9, 1999, ensuring that 1999 will have the highest level of new bank activity during the past two decades.

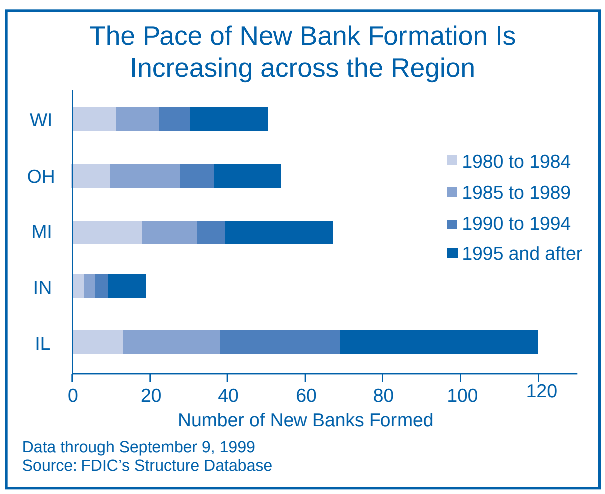
Illinois has reported the greatest number of new banks in the Region since 1980. Activity in the past five years has been concentrated in Illinois and **Michigan,** but the pace increased in all states in the Region (see Chart 9). Illinois may continue to lead, given that 19 applications for state charters were pending in that state as of early September.

Most new banks have been established in urban areas; 87 percent of institutions started since 1980 are located in MSAs (see Map 1, next page). In particular, the Chicago and Detroit metropolitan areas have had substantial new bank activity. **Cook, Lake,** and **DuPage counties** in Illinois—all part of the Chicago MSA—have experienced the highest level of new bank creation since 1990 totaling 28, 13, and 9 new banks, respectively. These large markets likely provide more opportunities to new bank organizers hoping to fill a niche.

Several Factors Are Leading to More New Bank Formation

The banking industry's record profitability in the mid-1990s and the strength and longevity of the current economic expansion have helped drive new bank creation. A strong stock market has improved access to capital. In addition, the prospect of gains through initial public

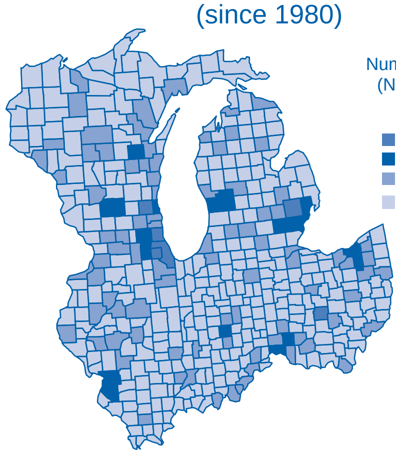
CHART 9



[5] New banks include de novo commercial banks and savings institutions established since 1980.

MAP 1

New Banks Concentrated in Larger Markets (since 1980)



Source: Bank and Thrift Call Reports for institutions established since January 1980

offerings or because of potential sales of new banks to other institutions attracts investors to bank start-ups.

Selected research also points to consolidation in the industry as a primary driver of new bank formation. For example, purchases of small, locally owned institutions by larger entities may lead to customer dissatisfaction and create opportunities for displaced banking executives and other entrepreneurs to provide small-business financing and personal banking services.

However, consolidation may not necessarily lead to new bank formation in the same market areas where the consolidation has occurred. A study by the ***FDIC's Division of Research and Statistics***[6] found that consolidation may not typically lead to new banks, at least in the same market areas. This study reviewed new bank activity in metropolitan markets from 1995 through 1997 and found that recent acquisitions tended to have a negative correlation with new bank formation.

The relaxation of unit banking laws and the emergence of interstate banking have contributed to increased merger activity and also may be contributing to new bank formation, particularly in Illinois, which previously had very strict unit banking laws. In addition, Illinois recently enacted the Banking on Illinois Act, empowering state-chartered banks and thrifts to sell virtually any product or service if the same function is allowed by at least one other state. This development may increase the appeal of an Illinois charter to new bank organizers over time; however, this legislation currently does not appear to have expanded the types of permissible banking activities in the state.

New Banks Face a Higher Risk Profile

Rapid asset growth and weak earnings levels are typical for new banks. They also traditionally report low profitability levels because of high overhead and interest expenses. The Region's new banks are no exception (see Table 3).

Profitability. New banks and thrifts take time to grow into their initial overhead and replace higher cost funding with more stable deposits. A recent study[7] found that while new banks report rapid improvement in profitability during the first three years of operation, an average of nine years of operation is required before they reach established banks' levels. New banks' weak initial earnings performance is attributable in part to high start-up costs and overhead expenses relative to a smaller earning assets base.

TABLE 3

HIGH OVERHEAD AND FUNDING COSTS HAMPER NEW BANKS' PROFITABILITY

PERFORMANCE MEASURES*	NEW BANKS** (%)	ESTABLISHED INSTITUTIONS (%)
INTEREST INCOME	7.90	7.53
INTEREST EXPENSE	4.11	3.68
NONINTEREST INCOME	0.44	0.53
OVERHEAD	3.61	2.85
RETURN ON ASSETS	0.40	1.03

* MEDIAN VALUES; RATIOS AS A PERCENT OF AVERAGE ASSETS
** CHICAGO REGION INSTITUTIONS IN OPERATION FOR MORE THAN ONE YEAR BUT LESS THAN THREE YEARS AS OF JUNE 30, 1999
SOURCE: BANK AND THRIFT CALL REPORTS, JUNE 30, 1999

[6] Steven Seelig and Timothy Critchfield, FDIC Division of Research and Statistics, "Determinants of De Novo Entry in Banking," 1999.

[7] Robert DeYoung and Iftekhar Hasan, "The Performance of De Novo Commercial Banks: A Profit Efficiency Approach," *Journal of Banking and Finance,* 1998, Volume 22, Issue 5.

Recently, the rate of new bank earnings improvement has moderated. Median earnings after the second year of operation have been declining slightly for the Region's new banks. Banks established from 1984 to 1990 achieved a median ROA of 0.34 percent after two years. This earnings level has declined to 0.31 percent for banks and thrifts established since 1991. This earnings trend may indicate a change in the conditions that in the past made opening new banks desirable. Increased competition and the aging economic expansion may be contributing to the decline in new bank earnings improvement.

Concentrations. The relative lack of diversification, both geographically and in asset mix, typical in new banks also poses potential risks. Because new banks are generally well capitalized initially, the likelihood of failure is extremely low in early years. The rate of failure quickly increases after the first few years of operation when capital levels have reached those of established institutions, but profitability and growth rates have not. At that point, many new banks may be experiencing rapid asset growth, weak earnings, declining capital levels, and less diversified loan portfolios than other institutions.[8]

High levels of C&I lending also evidence increased risk at new banks and may explain the higher interest yields shown in Table 3. The median share of C&I loans to total loans for institutions established after 1989 and open for at least one year is currently 22 percent, versus 11 percent for older institutions in the Region. New banks' reliance on commercial lending, which is highly cyclical and has historically represented a riskier loan category than other forms of lending, indicates that asset quality concerns could quickly arise in an economic downturn.

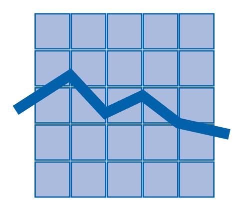
Funding. Funding strategies used by new banks add an additional layer of risk. Core funding represents only 69 percent of assets for institutions established in the 1990s, versus 76 percent for older ones. The high interest expense experienced by new banks and thrifts has resulted from this greater reliance on noncore funding sources.

[8] For further details, refer to Robert DeYoung, *Birth, Growth, and Life or Death of Newly Chartered Banks,* Federal Reserve Bank of Chicago, 1999.

While new banks typically rely on noncore funding, the composition of this funding has been changing. This development is illustrated by a greater number of the Region's new banks using a fairly significant volume of brokered deposits, which are traditionally viewed as a highly volatile source of funds. Currently, 13 percent of institutions established in the 1990s are funding 3 percent or more of assets with brokered deposits, compared with only 7 percent of established banks and thrifts. The number of new banks with a significant amount of brokered funds has increased from five years ago, when only 8 percent of new banks relied on brokered deposits to the same extent. As a result, any disruptions in capital markets may disproportionately affect new banks' funding capabilities and costs.

An Economic Downturn May Pose a Serious Threat to New Banks

The significant growth in new institution formation in the Region that is occurring late in an economic expansion is a concern. Although new bank failure rates have been low in the Region for institutions established since 1980, certain developments could heighten risk levels for new banks. Combined with the significant volume of new banks' commercial lending, higher noncore funding, and a declining pace of earnings improvement, an economic downturn in the next several years could excessively strain new banks. Many of these new banks have not experienced a recession, and their ability to adapt to weakening economic conditions is relatively untested.



As previously discussed, the risk of failure for new banks is greatest after the first few years of operation, while earnings remain low, capital levels are approaching established bank levels, and asset growth is high. Many new banks will be entering this period in the next few years and will need to manage carefully the effects of any economic downturn.

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