# Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION — SECOND QUARTER 1999



FDIC
DALLAS
REGION



DIVISION OF INSURANCE

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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.**

- ***Economic Developments*—Low interest rates, dormant inflation, and rising stock markets have all contributed to a generally positive near-term outlook for the U.S. economy.** *See page 3.*
- ***Trends Affecting Banking Lines of Business*—Although credit conditions appear strong, risks exist in the major banking lines of business.** *See page 7.*

  ***Consumer Lending*—Continued high consumer loan loss rates raise questions about how lenders will fare under less favorable economic circumstances.** *See page 8.*

  ***Commercial Lending*—Corporate loan growth accelerated in 1998 even as the corporate sector showed signs of stress.** *See page 9.*

  ***Commercial Real Estate and Construction Lending*—Selected metropolitan markets are experiencing rapid commercial development despite declining indicators of demand.** *See page 10.*

  ***Agricultural Lending*—Falling commodity prices threaten U.S. farm operators.** *See page 11.*

  ***Funding and Interest Rate Risk*—Intense competition and the changing term structure of interest rates have presented challenges for banks and thrifts.** *See page 12.*
- ***Indicators of Industry Performance*—Weaknesses appear to be developing for banks with certain types of exposures, and the dispersion in performance among insured institutions is increasing.** *See page 13.*

***By the Analysis Branch Staff***

## Regional Perspectives

**Despite sluggish fourth-quarter profits, insured institutions' performance for calendar year 1998 remains strong...Stress on the agricultural industry has yet to spill over into farm bank performance...The Region's economy is expected to experience slower growth in 1999, but it will still outpace the nation...Consumer spending, which has been key to the Region's growth, may increase consumer credit risk to banks...While consumer specialty banks in the Region are few, there is a significant aggregate exposure to consumer debt.** *See page 16.*

***By the Dallas Region Staff***


*A Publication of the Division of Insurance*

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# *Economic Conditions and Emerging Risks in Banking*

Periodically, the Division of Insurance assesses conditions in the economy and across the banking industry in an effort to evaluate the types of risks that could adversely affect the performance of insured depository institutions. The analysis that follows describes the salient aspects of this assessment by focusing on three areas: 1) developments and conditions in the U.S. and global economies; 2) trends affecting particular banking lines of business; and 3) selected indicators of bank performance.

In brief, the U.S. economy continues to provide a favorable environment for the banking industry. The industry as a whole has exhibited strong loan growth and minimal credit losses. Nevertheless, there are areas of concern, including subprime and high loan-to-value consumer lending, higher levels of leveraged commercial lending, localized overbuilding of commercial real estate, and the potential for credit quality problems among agricultural banks. Although it is uncertain when, or even if, these concerns will ultimately affect overall industry performance, the potential for stress among insured institutions is being monitored.

## *Economic Developments*

### *Conditions Have Improved Markedly since Late 1998*

The U.S. economy is now in its eighth year of expansion, the longest peacetime expansion during the post-World War II era. Although analysts raised concerns about the durability of the expansion amid the late-1998 financial market turmoil, the economic outlook since that time has improved for a number of reasons: 1) the 75 basis point reduction in short-term U.S. interest rates between September and November helped to support consumer spending and business investment; 2) following several quarters of decline, U.S. exports rose unexpectedly during the fourth quarter; 3) inflation remained dormant even though U.S. labor markets were extremely tight; and 4) equity valuations for large-cap stocks rebounded and erased most of the losses incurred during August and September.

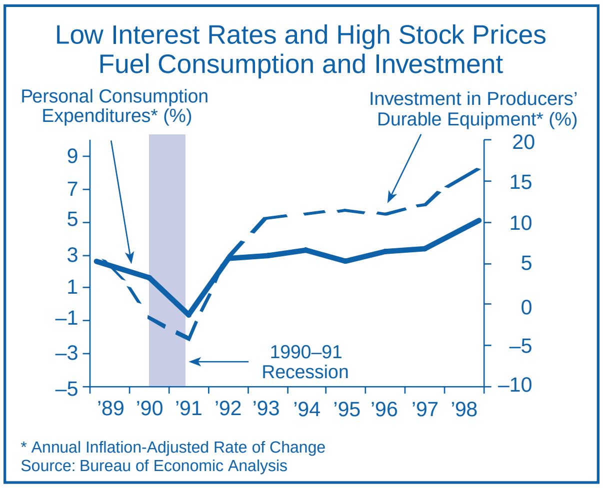
### *Consumer Spending and Business Investment Are Key to Economic Strength*

Most of the standard indicators of health for the U.S. economy currently register values associated with the best macroeconomic conditions in our history. Growth in real gross domestic product (GDP) was 3.9 percent for all of 1998—the third consecutive year in which growth exceeded 3.5 percent. The U.S. economy added over 3.1 million jobs during 1998, while unemployment averaged just 4.5 percent, the lowest annual figure since 1969. Despite this robust economic activity, inflation was also the lowest in a generation. Consumer prices rose by just 1.6 percent in 1998, extending a seven-year streak during which prices have risen by less than 3 percent per year. At the same time, strong gains in the productivity of U.S. workers helped real hourly earnings rise by 2.7 percent—the best performance since 1972—while unit labor costs of businesses rose by only 1.9 percent.

Growth in business investment spending, which typically peaks in the early years of an economic expansion, has actually accelerated during the current expansion (Chart 1, next page). A number of factors appear to be responsible for this investment boom. One is the need for producers to invest in new technologies in order to cut costs and remain competitive. Also, rising stock prices, low interest rates, and low yield spreads during the past few years have helped keep the cost of capital relatively low. The result has been an economic expansion in which approximately 20 percent of net growth in real GDP has come from investment in producers' durable equipment, versus approximately 10 percent during the long expansions of the 1960s, 1970s, and 1980s. Bank commercial and industrial lending has expanded at an average annual rate of 10.6 percent over the past five years, largely on the strength of business investment spending.

The underlying factors that drive consumer spending are strong. Low unemployment and rising real incomes have boosted the ***Conference Board's*** consumer confi-

CHART 1




dence index to its highest values since the late 1960s. Increases in new home construction reflect these favorable conditions. Almost 1.5 million new homes were completed during 1998—the highest level in ten years—while a record 4.8 million existing homes were sold (Chart 2). U.S. automobile sales reached 15.5 million in 1998, their best performance since 1986. Low interest rates also enabled a record number of homeowners to reduce their monthly interest expenses by refinancing their mortgages during 1998.[1]

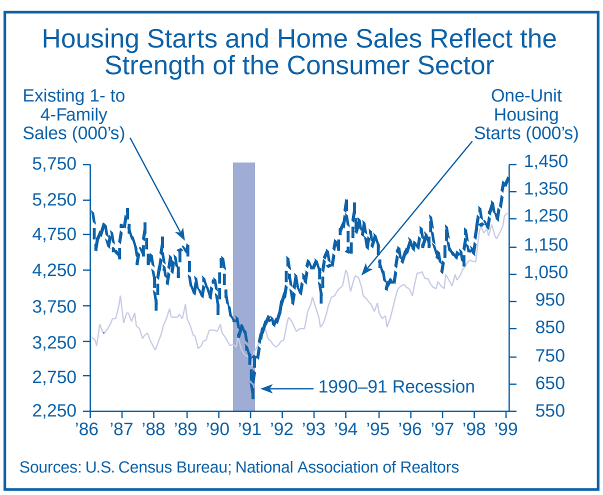
Although real disposable personal income grew by more than 3 percent during 1998, personal savings was essentially zero during the fourth quarter. This was the lowest rate of personal savings recorded in the United States since the Great Depression. The decline in personal savings has prompted much discussion of its causes and potential implications for the economy and for consumer credit quality. Most analysts have argued for the importance of a "wealth effect" from rising stock values on consumer spending.[2] They note that although consumers are saving little out of current income, household wealth continues to grow rapidly, driving consumer spending higher. The willingness of American consumers to spend has been a prime factor in prolonging the economic expansion for the United States and in supporting the economies of countries around the world that depend on exports to the United States. This high degree of reliance on the U.S. consumer has led analysts to voice concerns that the wealth effect might reverse itself, leading to a sharp drop in consumer spending if there is a sustained stock market decline.

### *Conditions Vary across Industry Sectors*

While overall conditions in the U.S. economy are good, certain sectors have been undergoing significant strain because of low commodity prices and weak foreign demand.

Commodity price weakness extends across a wide range of items, from agricultural goods to industrial commodities to basic manufactured goods (Chart 3). Among agricultural commodities, grain prices have fallen substantially from their record-high levels of just three years ago, while prices for hogs and soybeans have also been under severe pressure. Industrial commodity prices have fallen sharply, with steel prices down by nearly 30 percent since January 1997. Certain manufactured goods show a similar pattern. The price of the industrial chemical benzene has fallen by 40 percent since January 1997, while the price of computer memory chips fell by more than 80 percent during that time. Oil prices decreased by nearly 50 percent between January 1997 and February 1999. Since mid-March, however, oil prices have increased as a result of agreements among oil producers to limit output. Analysts are uncer-

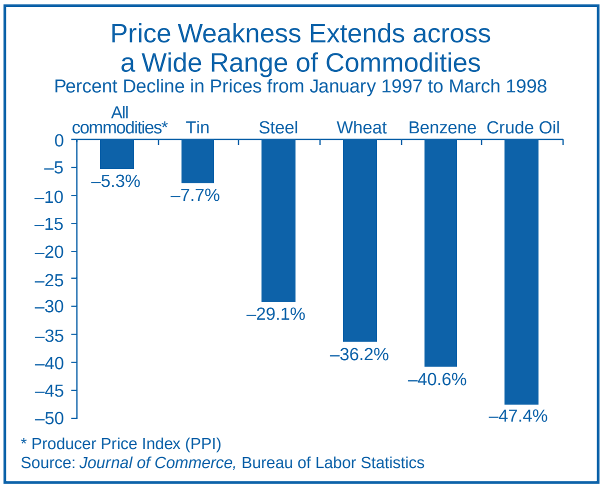
CHART 2




[1] The Refinancing Index of the ***Mortgage Bankers Association*** posted an all-time high of 4,389 in the second week of October 1998. The index is scaled to a level of 100 as of the third week of March 1990.

[2] Personal savings is measured as the difference between disposable personal income (personal income less tax payments) and total consumption outlays. Increasing household wealth may reduce personal savings either through a reduction in disposable income or through increased consumption outlays. Tax payments resulting from capital gains will reduce measured disposable personal income. Increasing household wealth may lead to higher consumption outlays by means of the wealth effect.

CHART 3




tain how long any reductions in output will be maintained or how much oil prices may increase during the next several months.

Three trends in the global economy appear to be responsible for weak commodity prices. First, sustained low inflation has taken root both in developed nations and in many emerging economies. Low inflation has eliminated much of the speculative demand for commodities that was evident during the 1970s. Low inflation has also made it difficult for manufacturing firms to raise prices, while at the same time encouraging the implementation of new technologies to cut costs. Second, large-scale investment in plant and equipment during the 1990s in both developed and emerging countries has added vast amounts of new global manufacturing capacity, making industrial overcapacity a source of price weakness in a number of industries. Third, successive currency crises and the resulting recessions that have taken place in Asia, Eastern Europe, and Latin America have reduced global demand for commodity goods. Moreover, U.S. firms find that their products are less price competitive abroad because of the relative strength of the dollar.

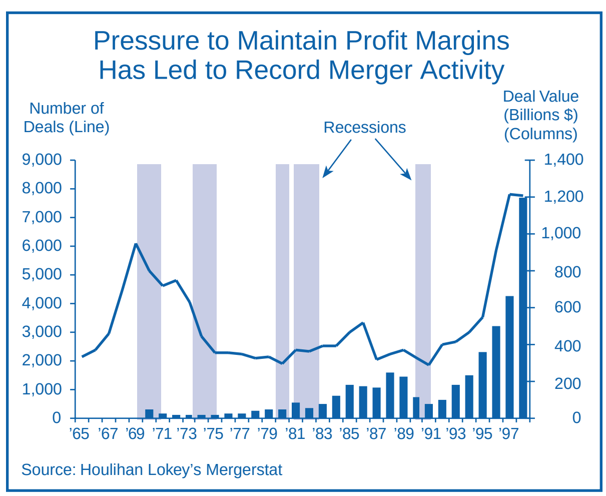
One reason the overall U.S. economy has proven so resilient in the face of weakness in the manufacturing sector is that firms have been able to restructure to cut costs and improve their market positions. Global overcapacity in industries such as oil and autos has been a driving force behind the record number and dollar value of merger deals announced during 1998. Mega-mergers involving Exxon-Mobil and Daimler Benz-Chrysler helped push the dollar volume of mergers announced in 1998 to almost $1.2 trillion—nearly double the level announced in 1997 and far greater than any year during the "merger mania" of the 1980s (Chart 4).

### *U.S. Foreign Trade Reflects Recent Turmoil in the Global Economy*

The U.S. economy increasingly relies on exports to fuel its overall growth. Between 1994 and 1997, export growth contributed about 1 percentage point each year to total net growth in real GDP. However, with the onset of the Asian economic crisis in 1997, the export sector stalled and became a drag on overall U.S. economic activity. During the first three quarters of 1998, exports decreased at an annualized rate of 4.4 percent, led by declines in capital goods, industrial material and supplies, and food and agricultural products. Weakness in exports was not limited to Asia; in fact, Canada, Mexico, and South America were also weak markets for U.S. goods and services during most of 1998. Declining goods exports and rising imports combined to push the U.S. balance of trade to a record deficit of $169 billion during 1998—a 50 percent increase from the year before. The trade deficit continued to increase in early 1999. Data for January show an imbalance of nearly $17 billion, the largest monthly deficit ever recorded.

Despite the weakness in foreign demand that was observed during much of last year, U.S. exports rose sharply at the end of 1998. Total exports jumped by 19.7 percent during the fourth quarter, contributing 2.0 percent of the total 6.0 percent growth in GDP during the

CHART 4



quarter. This unexpected increase in U.S. exports involved nearly every region of the world except Eastern Europe. Export shipments increased across most product types, with the greatest increase in activity observed in capital goods.

### *The Outlook for the Global Economy Remains Uncertain*

Developments during the past six months have resulted in an improved outlook for the global economy, but some key uncertainties remain. While the global financial system is more stable today than it was six months ago, some of the world's most important economies either remain in recession or are experiencing slower growth. In this environment, the potential remains for shocks to arise in the global economy that could adversely affect the performance of the U.S. economy and the credit quality of insured depository institutions.

**Canada.** The Canadian economy is healthier than at any time during the past several years. Canada's economy is expected to track overall growth in the United States, in part because U.S. demand for goods and services is the principal support for Canadian exports. Canada's relatively high dependence on weak commodity industries, such as metals, grains, and livestock, poses risks for producers and for local economies closely tied to these commodities.

**Mexico.** Mexican GDP growth was 4.6 percent in 1998, reflecting relatively strong employment and wage gains, high levels of foreign direct investment, and robust nonoil export growth. Looking ahead, inflation remains a concern. At the end of 1998, the inflation rate was 18.7 percent, up from a low of 15 percent in the middle of the year. The ***Blue Chip Economic Indicators*** consensus forecast calls for real GDP growth of 2.9 percent during 1999, down from 4.6 percent in 1998.

**Western Europe.** Europe's problems are similar to those of the United States in that they stem from declining growth in manufacturing exports. Despite a 175 basis point cut in short-term interest rates in the U.K. since October 1998, the Bank of England forecasts economic growth of less than 1.0 percent in 1999. In Germany, manufacturing activity has also decreased, owing to weakness in export markets. German GDP shrank by 0.4 percent during the fourth quarter of 1998, while unemployment remains above 10 percent. In response to signs of growing weakness in Germany and other major economies in the 11-member "Euro-zone," the European Central Bank cut short-term interest rates by 50 basis points to 2.5 percent on April 8, 1999.

**Eastern Europe.** Much of Eastern Europe is faced with slow growth or recession following the devaluation of the ruble and the default on Russian government debt in August 1998. The Russian economy shows few signs of recovery amid high inflation and halting progress in economic reform. Poland and Hungary, Eastern Europe's engines of growth before the Russian crisis, are facing rising current account deficits and a slowdown in export growth.

**Asian Pacific Rim.** The Japanese economy remains mired in a long-running recession that has resulted in a greater number of bankruptcies (up 17 percent in 1998), falling domestic demand, and pessimism among consumers and businesses alike. Japanese GDP fell by 2.8 percent during 1998, and analysts call for a drop of 0.8 percent in 1999.

There are signs that the worst phase of the Asian economic crisis may have passed.[3] In the Philippines, South Korea, Hong Kong, and Thailand, current accounts have moved from deficit to surplus as devalued currencies continue to depress imports. Foreign capital is returning to the region, as evidenced by the 27 percent increase in foreign direct investment in Korea during 1998. However, weak consumer spending remains a problem for the entire region, which ships fully 40 percent of all exports to other Asian Pacific Rim nations.

In China, which has been relatively immune to the worst of the region's economic crisis, slower growth is also forcing economic restructuring. With annual economic growth below the targeted 8 percent mark, economic planners have been forced to reduce production and close plants in the oil, steel, glass, and cement industries. Meanwhile, the government is trying to stimulate demand by investing in public infrastructure and by urging banks to increase lending to the private sector.

[3] See "The Asian Economic Crisis: Implications for the U.S. Economy," *Regional Outlook,* Third Quarter 1998. Also available at http://www.fdic.gov/publish/regout/ro19983q/ny/infocus1.html.

**Latin America.** With the apparent stabilization of the Asian economies, attention has now focused on emerging problems in Latin America. The 50 percent devaluation of the Brazilian *real* versus the dollar that began in January 1999 has depressed economic activity and renewed fears of inflation. Consensus estimates place Brazilian economic growth at negative 3.5 percent for 1999, while short-term interest rates are likely to remain high (currently about 42 percent) to prevent further capital flows out of the country.

### *Risks Remain despite a Positive U.S. Economic Outlook*

Robust economic growth, low inflation, and stable interest rates appear to be the most likely economic scenario for the remainder of 1999, according to the consensus forecast of the ***Blue Chip Economic Indicators.*** If this outlook actually comes to pass, we can expect that the vast majority of insured institutions will continue to enjoy moderate loan growth and generally favorable indicators of financial performance and condition.

Despite this positive outlook, the risk remains that the expansion could be derailed by one of three types of shocks. The first would be a resurgence of inflation resulting from demand-induced shortages of labor or other key economic resources. Although inflation has been consistently low in recent years, investors remain on the lookout for any signs of higher prices. While it is not certain that a recession would result, it is worth noting that rising short-term interest rates in response to increasing inflation have preceded every recession during the past 40 years.

The second type of shock that could end the expansion is a sustained period of deflation. Concern about deflation arises from the low prices many commodity producers are receiving and the effects of foreign currency devaluations on U.S. import prices. Although these trends have helped to keep U.S. inflation and interest rates low, at some point they could impose a heavier burden on U.S. businesses by shrinking revenues and profit margins, mirroring what has already occurred in some commodity-based industries.[4]

The third type of shock is financial market instability. Consumer confidence, which has reflected recent increases in stock market wealth, could tumble in the event of a severe and prolonged decline in the stock market. Business investment has also depended on the support of strong and stable financial markets that offer firms access to capital on favorable terms and facilitate restructuring in troubled industries. A recession accompanied by financial market instability could pose a particular threat to bank loan performance because it would likely produce a disorderly shakeout of troubled firms marked by a rise in bankruptcies and loan defaults.

[4] See "How Will the Expansion End?" *Regional Outlook,* Second Quarter 1998. Also available at http://www.fdic.gov/publish/regout/ro19982q/sf/infocus2.html.

## *Trends Affecting Banking Lines of Business*

### *Overview*

Trends in bank and thrift lines of business align closely with those of the economy. Most insured institutions have prospered during this economic expansion, as shown by the industry's continuing earnings growth, strong capital levels, and improving or stable loan performance across most major loan categories. Likewise, today's strong economy depends to a great extent on the continuing availability of consumer and business credit from banks and thrifts. Even during the closing months of 1998, when capital market funding sources became quite volatile, credit continued to flow from insured institutions. During that turbulent period, insured institutions may have acted as a stabilizing force for businesses, consumers, and farmers by continuing to provide credit, albeit at higher prices and with stricter underwriting terms in some cases.

Although credit conditions appear strong, a number of insured institutions' loan portfolios are shifting toward a riskier mix of credits. Underlying reasons for these shifts vary, but likely explanations include opportunities to earn higher yields and confidence about the overall economic outlook. The following paragraphs discuss credit risk trends and highlight possible areas of concern in the major lending lines of business at insured institutions. The influence of recent interest rate changes and competitive factors on asset/liability and credit risk management is also explored.

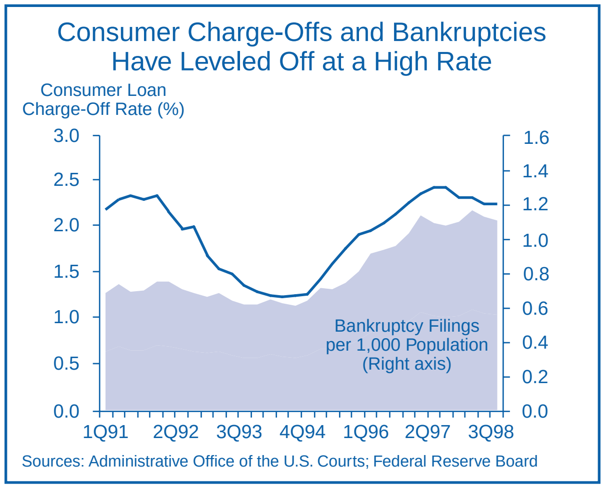
## *Consumer Lending*

### *Debt Growth Sustains Consumer Spending but Could Contribute to Financial Strains under Less Favorable Economic Conditions*

Much of the strength and stability of the overall U.S. economy owes itself to the continuing growth in consumer spending. While higher personal incomes and consumer confidence are important contributing factors, lower interest rates and expanding avenues of credit access have also played key roles in supporting consumer spending. With mortgage debt leading the way, consumer loan growth rates accelerated in 1998. The key factor driving mortgage loan growth was lower interest rates, which encouraged many consumers to purchase homes, refinance existing mortgages, and consolidate their personal debts through home equity loans. As a result, the growth in home mortgage credit during 1998 reached a post-recession high of 10 percent. Other consumer loan types, such as auto and credit card debt, grew at slower but accelerating rates of 8 percent and 5 percent, respectively.

Nonmortgage consumer loan loss rates remain above previous recession levels despite the apparent strength of the consumer sector. Chart 5 shows that nonmortgage consumer loss rates have declined slightly from their peak in the fourth quarter of 1997, but remain above the rates experienced during the prior recession. The chart also shows that consumer credit loss rate trends are closely related to the rise in personal bankruptcy filings, which reached an all-time high of 1.4 million in 1998.[5] The good news for consumer lenders is that the growth rate in personal bankruptcies has slowed. However, this leveling off does not mean that consumer credit quality concerns have abated. The overriding concern is how personal bankruptcies and consumer credit losses, already at high levels, would be affected by less favorable economic conditions. Another concern is whether current consumer spending patterns will be supported by a new round of credit card growth. Since revolving credit card balances typically carry higher interest rates than home equity loans, this

CHART 5




"reloading" of credit card debt would further strain the financial flexibility of consumers.

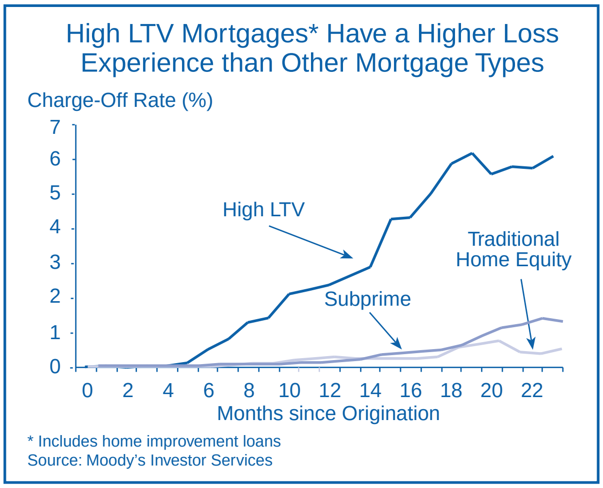
### *High Loan-to-Value Mortgage Products and Subprime Lending Transform Consumer Lending*

Consumer lending practices have changed significantly since the last recession. Because of intense competition and declining net interest margins, consumer lenders are reaching out to borrowers further down the credit quality spectrum and relaxing traditional collateral requirements. Bank supervisors have indicated that a growing number of insured institutions are involved in some form of subprime lending. Subprime loans, designed for borrowers with blemished or limited credit histories, can take a variety of forms, including home equity, automobile, and credit card loans. As compensation for increased risk, subprime loans carry higher interest rates than prime-rate loans and often require substantial collateral margins.

Insured institutions are also embracing another relatively new consumer loan product: high loan-to-value (LTV) loans. High LTV loans, where the combined amount of senior and junior liens against a home exceeds its value, are usually made to borrowers with "clean" or unblemished credit histories. However, the lack of collateral protection results in much higher loss experience when a borrower defaults. As Chart 6 shows, high LTV loans have had a higher loss rate experience (adjusted for seasoning) than either traditional home equity loans or subprime loans. Moreover, the delinquency rates on recent-vintage home equity loan pools

[5] Reasons for the rise in personal bankruptcy rates are further explored in a series of ***Bank Trends*** articles published by the FDIC. See, for example, "A Time Series Model of the U.S. Personal Bankruptcy Rate, 1970-1996," February 1998, and "The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-Offs, and Personal Bankruptcy Filings," March 1998. Both reports can be accessed at www.fdic.gov/publish/bktrnds/index.html.

CHART 6




have deteriorated as high LTV loans have proliferated.[6] At the same time, recent regulatory surveys of credit underwriting practices show easing standards on home equity loans.[7] The loss experience of these higher risk consumer products during less favorable economic circumstances is unknown and continues to be a concern.

## *Commercial Lending*

### *Commercial Loan Performance Remains Strong but Corporate Financial Strains Are Developing*

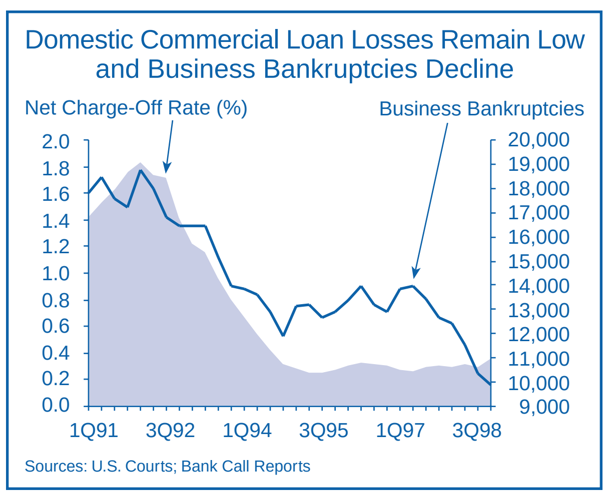
Continued strength in the corporate sector is reflected in the level of corporate bankruptcy filings, which have declined since the middle of 1997 to just under 10,000 in the fourth quarter of 1998. Bank losses on commercial credits remain low but did register a modest increase during the fourth quarter (see Chart 7). In addition to strong economic fundamentals in high tech, construction, finance, service-related, and other sectors, U.S. businesses have benefited from significantly lower interest rates and an abundant supply of credit. Credit access provided by banks was particularly important to U.S. businesses in the latter part of 1998. During this period, sharply higher interest rate spreads on corporate bonds[8] and commercial paper led many companies to tap cheaper funding sources, including existing unused credit and commercial paper lines held by commercial banks. As a result, commercial banks experienced a 15 percent (annualized) rate of growth in fourth quarter 1998, the highest rate of commercial loan growth in 16 years.

Although commercial loan loss rates are low, financial strains are becoming apparent among certain U.S. business sectors. Bank lending to U.S. businesses has grown at a faster pace than GDP during each of the past eight quarters. Moreover, growth in bank commercial lending through 1998 has come at a time when total after-tax U.S. corporate profits have begun to decline.[9] Deteriorating profits are especially prevalent in sectors with exposure to weak commodity prices and slower export growth. For many businesses, lower profits have resulted in a reduced capacity to service outstanding debt obligations. For instance, a recent ***Bank of America Corporation*** study reported that amendments to syndicated loans in the latter half of 1998 were driven increasingly by borrowers seeking relief from financial performance-related covenants.[10] Financial strains are

[6] "Moody's Home Equity Index Update." *Moody's Investor Services*, October 2, 1998, p. 3.
[7] For example, the ***Office of the Comptroller of the Currency's*** "1998 Survey of Credit Underwriting Practices" indicated that 33 percent of the banks offering home equity loans eased standards, compared with only 7 percent that tightened standards. The report is available at http://www.occ.treas.gov/cusurvey/scup98.pdf.

[8] ***The Merrill Lynch U.S. Investment Grade Corporate Bond Master Index*** indicates that corporate bond spreads over ten-year Treasury rates rose 58 percent, an increase of 63 basis points, from the end of July 1998 to the end of October 1998.
[9] See the ***Bureau of Economic Analysis Corporate Profit Index.***
[10] "Covenants Provide Loan Repricing Opportunity." *Bank of America Report*, January 25, 1999.

CHART 7



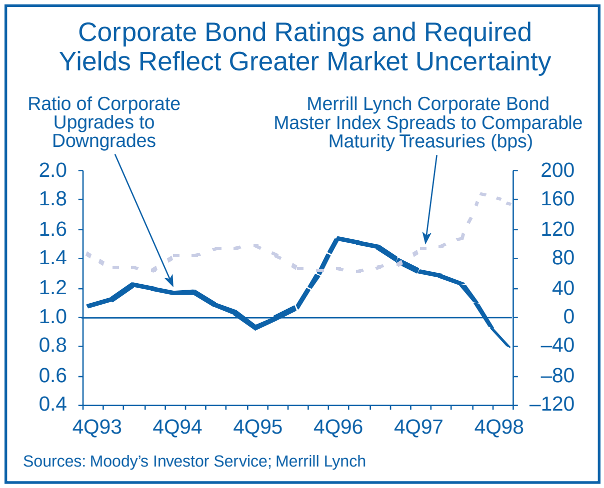
also reflected in the level of corporate bond defaults, which ***Standard and Poor's*** reported at 48 ($10.8 billion in affected debt) in 1998, up 182 percent from 1997 levels (up 150 percent in dollar volume terms).[11]

### *As Debt Markets Become More Cautious, Syndicated Lending Shifts toward Higher Risk Borrowers*

Although the longer-term trend has been toward more aggressive corporate lending strategies, many insured institutions responded to the financial market turmoil in late 1998 with a heightened sense of caution. Recent surveys of underwriting practices conducted by the federal banking agencies show that many banks tightened standards in late 1998 across many product lines.[12] However, tighter lending terms do not appear to have quelled either loan demand or loan production substantially.

Syndicated lending trends suggest an increase in corporate lending risks.[13] Despite the flight to quality that occurred in the latter part of 1998, syndicated loans to leveraged companies jumped 41 percent to $273 billion during 1998. Over the same period, nonleveraged loans declined 35 percent to $599 billion. Although corporate merger activity accounts for much of the increase in leveraged lending volume in 1998, some lenders appear to be taking advantage of the higher yields available in this market relative to yields on lower risk credits. The apparent shift toward a higher risk mix of total syndicated credit outstanding is occurring at the same time that corporate bond defaults for speculative grade issues are trending upward.[14] Moreover, trends in corporate bond spreads and rating agency actions on corporate bond debt suggest a bond market that is becoming increasingly cautious about the outlook for U.S. businesses (see Chart 8).

CHART 8




## *Commercial Real Estate and Construction Lending*

### *Construction Loan Growth Accelerates as Overbuilding Pressures Increase in Certain Markets*

In 1998, the value of private commercial construction rose 4.0 percent over 1997 levels, reflecting a moderate slowdown in growth compared with a compounded average annual growth rate of 8.4 percent since 1992. In contrast, the pace of residential development has accelerated. The value of private residential construction rose 11.5 percent in 1998, compared with an annual average growth rate of 8.0 percent since 1992. Construction loans at insured institutions grew 20 percent in 1998, the highest growth rate since 1986.[15]

Although market fundamentals are strong throughout most major U.S. markets, some metropolitan areas appear to be vulnerable to an oversupply of commercial space. The ***Regional Outlook***, First Quarter 1999, highlighted nine markets that may be susceptible to commercial overbuilding on the basis of the following factors: 1) the rapid pace of current construction activity in those markets; 2) high vacancy rates relative to construction in progress in some cases; 3) projections of rising vacancy rates by market analysts; and 4) various recent shifts in demand indicators. Data through June 1998 indicate that construction activity in these markets

[11] "Corporate Defaults Rise Sharply in 1998," ***Standard & Poor's,*** March 5, 1998.

[12] See ***Federal Reserve Board*** Senior Loan Officer Opinion Surveys for November 1998 and January 1999, http://www.bog.frb.fed.us/boarddocs/snloansurvey/.

[13] Syndicated loans are credit facilities made to medium and large corporate borrowers by a group or syndicate of lenders. Analysts often segment this market into "leveraged" lending (loans to heavily indebted companies) and nonleveraged lending.

[14] ***Moody's Investor Services*** reports that trailing 12-month default rates for speculative-grade issuers rose from 2.02 percent at the end of 1997 to 3.31 percent at year-end 1998. These default rates compare to an all-corporate trailing default rate of 0.68 percent in 1997 and 1.27 percent in 1998.

[15] Construction loan growth captures growth in both residential and nonresidential development.

has not yet abated to reflect moderating demand levels.[16] Overbuilding concerns may be tempered to the extent that tighter commercial real estate lending standards slow the pace of development.[17]

### *Loan Underwriting Study Reveals Sounder Practices Compared with the 1980s, but Intense Competition Forces Some Concessions on Pricing and Structure*

Beginning in August 1998, FDIC analysts set out to investigate construction loan underwriting practices in banks servicing various rapidly growing markets. The study identified several differences between today's lending practices and those prevalent during the last cycle. Most importantly, today's lenders are making credit decisions on the basis of improved appraisals, increased attention to project cash flows and project feasibility, and better market information on competing projects. However, intense competition has forced an across-the-board reduction in loan pricing margins even compared with margins at the height of the 1980s building boom.

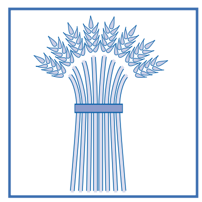
The study also identified some instances of aggressive loan structures, including pricing at extremely thin margins, waiving or limiting personal guarantees, waiving cash equity requirements, and lending on thin collateral margins. Borrowers who secured the most aggressive loan terms were typically larger developers, who presumably have the resources and financial flexibility to weather adverse conditions. Nevertheless, waiving personal guarantees and eliminating a borrower's financial exposure to project risks are practices often cited in conjunction with the heavy construction loan losses experienced during the previous real estate downturn. Finally, the study found that many real estate investment trusts and large corporate developers have been able to obtain long-term unsecured financing for development purposes. The lack of collateral protection could make these loans particularly vulnerable to declining commercial real estate prices.[18]

## *Agricultural Lending*

### *Farm Banks Threatened by Falling Commodity Prices*

Farm banks generally performed well in 1998, reporting a modest increase in nonperforming loans from 1.09 percent at year-end 1997 to 1.13 percent as of year-end 1998. Although delinquent loans rose only slightly in the aggregate, farm banks in some localized areas such as northeast North Dakota and northwest Minnesota experienced sharply higher problem loan levels and reduced profits in the aftermath of three consecutive years of low prices, bad weather, and crop disease-related problems. Moreover, recent surveys by the federal banking agencies, which show rising levels of farm carryover debt at farm banks, suggest that nonperforming loan data may understate borrower difficulties.

During 1998, the outlook for significant portions of the farm sector deteriorated following a dramatic fall in prices for several major farm commodities. Prices for wheat, corn, soybeans, and hogs fell to ten-year lows and were below the economic breakeven cost of production for many producers. For areas heavily dependent on these commodities, the ***U.S. Department of Agriculture*** (USDA) projects that producers will experience substantial declines in net cash income from 1999 through 2003.[19] In 1999, the USDA projects farm income to fall 7.1 percent, to $44.6 billion, from last year's level of $48 billion.



Although current conditions have the potential to cause stress for substantial numbers of farm banks in certain regions, some significant differences exist between today's circumstances and those that led to the farm

[16] The nine markets are Atlanta, Charlotte, Dallas, Las Vegas, Nashville, Orlando, Phoenix, Portland, and Salt Lake City. "Commercial Development Still Hot in Some Markets but Slower Development May Be Ahead." *Regional Outlook,* First Quarter 1999, www.fdic.gov/publish/regout/ro19991q/na/index.html.

[17] Consistent with commercial and industrial underwriting trends, commercial real estate lenders reacted to market volatility in late 1998 by tightening loan terms and raising pricing margins. See, for example, the Federal Reserve Board Senior Loan Officer Opinion Survey for November 1998 and January 1999.

[18] Loan covenants may mitigate some of the risks of lending without collateral protection. Common covenants include maximum leverage ratios, minimum equity requirements, and limits on encumbered assets through recourse or cross-collateralization to third parties.

[19] A substantial portion of the ***USDA's*** projected decline in the net cash income for U.S. farmers over the next five years is attributable to reductions in government payments to farmers.

bank crisis of the mid-1980s. Current favorable factors include 1) lower debt-to-equity for farm producers; 2) substantially lower interest rates; 3) moderately appreciating farmland prices relative to the more rapid appreciation (and subsequent price corrections that followed) in the 1970s and 1980s; and 4) better underwriting practices by farm lenders. Nevertheless, if weak exports of farm products and low commodity prices continue for the remainder of this year, the condition of farmers could deteriorate significantly, increasing financial stress at insured farm banks.

## *Funding and Interest Rate Risk*

### *Deposit Funding Becomes More Difficult to Obtain*

Competitive pressures in the banking industry are not restricted to lending. Insured institutions are also finding it difficult to attract deposits in today's marketplace, largely because of the existence of higher yielding investment products. For example, the ***Investment Company Institute*** reports that net inflows into mutual funds have exceeded net increases in deposit accounts in all but three quarters since mid-1991. The fourth quarter of 1998 marked the sixteenth consecutive quarter that mutual fund inflows outstripped deposit increases. As deposits have become more difficult to attract, loan portfolios have expanded in line with the overall growth in the economy. As a result, institutions have turned increasingly to other borrowings for funding. These trends are captured in Chart 9, which shows that the ratio of bank and thrift loans to deposits reached a record 88 percent in December 1998. Small community banks and thrifts (institutions with less than $1 billion in assets) are most affected by deposit trends, since they tend to rely more heavily on deposit funding than larger institutions with greater access to the capital markets.

### *Interest Rate Changes Pose Asset/Liability Management Challenges*

Interest margin pressures are posing challenges for insured institutions. In addition to the effect of competitive pressures, changes in interest rates have had a substantial influence on institutions' net interest margins. The flattening of the yield curve in 1998, for example, appears to have contributed to a decline in margins to their lowest levels since 1991 for both large and small insured institutions (see Chart 10). For insured institutions with more traditional asset/liability structures (longer-term asset holdings funded with shorter-term deposits and borrowings), a flatter yield curve results in lower spreads between asset yields and interest costs.

The decline in long-term interest rates during 1998 also led to a record volume of mortgage refinance activity, as indicated by the ***Mortgage Bankers Association's Refinancing Index.***[20] Among many mortgage lenders, the most immediate impact from this refinancing activity was the revaluation of servicing assets and lower servicing fee income. Some mortgage lenders also saw a significant increase in overhead as they expanded staff to accommodate higher loan application volumes. A

[20] This index hit its peak in mid-October and has since declined in line with a modest upward movement in fixed mortgage rates.

CHART 9

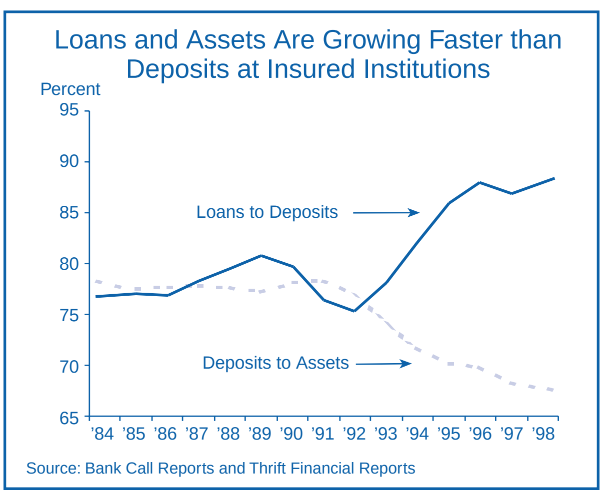
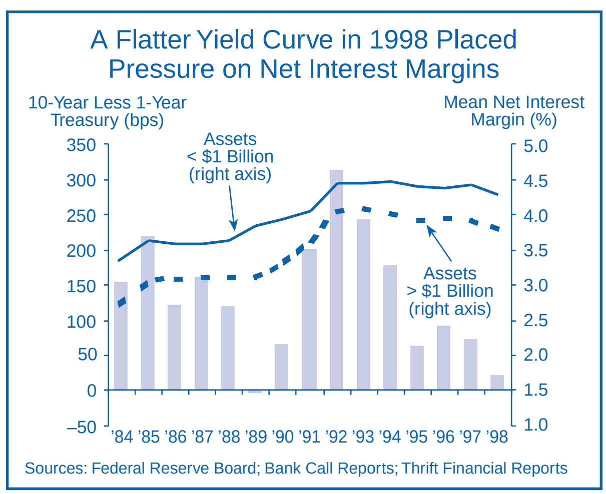



CHART 10



longer-lasting impact involves the shift in borrower preferences toward fixed-rate mortgages. According to ***Freddie Mac,*** approximately 65 percent of adjustable-rate mortgages refinanced in 1998 were replaced with 30-year fixed-rate mortgages. Another 30 percent were refinanced into 15- and 20-year fixed-rate mortgages. As a result of this activity, mortgage lenders may tend to have a higher proportion of assets held in longer-term mortgage loans, leading to further margin pressures should interest rates rise.

As discussed in previous sections, many insured institutions appear to be turning toward higher risk consumer and corporate lending strategies. Such strategic shifts may be at least partially in response to pressures on net interest margins. The search for higher yield spreads may also explain the continuing growth in nondeposit funding sources, which often take the form of complex obligations with embedded options that can reduce funding costs at the expense of additional interest rate risk.

## Indicators of Industry Performance

### *Market Signals for the Banking Industry Are Mixed*

Diminished concerns over the near-term economic outlook and reduced financial market volatility resulted in a sharp turnaround in investor attitudes toward banks in the fourth quarter of 1998. During the quarter, the ***SNL Bank Stock Index***[21] rose 21 percent, recovering all of the value it lost during the turmoil of the third quarter. The index has continued to rise in 1999.

Although equity indicators have been generally positive, ratings actions in 1998 for the long-term debt of U.S. banks and finance companies reflect developing problems for certain industry segments. In sharp contrast to the previous six years, when upgrades far exceeded downgrades, ***Moody's*** downgraded as many bank and finance company debt ratings as it upgraded during 1998. In the fourth quarter of 1998, Moody's downgraded the long-term debt ratings of 27 bank and finance companies and upgraded only 15—the highest quarterly ratio of downgrades to upgrades since 1992. Downgrades during 1998 were centered in finance companies specializing in nonportfolio subprime lending and bank holding companies with exposure to emerging markets.

### *Bank Performance Remains Strong but Earnings Variability Is Increasing*

Recent stable industry profitability in the aggregate has masked an increasing range of profit variability for individual commercial banks. Over the past six years, the annual aggregate return on average assets (ROA) for commercial banks has shown little fluctuation, ranging from a low of 1.15 percent in 1994 to a high of 1.24 percent in 1997.[22] However, the variability in commercial bank profitability, as measured by the distribution of the industry's ROA excluding the top and bottom 5 percent, has widened since 1994 (see Chart 11). For example, ROA for the worst 5 percent of the industry was negative 0.29 percent or less in 1998, reflecting a steady decline from 0.2 percent in 1995. Similarly, ROA for the most profitable 5 percent of commercial banks was above 2.16 percent, up from 1.94 percent in 1994.

Reasons for the increasing variability of commercial bank ROA can be further analyzed by segregating institutions along predominant product or business lines. Chart 12 (next page) details the distribution of 1998

[21] This index tracks the market capitalization of approximately 520 banking companies.

[22] *FDIC Quarterly Banking Profile,* Fourth Quarter 1998, www2.fdic.gov/qbp.

CHART 11

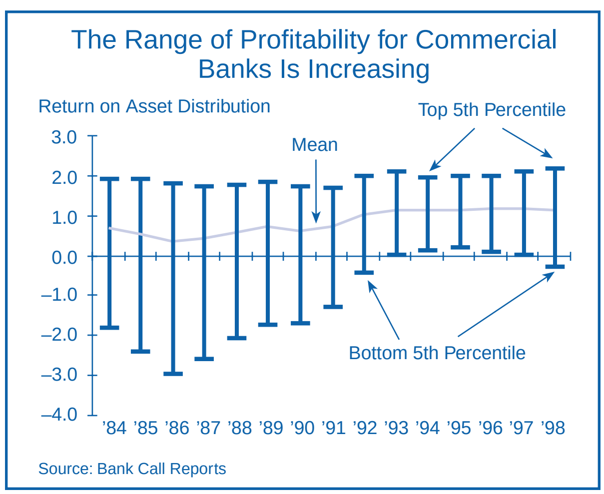
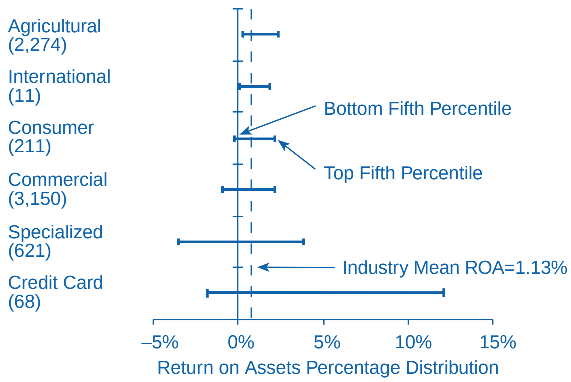


CHART 12




Note: Group institution count is in parentheses.
Source: Bank Call Reports (Research Information System)

ROA for six selected groups of banks segregated by line of business concentrations. This chart reveals that bank performance varies considerably by business specialty. For example, the distribution of ROA of credit card lenders[23] differs significantly from that of other bank groups, including other consumer lenders.[24] Small specialized banks[25] and commercial lenders[26] followed credit card lenders as the groups with the greatest variability in profitability in 1998. Moreover, 75 percent of the least profitable commercial banks were members of small specialized or commercial groups. New banks have also influenced the dispersion of bank ROA. Banks chartered in 1997 and 1998 make up more than 60 percent of the industry's worst performers. However, earnings variability widened in 1998 even when newer institutions are excluded from the analysis.

Far fewer commercial banks posted losses in 1998 than during the period from 1984 to 1992. Still, the number of unprofitable institutions appears to be rising despite generally favorable economic conditions. These concerns are mitigated somewhat, since today's worst-performing institutions are generally much better capitalized and are burdened with fewer problem assets than their counterparts during the 1980s.

### *Summary*

Most indicators of U.S. economic health remain robust in spite of the difficulties posed by low commodity prices and falling exports during 1998. The consensus forecast of leading economic analysts calls for continued growth in the U.S. economy for the rest of 1999. At the same time, a number of threats to this favorable outlook exist, including the possibility of higher inflation and higher interest rates stemming from strong economic growth. Other scenarios involve a very different threat—namely, price deflation brought on by global overcapacity and a decline in U.S. exports. Shocks that might arise in the foreign sector or in the financial markets, as experienced during 1998, remain a significant concern during 1999. Consumer spending and business investment seem particularly vulnerable to such shocks at this stage of the expansion.

Favorable economic conditions are reflected in the overall performance of the banking industry. Still, a number of indicators suggest that the risk profile of some insured institutions is increasing. Responding to significant competitive pressures, and perhaps emboldened by the long duration of the current expansion, many institutions are expanding their involvement in higher-risk consumer loan products, such as subprime and high LTV loans and higher-risk leveraged commercial loans. The overall shift toward higher-risk credits is occurring despite signs of financial strain on the part of many consumers (in the form of record personal bankruptcies) and businesses (in the form of declining profits and increasing bond default rates). Credit-related concerns also extend to commercial real estate, where some markets are exhibiting rapid commercial real estate development at the same time that demand indicators are

[23] Banks with at least 50 percent of managed loans in managed credit card receivables and at least 50 percent of managed loans in total managed assets.
[24] Banks with consumer loans and single-family mortgages in excess of 50 percent of assets that do not meet separate credit card or mortgage lending concentration thresholds.
[25] Banks with total assets less than $1 billion, and less than 40 percent of assets held in loans, that do not fall in other business specialties. Members of this group include *de novo* banks and more seasoned banks with low loan activity, such as trust companies.
[26] Banks with 25 percent or more of assets in commercial and commercial real estate loans.

trending downward. Finally, sustained weak commodity prices are placing strains on farmers and could eventually lead to higher agricultural loan delinquencies.

Bank and thrift net interest margins are being pressured by a flatter yield curve and heightened competition. Community institutions, which rely most heavily on interest income, are particularly vulnerable to tighter margins. The major concern in this area is that insured institutions will combat falling margins by entering into riskier funding and lending strategies.

Market indicators and reported financial data reflect favorable industry performance as well as new sources of risk. Investor attitudes toward banking companies have improved since late 1998 because of an improved near-term economic outlook and a reduction in financial market volatility. However, a recent increase in ratings downgrades of bank and finance company long-term debt suggests growing concern over bank exposures to such areas as subprime lending and emerging markets. Despite relatively strong aggregate industry performance, profit variability among individual commercial banks has increased because of new chartering activity and pressures in consumer and commercial lending. As a result, for the first time since 1992, the worst performing 5 percent of all commercial banks were unprofitable last year.

*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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# Dallas Regional Perspectives

- **Despite sluggish fourth-quarter profits, insured institutions reported strong results for calendar year 1998.**
- **The Region's economy is expected to experience slower growth in 1999, but it will likely outpace the nation.**
- **Consumer spending has been key to the Region's growth, but growth in consumer spending may increase consumer credit risk.**

## Banking Overview—4th Quarter Profits Fall, but Calendar Year Results Still on Track

In general, insured institutions in the Dallas Region continued to report strong financial results and few credit quality problems for the fourth quarter of 1998; however, there were some signs of weakness in the quarter's results. As shown in Table 1, the Region's return on assets (ROA) and return on equity (ROE) for the fourth quarter were 1.00 percent and 11.60 percent, respectively, the lowest figures reported for both profitability measures in the past 12 quarters. Moreover, 270 banks and thrifts in the Region, with over $29 billion in assets, have converted to Subchapter S status and therefore pay no corporate taxes. Without these conversions, the Region's ROA and ROE would have been even lower. In addition, the number of institutions that lost money increased from 170 institutions with $11 billion in combined assets during the fourth quarter of 1997 to 196 institutions with $36 billion in combined assets during the fourth quarter of 1998.

Several factors contributed to the fourth-quarter decline in profitability. First, banks and thrifts in **Colorado** reported a combined ROA of only .67 percent. One institution alone reported an ROA (fourth quarter 1998, annualized) of negative 29 percent as a result of its charge-offs of subprime loans. As of December 31, 1998, 206 banks and thrifts were headquartered in Colorado, with combined assets in excess of $37 billion. If the ten institutions with the worst quarterly profits were excluded from this group, the ROA for the remaining institutions would climb to 1.11 percent, more in line with previous quarters. Thus, a small number of banks are significantly influencing the decline in ROA for banks in Colorado. In fact, the number of banks in that state reporting fourth-quarter losses actually declined from the previous fourth quarter. The increase in the number of unprofitable institutions is occurring in other states in the Region. Factors contributing to the increase

**Table 1**

**Fourth-Quarter Profitability Falls**

| | Dallas Region Institutions | | | Dallas Region Institutions under $100 Million | | | National Totals | | |
|---|---|---|---|---|---|---|---|---|---|
| | 4Q98 | 4Q97 | 4Q96 | 4Q98 | 4Q97 | 4Q96 | 4Q98 | 4Q97 | 4Q96 |
| Return on Assets | 1.00 | 1.22 | 1.20 | 0.96 | 0.99 | 1.03 | 1.06 | 1.18 | 1.14 |
| Net Interest Margin | 4.25 | 4.18 | 4.28 | 4.74 | 5.03 | 5.06 | 3.90 | 4.02 | 4.10 |
| Return on Equity | 11.60 | 14.44 | 14.40 | 9.13 | 9.61 | 10.20 | 12.23 | 13.97 | 13.84 |
| Tier 1 Leverage | 7.85 | 7.65 | 7.78 | 10.16 | 10.02 | 10.01 | 7.59 | 7.63 | 7.66 |
| % Unprofitable | 13.14 | 11.10 | 9.37 | 16.08 | 13.18 | 11.04 | 11.36 | 10.02 | 9.04 |
| Charge-off Rate | 0.57 | 0.55 | 0.46 | 0.60 | 0.64 | 0.68 | 0.60 | 0.61 | 0.58 |
| Past-due Loans | 2.37 | 2.36 | 2.60 | 3.14 | 3.08 | 3.23 | 2.17 | 2.27 | 2.45 |

Source: Bank and Thrift Call Reports

include a growing number of newly chartered banks that have not reached profitability; compressed net interest margins at small banks; some high, nonrecurring noninterest expenses at three large banks; and significant loan loss expenses charged in the fourth quarter.

A second factor that contributed somewhat to an overall lower ROA is the decline in the net interest margin (NIM) for small banks (those under $100 million in assets). Small banks in the Dallas Region reported an ROA of only .96 percent. As Table 1 shows, the NIM for these banks fell from 5.03 percent for the fourth quarter of 1997 to 4.74 percent for the fourth quarter of 1998. The yield on earning assets for these small banks fell by 40 basis points from the fourth quarter of 1997 to the fourth quarter of 1998, while the cost of funding for earning assets decreased by only 11 basis points. The evidence suggests that even small banks are feeling the competitive pressures on loan rates from bank and nonbank rivals, while the rates banks pay for deposits appear to have bottomed out. Because smaller banks generally earn a greater portion of revenues from loan income than larger banks do, the combination of a relatively flat yield curve, an already low interest rate environment, and a competitive market are placing greater pressures on small banks to sustain NIMs. Sustaining NIMs could become increasingly difficult unless banks accept additional credit risk and commensurate yield compensation.

Another factor contributing to the decline in ROA is the fact that noninterest income, as a percentage of average assets, decreased by 31 basis points to 1.52 percent in the fourth quarter of 1998. Merger activity—in particular, the consolidation of ***NationsBank of Texas*** with its North Carolina affiliate—explains the dramatic drop in noninterest income. If NationsBank of Texas is excluded from the analysis, noninterest income as a share of average assets actually rose 12 basis points. However, at 1.52 percent, the Region's noninterest income rate compares unfavorably with the nation's 2.28 percent.

The ROA for the calendar year was in line with the rest of the nation, despite the lower fourth-quarter profitability. The ROA for the Region during 1998 was 1.16 percent, the same as that reported nationwide. The NIM for the 12 months ending December 31, 1998, was 4.29 percent, 4 basis points higher than that reported for 1997. This represents the highest NIM for the Dallas Region in the past ten years and is considerably higher than the 3.91 percent reported for the nation. Noninterest income is still low compared to that of the nation: as a percentage of earning assets, noninterest income was 1.65 percent for the Region and 2.45 percent for the nation. The fact that the Dallas Region is headquarters for fewer large regional or money center banks may explain this difference. Whether the fourth-quarter results are the beginning of a trend is too soon to tell.

### *Agriculture Bank Update*

Previous Dallas ***Regional Outlooks*** have assessed the effects of past droughts and low commodity prices on the Region's agricultural producers and farm banks. Despite the significant losses experienced by **Texas** and **Oklahoma** cotton and livestock producers, farm banks[1] in the Dallas Region continue to report financial strength. The ROA for farm banks of 1.03 percent during the fourth quarter of 1998 is identical to that reported for the fourth quarter of 1996, following that summer's drought, and only slightly lower than the fourth quarter of 1997. Likewise, leverage, past-due, and margin statistics have not deteriorated from previous periods. Crop insurance and early disbursements of production flexibility contract payments have provided cash flow to help farmers meet short-term needs. However, the ***U.S. Department of Agriculture*** (USDA) expects grain and cotton prices to remain weak this year, which would place stress on agricultural producers in the Region, likely affecting loan quality and earnings at farm banks.

### *Interstate Banking—What's Behind the Numbers?*

The Riegel-Neal Act in 1995 allowed banks to establish branches across state lines. Only Texas and Montana chose to opt out of the law. During 1997 and 1998, ***NationsBank Corporation,*** headquartered in North Carolina, successfully defended itself against lawsuits brought by the ***Texas Department of Banking*** to keep the bank holding company from merging its Texas banking operations into the NationsBank North Carolina parent. On May 7, 1998, the Court decided in favor of NationsBank, and the prohibition against interstate banking effectively gave way in Texas allowing other banks to follow. In the Dallas Region, more than $39.5 billion in deposits have since been consolidated at branches of banks headquartered in other states.

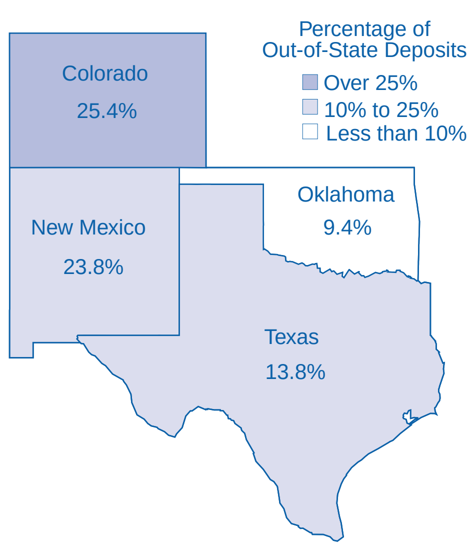
[1] Farm banks are defined as banks with more than 25 percent of total loans in agricultural production or agricultural real estate loans.

Map 1 shows the percentage of deposits held by out-of-state banks and thrifts in each of the Region's states. For example, the map shows that 13.8 percent of total deposits in Texas are held at branches of institutions headquartered outside Texas. Considering that Texas began interstate banking just one year ago, it seems likely that this percentage will increase. To illustrate the potential for further consolidation, as of December 31, 1998, 105 insured institutions headquartered in the Dallas Region had out-of-state parent holding companies. Combined assets for these institutions exceeded $121 billion and represented over one-third of the assets in the Region. Many of these institutions are likely to be consolidated as branches of their parent entities.

From the consumer's perspective, there may be no difference when a financial institution becomes a branch of a bank or thrift located outside the state. However, since banks report financial data according to the location of their headquarters, the consolidation of banks and thrifts across state lines results in reported financial data being less meaningful on a state or regional basis. For example, when NationsBank of Texas consolidated with NationsBank of North Carolina, the $60 billion in assets originally reported in the Dallas Region and still held by branches in the Region are now reported as assets of NationsBank of North Carolina, in the Atlanta Region. Unless the method of reporting is modified, it will become increasingly difficult to report meaningful trends by Region.

**Map 1**

Out-of-State Banks Hold a Large Share of the Region's Deposits




Source: FDIC Summary of Deposits as of June 30, 1998

### *1999 U.S. Economic Overview*

Despite a strong fourth quarter performance in 1998, real U.S. gross domestic product (GDP) is expected to slow in 1999. After averaging nearly 4 percent in 1997–98, most ***Blue Chip*** economic forecasters are calling for U.S. economic growth of between 3 and 3.5 percent in 1999.[2] With exports hurt by the strong U.S. dollar and recessions occurring among several key trading partners, the U.S. trade deficit will likely continue to be large. For the Dallas Region in particular, developments in commodity prices (e.g., agriculture, energy, and semiconductor chips) and in the global economy (e.g., Asia, Latin America, and Russia), with the turmoil they could bring to world financial markets, will be important factors in determining the health of some sectors of the economy.

### *Dallas Region Overview: Slower but Steady Growth*

All four states in the Dallas Region have enjoyed economic expansions of longer duration and typically faster growth than has been the case for most of the nation. Most analysts believe this trend will continue in 1999, although the Region's growth is likely to be slower. Moreover, in the absence of a general downturn in the overall U.S. economy, it is unlikely that the Region will fall prey to a recession. The Region enjoys a comparative advantage in costs of living and doing business, and it possesses a quality labor supply, both major attractions for relocating or expanding businesses. Its strong housing market will likely continue to benefit from low mortgage interest rates; this market, in turn, has significantly benefited the Regional economy by stimulating sales of household furnishings and appliances.

A tight labor market, however, will be a constraint on employment growth in 1999. Colorado, Oklahoma, and Texas are at or near full employment and will consequently have a difficult time generating job growth above the rates of the past few years. On the plus side, the tight labor market should enable workers affected by downsizing industries to find new jobs quickly.

[2] *Blue Chip Economic Forecast,* March 1999.

The crisis in Asia has resulted in deflationary pressures for many commodities, and the demand will likely continue to be weak for the Region's chemicals, oil, semiconductor chips, cattle, wheat, and cotton. In addition, the prolonged effects of Mexico's 1994 peso crisis, combined with oil revenue woes and a strong U.S. dollar, have hurt the border economy. Finally, both Brazil's decision to devalue the real earlier this year and Mexico's moderating economy will likely hurt export growth from the Region and put additional pressures on Latin American economies. Consequently, the Region's economy is expected to experience slower growth in 1999. The following is a state-by-state look at the Dallas Region. Table 2 lists the possible risks to each of the Region's four states.

***Colorado:*** Colorado is one of the most diversified states in the Region, with a large share of employment in the fast-growing services, trade, and communications industries and a small share of employment in the cyclical manufacturing industry. Colorado's economy is closely tied to the national economy; most state forecasters, however, believe Colorado's slowdown will not be as pronounced as that forecast for the United States.[3] The state's expanding services, construction, and trade sectors should more than offset weaknesses in its mining and manufacturing base.

Colorado continues to be affected by the Asian malaise, particularly the ongoing recession in Japan, its number two trading partner. Weak oil and natural gas prices have resulted in continued consolidation in the energy industry, placing pressure on the state's mining employment. The recent up-tick in oil prices will offer some relief to oil producers; however, job losses may continue to occur for a while longer. Construction activity is softening across the board in the residential, nonresidential, and heavy construction sectors. Particularly vulnerable in many counties is the secondary home market, which depends heavily on discretionary spending trends. The slowdown in economic activity may contribute to a better balance in residential and nonresidential construction activity, calming fears of overbuilding in some markets.

Colorado has enjoyed strong personal income growth and is the only state in the Dallas Region in which per capita disposable personal income is above the national average (Chart 1, next page). High-income households are more likely than low-income households to invest heavily in the stock market, and the booming stock and real estate markets have resulted in increased wealth for many Colorado residents, contributing to a surge in retail sales. Many analysts believe it may be difficult for disposable personal income and stock prices in 1999 to keep pace with their performances of a year ago, resulting in some moderation in consumer spending. A major correction in the stock market could have a disproportionate effect on the state, especially on purchases of expensive homes and automobiles. Spending reductions in leisure activity could hurt the state's vital tourism and recreational industries.

[3] "Focus Colorado: Economic & Revenue Forecast, 1999–2004," State of Colorado, Colorado Legislative Council Staff Report, March 1999; "Colorado Economic Perspective," Office of State Planning and Budgeting, First Quarter, Fiscal Year 1999.

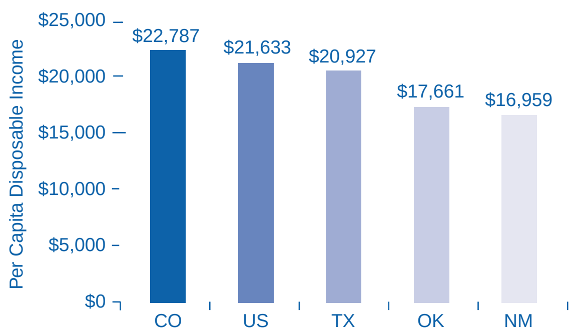
**Table 2**

**Problem Areas that Could Affect Economic Growth in 1999 and the States that Will Be Affected**

| | Colorado | New Mexico | Oklahoma | Texas |
|---|---|---|---|---|
| Decreased Exports to Asia | X | X | | X |
| Decreased Exports to Latin America | | | X | X |
| Major Correction in Stock Prices | X | X | X | X |
| Weak Agriculture Prices/Farm Income | X | | X | X |
| Slowdown in High-tech Investment | X | X | | X |
| Tight Labor Markets | X | | X | X |
| Rapid Commercial Development | X | | | X |
| Weak Oil Prices | X | X | X | X |
| Higher Living/Business Costs | X | | | |

CHART 1

Only Colorado Exceeds the U.S. in Per Capita Disposable Income (1997)




Source: U.S. Department of Commerce, Bureau of Economic Analysis

***New Mexico:*** **New Mexico** has lagged behind the nation in employment growth since 1996. That could change in 1999, although more as a result of U.S. job growth slowing down than New Mexico employment accelerating. In fact, New Mexico employment growth is forecast to grow at a moderate 1.5–2.0 percent this year.[4] The fallout from weak commodity prices in oil, copper, and molybdenum has exacted a heavy toll on the state's mining sector, and the recent rise in oil prices is unlikely to help the state's mining sector because of weakness in metallic mining. Although most of New Mexico's oil producers are small, in the aggregate they account for approximately 4 percent of its gross state product.[5] Many small producers have had to shut down production, some permanently, because prices have fallen far below breakeven.

The state's important government sector remains under pressure as a result of years of austere federal government budgets. Approximately one-quarter of New Mexico nonfarm employment is involved in government activity (the fourth-highest share in the nation), and job growth in this important sector was flat between December 1997 and December 1998.

Growth in the semiconductor industry was a major factor contributing to robust economic growth in the state during the first half of this decade. More recently, the semiconductor chip industry has been under intense price competition from overseas, resulting in sluggish growth. ***Intel, Motorola, Philips Semiconductors,*** and ***Sumitomo Sitix*** cut a total of 2,000 jobs in New Mexico as Asia's economic woes reduced demand for computer chips, cellular telephones, and other electronic products.[6]

Relatively low costs and continued in-migration will likely contribute to growth in the state's transportation, trade, and services sectors in 1999. The continued expansion of call centers and back office operations in the state, such as ***Sprint PCS*** and ***NationsBank,*** should also help pick up some of the slack in the economy.

***Oklahoma:*** Employment in Oklahoma has grown consistently between 2.5 percent and 3 percent for the past five years. An ailing oil and gas industry, however, is expected to cause some deceleration in Oklahoma job growth this year.[7] Although oil and gas employment is a much smaller share of total nonfarm employment in 1999 (2.2 percent) than in 1982 (9 percent), a large number of manufacturers across the state still depend heavily on the industry (e.g., producers of oil machinery, equipment, and pipelines). The decline in oil prices and working rig counts, and the reduction in exploration, well-servicing, and ancillary activities, will create a drag on economic activity in Oklahoma. Oil prices have rebounded in recent months, but there is a great deal of uncertainty concerning the level at which they will stabilize. Nonetheless, employment and production are likely to finish lower in 1999 than in 1998.

Helping to offset some of this weakness in the energy-related sectors will be a robust housing market, aggressive state and local economic development activities, and a growing transportation and communications sector. Oklahoma is also becoming more aggressive in exporting locally produced goods, such as primary and fabricated metals, furniture and wood products, industrial machinery, and instruments. The Asian crisis is not as big a problem for Oklahoma's economy as it is for the Region's other three states, because far fewer of Oklahoma's exports are destined for the Far East. Oklahoma stands to benefit from continued domestic in-migration and foreign immigration.

In 1998, commodity prices for corn, wheat, soybeans, and cotton fell to their lowest levels in decades. Last year's drought decreased production while global supply

[4] FOR-UNM Economic Forecasting Service, December 1998.

[5] Regional Financial Associates, Inc., December 1998.

[6] "New Mexico Economy Expected to Plod through '99," Macario Juarez, Jr., *Albuquerque Tribune,* December 31, 1998.

[7] "1999 Oklahoma Economic Outlook," College of Business Administration, Oklahoma State University.

and demand factors forced commodity prices downward. These circumstances have caused many producers to evaluate their risks more carefully in the event that commodity prices remain weak for another year.

***Texas:*** The Texas economy showed few signs of slowing in 1998, although there was a deceleration in job growth from 4.5 percent at the beginning of the year to nearly 3 percent at year's end. Asia's woes and the lowest oil prices in ten years affected the state's manufacturing and mining industries, resulting in thousands of lost jobs. Meanwhile, state exports rose 3 percent in 1998, their lowest annual growth rate so far this decade, compared with a decline of 1 percent for the nation. More telling, perhaps, is that Texas exports began declining in the second half of 1998, primarily owing to weakness in Asia and South America. These negative effects are likely to continue in 1999. Texas agriculture endured the effects of a severe drought and weakened Asian demand in 1998; the latter in particular negatively affected the price of key commodities such as cattle, wheat, corn, and hogs. A consensus opinion at the USDA's Outlook Conference projected continued weakness in farm prices and income during 1999.

Despite their recent rebound, oil prices remain below $20 per barrel, resulting in layoffs and cutbacks in oil exploration budgets. Between March 1997 and March 1998, crude oil prices fell by 38 percent, and oil and gas extraction employment in Texas fell by 11,700. Lower oil prices are affecting the Texas economy in two ways. First, spending plans for exploration and development, refining, and service companies have been dramatically reduced, resulting in laid-off workers. Second, lower oil prices mean less oil revenue for two of the state's major trading partners, Mexico and Venezuela, which in turn can be expected to lower their demand for Texas-produced goods and services. Unlike the situation in the 1980s, lower oil prices do not spell doom for the Texas economy. Economists at the ***Federal Reserve Bank of Dallas*** estimate that state employment growth is 75 percent less sensitive to oil price fluctuations today than it was in 1982.[8]

Thus, there is both good news and bad news in the 1999 Texas outlook. The bad news is that the state will face lingering problems in energy, foreign trade, and agriculture that will constrain growth. The good news is that much of the decline in these sectors appears to have occurred already. Although stabilizing at rather weak levels, these sectors are not likely to contribute to the further deterioration of economic growth.

### *Consumer Spending Has Been Key to the Region's Growth, but Growth in Spending May Increase Consumer Credit Risk*

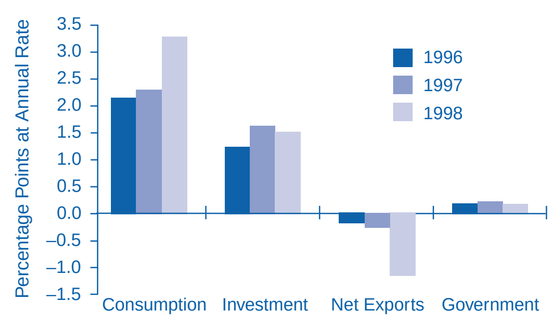
Consumers will be a key factor in the performance of the national and Dallas Region economies in 1999, when both are expected to enter a period of slower economic growth. Consumer spending has been particularly important to the Region, with the tremendous gains in retail spending of the past decade driving the Region's faster growth in gross regional product and employment compared with the nation. In 1999, with continued weakness in many foreign economies and a clouded export picture, consumers may once again be counted on to do the heavy lifting for the Dallas Region's economy.

Typically, consumer spending accounts for two-thirds of total domestic spending. Chart 2 shows the net contribution to real GDP that consumers have provided to the nation's economy in each of the past three years. Personal consumption expenditures (consumer spending) contributed 64 percent, 59 percent, and 85 percent of the net growth in real GDP in 1996, 1997, and 1998, respectively. The contribution by consumers last year was especially important because the ballooning U.S. trade deficit subtracted more than a percentage point from U.S. economic growth.

For the nation, consumer spending has achieved or exceeded 4 percent growth each year since 1995 and has

CHART 2

Consumers Contributed More Than 85 Percent to U.S. Economic Growth in 1998




Consumption = personal consumption expenditures, Investment = gross private domestic investment, Net Exports = U.S. exports less U.S. imports, Government = government expenditures
Source: U.S. Department of Commerce, Bureau of Economic Analysis

[8] Southwest Economy, Texas Update and Outlook, Federal Reserve Bank of Dallas, January/February 1999.

averaged over 4 percent during the 1990s, propelled by strong gains in personal income, decreasing inflation rates, and low interest rates. Last year was a particularly strong year, with retail sales gains of more than 5 percent for the nation.

Consumer spending has been very strong in the Region over the past decade. Three of its four states—Colorado, New Mexico, and Texas—had average retail sales growth rates above that of the nation. Retail sales growth in Colorado and Texas (two states that account for 85 percent of the Region's output) averaged more than 8 percent annually from 1990 to 1997, almost twice that of the nation for the same period.

### *Which Came First, Economic Growth or Consumer Spending?*

The tremendous growth in consumer spending in the Dallas Region during the 1990s has been fueled largely by the rapid growth in employment and income. However, other factors also have contributed. Two of these factors are significant changes in the household savings rate and changes in household debt levels relative to income. The household savings rate has declined dramatically during the 1990s (see Chart 3). The national rate of personal savings averaged between 7 and 8 percent from the 1960s through the early 1990s. Recently, the rate[9] has been decelerating, to 2.9 percent in 1996, 2.1 percent in 1997, 0.5 percent in 1998, and dipping below zero during the fourth quarter of 1998 for the first time since the 1930s.

Consumers also have been able to maintain their high level of spending by increasing their level of household debt relative to income. Since 1992, the debt-to-income ratio of households has climbed steadily (see Chart 4) in 1998, it surpassed 100 percent for the first time since records for this indicator have been kept.

Growing household wealth from stock market gains on retirement and other mutual fund holdings has increased consumers' confidence and their willingness to spend and borrow. The ***Conference Board's*** consumer confidence index stood at 133.9 in March 1999, inching back up toward the record level of 138.2 set in the summer of 1998. Meanwhile, the S&P 500 rose more than 20 percent for the fourth year in a row in 1998. At the close of fourth-quarter 1998, the S&P 500 index was 350 percent higher than when the current economic expansion began. Thus, despite high household debt-to-income levels, household debt relative to net worth has been declining since 1994 (see Chart 4).

In addition, although household debt relative to income is at historically high levels, the growth and level of household debt service burden (interest and principal payments relative to income) have been more modest in recent years. Debt service burdens have remained low, in part because of low interest rates and debt consolidation into lower-rate home equity loans. The declining interest rate environment and debt consolidation into home equity loans have allowed consumers to afford more debt.

[9] Personal savings rate data are collected and distributed by the Bureau of Economic Analysis.

CHART 3

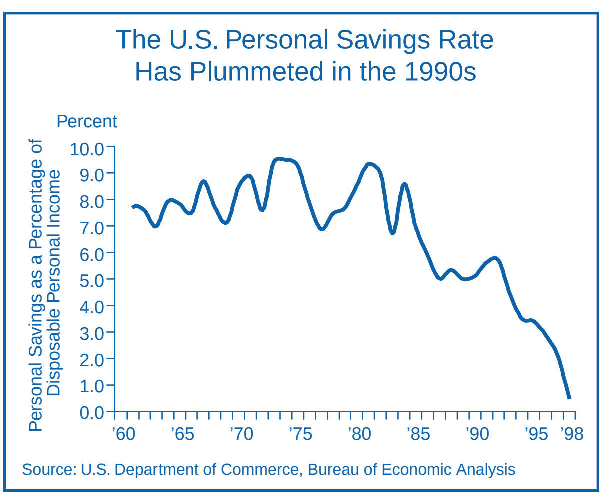
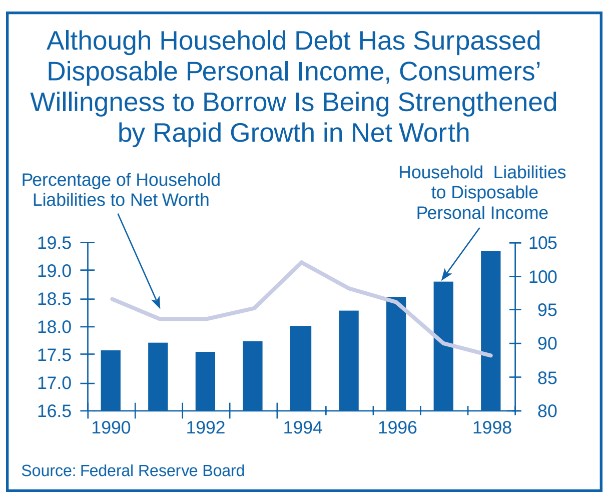



CHART 4



Households appear to be borrowing (credit cards, home equity loans, mortgages, etc.) in part as a result of increased wealth from the bullish stock market. It is not surprising that, since 1994, household liabilities as a percentage of disposable personal income have been increasing, while liabilities as a percentage of net worth have been decreasing (see Chart 4).

Income and employment growth, low interest rates, and rising household wealth have increased the economic well-being of consumers and have resulted in robust consumer spending and increased borrowing across the nation and especially in the Dallas Region. Although the strength of consumer spending has been good for the nation and the Dallas Region, there could be some negative aspects. Household debt relative to income is at historically high levels. Nonbusiness bankruptcies in the Dallas Region have accelerated greatly in the past four years. Considering that the rise in personal bankruptcies has taken place in otherwise very favorable economic conditions, a slowdown or recession would likely drive bankruptcy rates much higher.

Any significant rise in interest rates would not only exacerbate the debt service burden but would very likely diminish the net worth of consumers through losses in stock and mutual fund valuations. A recession caused or accompanied by higher interest rates, for example, could result in reduced household incomes, increased debt service burdens, and diminished net worth—a potentially troublesome mix for borrowers and their lenders.

### *Implications for Banking*

Consumer lending is an important business line for insured institutions in the Dallas Region. Financial institutions in the Region held $36.2 billion in consumer loans at December 31, 1998, representing 19.5 percent of all loans in the Region and significantly above the national average of 15.8 percent. Because the Region has few credit card banks and because credit card banks tend to be national in scope, these data suggest that the Region's insured institutions' exposure to consumer loans is more localized than many other parts of the country. In addition, banks and thrifts in the Region held $47.3 billion in residential mortgages (1- to 4-family) as of December 31, 1998, accounting for 26.4 percent of total loans.[10] Financial institutions across the nation have a similar aggregate exposure to consumer lending, but they tend to have a higher percentage of residential mortgages (29.5 percent for the nation compared with 25.5 percent for the Dallas Region).

Another way to determine the risk of consumer debt to the Region is to identify institutions that have significant exposure or rapid growth in consumer lending. A group of "consumer banks" (defined earlier in this publication's ***In Focus*** article were identified—21 financial institutions with $1.3 billion in assets. Although $1.3 billion is significant, it accounts for only 0.4 percent of total Dallas Region assets.

A broader analysis of consumer lending in the Region considers institutions that reported rapid growth in consumer loan portfolios. There are 683 insured institutions in the Dallas Region that have grown their consumer loan portfolios by 25 percent or more over the past three years. These banks reported solid earnings, evidenced by an ROA of 1.28 percent for 1998, the highest rate for this peer group since 1993. The net interest margin has been consistent, ranging between 4.53 and 4.62 percent over the past six years. In addition, these banks and thrifts reported consumer loan charge-offs of only 0.88 percent at year-end 1998, compared with 2.39 percent for the nation. The charge-off rate is very low; however, these portfolios are growing rapidly and have a large share of new, unseasoned loans. The real test for credit quality will be when these loans become seasoned. Despite the high growth for these institutions, their reported capital levels remain relatively high, with an aggregate leverage ratio of 8.76 percent, slightly above the 8.53 percent reported as the industry average.

Banks operating in areas where consumer bankruptcy rates are high, however, reported significantly different results. As shown in Table 3 (next page), 80 counties in the Dallas Region reported personal bankruptcy rates as high or higher than the national average of 4.72 percent based on December 31, 1997, data.[11] There were 458 banks in these counties, with assets of over $137 billion as of December 31, 1998. Of more concern are the 13 counties in the Region that reported bankruptcy rates 1.5 times the national average. These counties were headquarters for 86 banks and thrifts holding $20.5 billion in combined assets as of year-end 1998. It is noteworthy that these institutions have, on a merger-adjusted basis, reduced their exposure to consumer lending. Consumer loans as a percentage of total loans have decreased from 20.8 percent at June 30, 1997, to

[10] Mortgage and traditional consumer loans account for almost half of total loans in the Dallas Region.

[11] Bureau of the Census.

**Table 3**

| Institutions in Counties with High Bankruptcy Rates Hold 6 Percent of the Region's Assets | National Average 4.72% | | | 1.5 X National Average | | |
|---|---|---|---|---|---|---|
| | Inst (#) | Assets ($000s) | Counties (#) | Inst (#) | Assets ($000s) | Counties (#) |
| CO | 77 | 24,510,205 | 9 | 4 | 561,003 | 1 |
| NM | 23 | 8,578,333 | 7 | 0 | – | 0 |
| OK | 243 | 38,239,406 | 47 | 76 | 19,383,232 | 10 |
| TX | 115 | 66,204,423 | 17 | 6 | 590,925 | 3 |
| Region | 458 | 137,532,367 | 80 | 86 | 20,535,160 | 14 |
| Region (%) | 31.7 | 41.6 | 18.7 | 5.9 | 6.2 | 3.0 |

Source: Bank and Thrift Call Reports, December 31, 1998

14.7 percent at December 31, 1998. This rapid decline is a consequence of the contraction in consumer loan portfolios at the same time total loans were growing: consumer loan portfolios for these banks contracted 13.7 percent while total loans expanded 22.8 percent. Consumer loan charge-offs had been increasing steadily, from 0.92 percent for the quarter ending March 1996 to 6.52 percent for the quarter ending December 31, 1997. This trend suggests that bankers in these counties have recognized the distressed consumer environment and adjusted their loan portfolios accordingly.

*Dallas Region Staff*

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