Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION FOURTH 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.**

- ***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*—The Dallas Region's economy continued to moderate from very robust levels in the mid-1990s to a more sustainable 2 to 3 percent growth in the past year. Housing demand, although fairly strong, is expected to taper off in 2000. The Region's financial institutions are reporting healthy conditions; however, Oklahoma agricultural banks are showing signs of stress as evidenced by relatively high past-due levels. *See page 18.***

◆ ***Number of Institutions Electing S Corporation Status Is Increasing*—The number of financial institutions in the Region electing S corporation tax status increased dramatically; the Region now accounts for about one-quarter of all S corporation banks nationwide. Because of the effect of this tax-advantaged status on profitability measures, the conversion of a significant number of small institutions to Sub S status makes performance comparisons over time more difficult and may mask earnings deterioration in non–Sub S banks. *See page 22.***

◆ ***Lengthening MBS Maturities Could Expose Institutions to Higher Levels of Interest Rate and Market Risks*—Mortgage-backed securities represented over half the Region's total securities portfolio as of June 30, 1999, and have significantly longer maturities than the national average. While the unique asset mix of the Region's financial institutions may result in lower levels of credit risk, holding a greater percentage of securities may also expose many institutions to higher levels of interest rate and market risk. *See page 25.***

By the Dallas Region Staff

The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation institutions and financial institution regulators. It is produced for the following eight geographic regions:

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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.

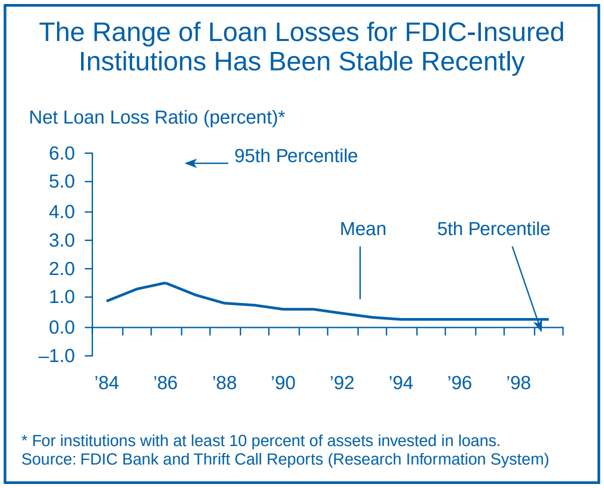
Indicators of Industry Performance

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



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).

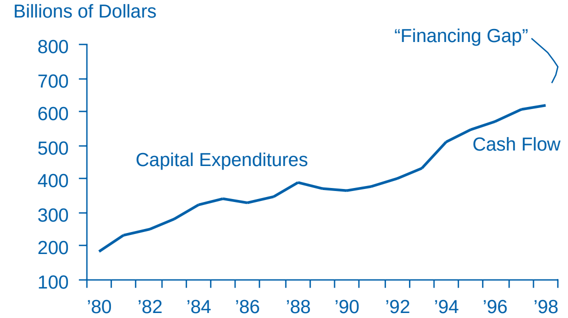
Chart 2 tracks the steady growth of fixed investment by U.S. corporations during the current expansion. It also shows, however, that growth in cash flow available to finance investment has slowed in recent years. This "financing gap" has grown steadily, reaching a record $86 billion in 1998.

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.

CHART 2

The Financing Gap Has Widened for Nonfinancial Corporations



Source: Federal Reserve Board (Haver Analytics)

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]

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-

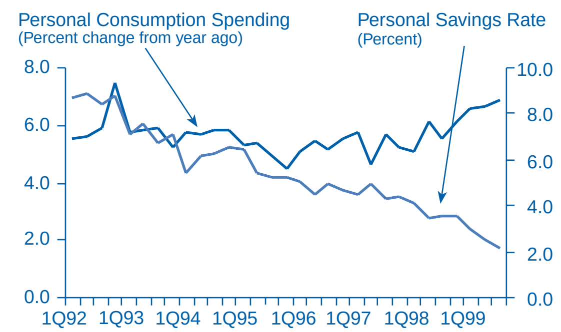
[3] The housing affordability index published by the ***National Association of Realtors*** equals 100 when the median family income qualifies for an 80 percent mortgage on a median-priced existing single-family home. The value of the index as of the third quarter of 1999 was 127.1.

[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

Strong Consumer Spending Has Been Accompanied by a Falling Personal Savings Rate



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).

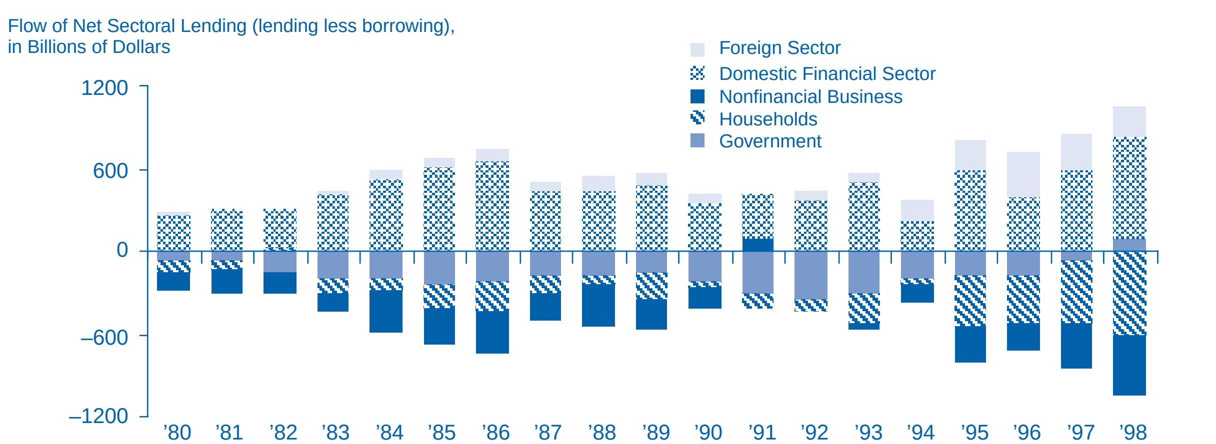
The private deficit was financed from three sources in 1998. One source was the $73 billion surplus in the government sector, the first surplus in 28 years. The largest portion of the 1998 private deficit was financed by the creation of credit by the domestic financial sector and by an inflow of foreign 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

Net Borrowing by Businesses and Households Represents a Growing "Private Deficit"



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.

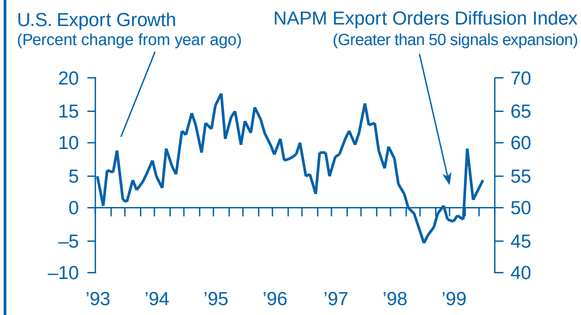
A global economic recovery during the first three quarters of 1999 has led to higher demand for investment capital outside the United States. The ***International Monetary Fund*** estimates that growth in the global economy will increase from 2.5 percent in 1998 to 3.0 percent in 1999 and 3.5 percent 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

U.S. Exports Fell in 1998, but Rising Orders Point to Growth in 1999



Source: Bureau of the Census; National Association of Purchasing Managers (NAPM) (Haver Analytics)

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.

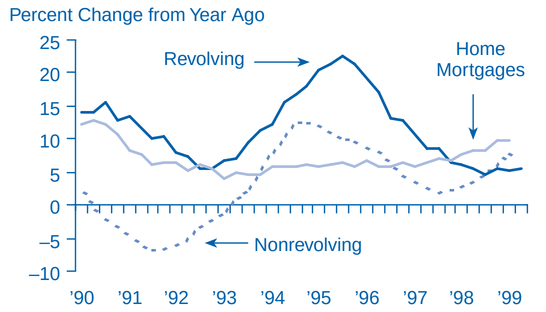
Consumer Lending

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

Household Borrowing Is on the Rise, Led by Increases in Mortgage Debt



Source: Federal Reserve Board (Haver Analytics)

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]

[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.

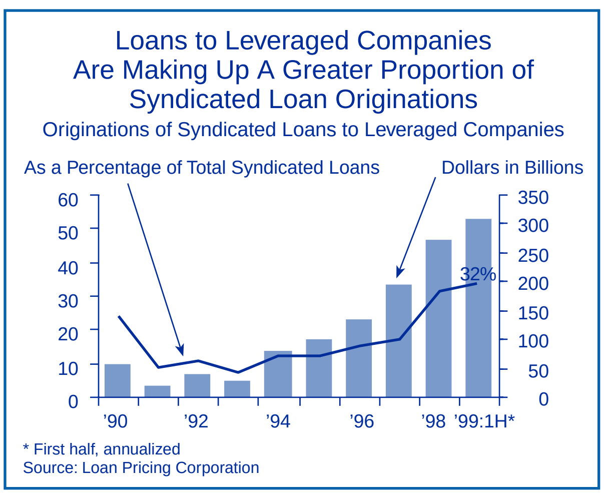
Factors driving growth in leveraged lending include a high volume of corporate mergers and acquisitions, increasing investor demand for higher-yielding loans, and a shift in preference for loans over bonds by high-yield issuers.[25] While bank syndicators pass a large volume of these loans along to nonbank 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.

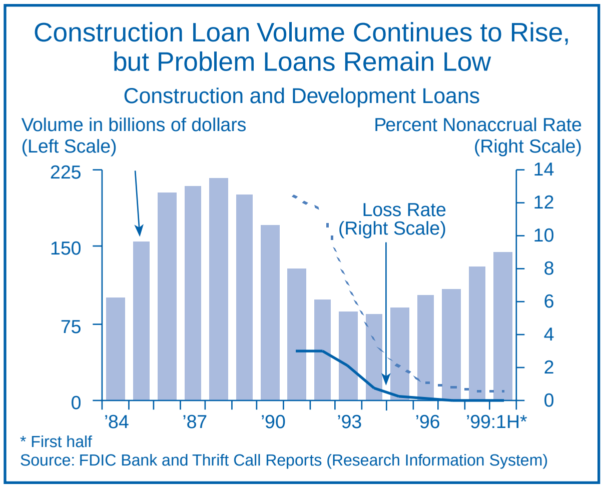
Office Vacancy Rates Are Rising in Many Top Markets

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



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.

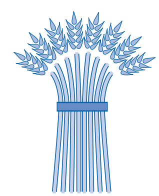
The FDIC also recently published the findings of a targeted evaluation of the underwriting practices of banks operating in three of the fastest-growing metropolitan areas in the country—Atlanta, Dallas, and Las Vegas.[29] Results indicated that competition was generally driving pricing margins down to 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.

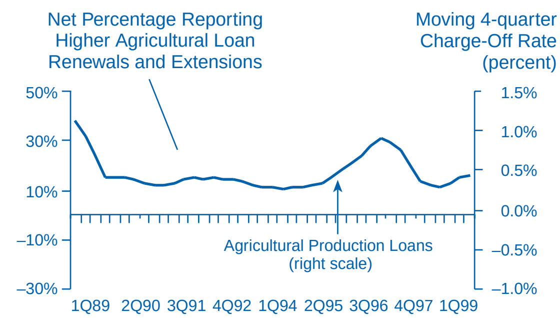
[33] Twenty-three percent of insured farm banks have adopted a Subchapter S designation since 1997, when banks were first allowed to take advantage of the favorable tax treatment available under this section of the Internal Revenue Service code. Because of the effects of this tax treatment on reported 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).

CHART 9

Rising Levels of Carryover Debt Suggest Future Increases in Loan Losses at Farm Banks



Reports (Research Information System)
Source: Federal Reserve Bank of Kansas City; FDIC Bank and Thrift Call

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.

[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.

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.

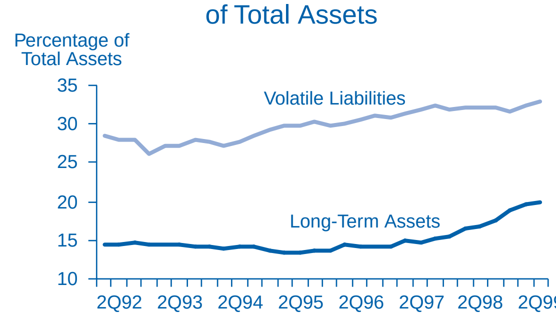
[37] Securitizations are often structured in tranches such that a subordinated security bears the credit risk for a senior piece. The relative size of the subordinated piece affects not only funding costs for the issuer, but also the amount of effective leverage achievable through securitization.

[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.

[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.

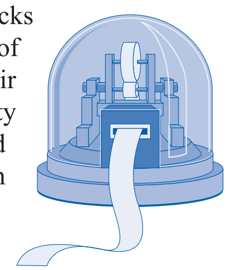
Implications

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 Dallas Region's economy continues to moderate, experiencing slower growth from very robust levels in the mid-1990s to a more sustainable 2 to 3 percent in the past year.**

- **Housing demand in the Region remains fairly strong and mortgage rates are still relatively low; however, home building peaked in 1998 and is expected to taper off in 1999 and 2000.**

- **Overall, financial institutions in the Dallas Region are reporting healthy conditions; however, Oklahoma agricultural banks are beginning to show signs of stress.**

- **The Region's financial institutions continue to elect S corporation tax status in dramatic numbers and currently account for 24 percent of all S corporation banks nationwide. Dallas Region Subchapter S banks report twice the return on assets of all other banks but also have a much higher dividend payout ratio to help shareholders pay their pass-through tax liability.**

- **Mortgage-backed securities with lengthening maturities may be exposing the Region's balance sheet to rising interest rates.**

Dallas Region Economy Continued to Moderate

The Dallas Region's economy continued to moderate during the second quarter. With payroll employment as an indicator, three of the Region's four states—**Oklahoma, Colorado,** and **New Mexico—**grew at or below the national average of 2.2 percent for the 12 months ending August 1999 (see Table 1). **Texas'** 2.7 percent employment growth rate continues to exceed the national average. However, with the exception of New Mexico, each of the Region's states experienced slowing growth rates from very robust levels in the mid-1990s to a slower but more sustainable 2 to 3 percent in the past year because of tight labor markets. New Mexico, however, continues to underperform the nation with an employment growth rate of less than 2 percent.

The construction, transportation, and services sectors continue as sources of strength for the Region's economy. In contrast, weaknesses in mining, which includes the oil and gas industry, and manufacturing resulted in lost jobs contributing to the slower growth rate. Recent mining employment data suggest that the industry may be stabilizing because of rising oil prices; after 15 consecutive months of job losses in the mining sector, employment finally touched bottom in July 1999.

All states in the Region continue to experience declining unemployment rates for the 12 months ending August 1999 (see Table 1). Reductions in unemployment continue to reflect tight labor markets and may have influenced recent market interest rate hikes. These interest rate hikes are expected to influence consumer decisions on purchasing and financing new and existing housing. The next section of this article discusses the importance of the housing industry to the Region and the potential effects of rising home prices and increasing mortgage rates.

Table 1

The Region's Employment Growth Is Slowing as Labor Markets Continue to Tighten

	Employment Growth Rate (%)		Unemployment Rate (%)	
Area	Aug-98	Aug-99	Aug-98	Aug-99
United States	2.6	2.2	4.5	4.2
Colorado	3.8	1.9	3.3	2.8
New Mexico	1.9	1.3	6.4	6.1
Oklahoma	3.9	2.1	4.3	3.4
Texas	3.8	2.7	5.0	4.4

Source: Bureau of Labor Statistics

Region's Hot Housing Market Expected to Cool by Year-End

Housing Has Been a Source of Strength throughout This Expansion

A strong housing market and stock market contributed to strong domestic consumption and economic growth in the Dallas Region throughout much of this expansion. The effects of home building on the local economy are significant. For example, the ***National Association of Home Builders*** estimates that for every 1,000 single-family homes built, 2,448 full-time jobs in construction and construction-related industries are created, $79.4 million in wages are paid, and $42.5 million in government revenues are generated. Building permits for approximately 155,000 single-family homes were authorized last year in the Dallas Region, the highest total this decade. Home building creates additional jobs and income in ancillary industries such as mortgage banking, furniture and appliances, home security, and landscaping. Finally, the combination of rising home values and lower mortgage rates allowed many homeowners to obtain cash-out refinancing or reduce monthly loan payments, fueling additional spending. During this expansion, Dallas Region households have spent at an average annual growth rate of 5 to 8 percent compared with the nation's rate of 4 to 5 percent.

Higher Mortgage Rates Have Not Yet Deterred the Region's Hot Housing Market

Despite mortgage interest rates rising to their highest level in two years, new and existing home sales and residential building permits remained strong through the summer (see Chart 1, next page). According to the ***Federal Home Loan Mortgage Corporation,*** the monthly average commitment rate[1] on 30-year fixed-rate mortgages reached a low of 6.71 percent in October 1998. Mortgage rates, however, did not begin escalating until after April 1999, rising 71 basis points in three months to 7.63 percent in July 1999. The ***Mortgage Bankers Association of America*** reported that average contract interest rates for 30-year fixed-rate mortgages reached as high as 8.15 percent in mid-August.

[1] Commitment rate is the interest rate a lender would charge to lend mortgage money to a qualified borrower exclusive of the fees and points required by the lender. This commitment rate applies only to conventional financing on conforming mortgages with loan-to-value ratios of 80 percent or less.

Despite the higher rates, single-family building permits for the first seven months of 1999 exceeded last year's pace by 5 percent, reflecting the strong underlying demand for new homes in the Dallas Region. How has the Region's housing demand remained strong at a time when mortgage rates are rising? Contributing factors include the following:

- *Moderately strong job growth.* Nonfarm employment continues to grow at a healthy clip of 2.5 percent, slightly faster than the nation, and a rate that would result in approximately 350,000 new jobs in the Dallas Region in 1999. Job growth, even more than mortgage interest rates, is considered the most important variable driving housing demand.

- *Moderately strong levels of in-migration.* The Dallas Region recently has enjoyed significant success in attracting relocating businesses and families. These in-migrants have an immediate effect on housing demand. The Region's population growth is twice that of the nation; in recent years, both domestic and foreign in-migration contributed to the strong housing demand.

- *Rising home prices and mortgage rates.* In the near term, concern about rising home prices and mortgage interest rates may encourage potential home buyers to enter the housing market as quickly as possible.

- *Alternative mortgage products.* The renewed popularity of adjustable-rate mortgages (ARMs) and the introduction of hybrid ARM products have provided homebuyers with access to low mortgage rates, benefiting those who might otherwise have been shut out of the housing market.

- *Affordable housing.* Seven of the ten most affordable housing markets in the nation are in Oklahoma and Texas, according to ***Coldwell Banker Real Estate Corporation's*** twenty-first annual home price comparison index.[2] Low-cost housing and a significant

[2] The Coldwell Banker Real Estate Corporation home price comparison index surveys 300 major U.S. housing markets with the following characteristics: 2,200 square feet, four bedrooms, two and a half baths, a family room (or equivalent), and a two-car garage. Surveyed homes and neighborhoods are typical for corporate middle-management transferees.

number of first-time home buyers have helped keep average and median home prices low in the Dallas Region.

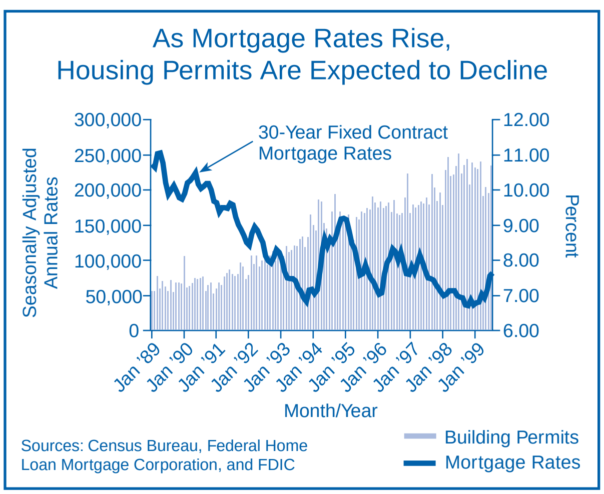
However, Home-Building Activity Is Expected to Cool Later This Year

While the housing market has been strong this year, a slight slowing in residential building permits is anticipated later this year and into 2000 because of the following factors:

- *Slower job growth.* Economists from ***Regional Financial Associates*** are forecasting a further slowing in employment growth, from 2.3 percent in 1999 to 1.9 percent in 2000. Slower job growth can be attributed, in part, to a moderating U.S. economy (according to the ***August 1999 Blue Chip Consensus Forecast,*** economic growth is expected to slow from 3.9 percent in 1999 to 2.6 percent in 2000) and tight labor markets. Regional labor force growth decelerated to 1.4 percent in July 1999 from 2.8 percent a year earlier.

- *Higher mortgage rates.* Even though mortgage rates are considerably lower than they were five years ago, their recent rise is expected to have a negative effect on housing demand, particularly among first-time homebuyers (see Chart 1). Many housing analysts believe mortgage rates will continue to fluctuate between 7.75 percent and 8.25 percent over the near term.

CHART 1



- *Higher home values.* Many local realtor real estate associations in the Region are reporting a shortage of available housing. In many places, homes that would sell in six months in a stable market are now selling in only three to four months. In addition, builders' backlogs have lengthened considerably because of shortages in raw materials and skilled labor. These low housing inventories and shortages in labor and materials have caused a sharp increase in home values. **Denver** home prices are rising at a double-digit rate; one local real estate agent estimates that home prices in the Denver market are increasing $2,000 to $3,000 a month. Although many of the Region's housing markets are some of the more affordable in the nation, prices are much higher than a year ago in several metropolitan markets.

In summary, housing demand in the Region remains fairly strong, and mortgage rates are relatively low. However, home building peaked in 1998 and is expected to slow in 1999 and 2000. Looking at rates over the past ten years, it is clear that mortgage and unemployment rates have strongly influenced the number of residential building permits.[3] In fact, the regional unemployment rate, more so than the level of mortgage rates, was strongly related to the number of building permits. For example, a percentage point increase in the Region's unemployment rate, on average, resulted in a reduction in the number of residential building permits in the Dallas Region by approximately 34,500. Similarly, a 100-basis-point increase in mortgage rates (with a two-month lag) resulted, on average, in a decline of 28,300 residential building permits in the Region. The fact that the demand for building permits remains strong may be attributed to the strong regional economy mitigating the effects of slightly higher mortgage rates, which is what the model would predict given that the Region's unemployment rate continues to decline. In addition, the recent rise in mortgage rates is unlikely to show up in the building permit data until fourth quarter 1999.

[3] The following linear regression model developed by the Dallas Region office was estimated:
$Y=\beta_0+\beta_1X_1(Lag)+\beta_2X_2+\epsilon_i$, where Y is the dependent variable building permit; X_1 and X_2 are the independent variables Mortgage Rate and Unemployment Rate, respectively; β_0, β_1, and β_2 are unknown parameters; and ϵ_i is the error term.
This model proved to be statistically significant with the independent variables explaining 92 percent (R^2) of the variation in the dependent variable. The independent variables tested are both statistically significant at the 0.001 alpha level. In addition, a first-order autoregressive technique was applied to obtain unbiased estimators.

Dallas Region Financial Institutions Report Healthy Conditions

The strength of banks' and thrifts' earnings is evidenced by the strong return on assets (ROA) and the decrease in the percentage of unprofitable institutions (see Table 2). The average ROA for the Dallas Region was 1.34 percent for the second quarter of 1999, 13 basis points higher than the nation and 23 basis points higher than the Region's first-quarter ROA. The Region has tracked at or above national ROA averages since 1990, when it recovered from the bank and thrift crisis of the late 1980s. The Region's average charge-off and past-due rates show improvement over the previous quarter and compare favorably with the national averages.

While Oklahoma banks and thrifts appear to be performing in line with the nation and the Region, one group is showing signs of stress. Even though the average Oklahoma agricultural bank[4] reported an ROA of 1.25 percent, slightly below rates reported for the Region, past-due ratios remain relatively high. As of June 30, 1999, the overall past-due ratio for Oklahoma agricultural banks was 3.43 percent, significantly higher than the 2.63 percent for all other agricultural banks in the nation. Moreover, this represents a significantly higher past-due ratio than reported by the nation at 1.98 percent or the Region at 2.22 percent. The largest past-due portfolio segments for Oklahoma agricultural banks include agricultural real estate loans (3.54 percent) and commercial and industrial loans (4.30 percent), which include commercial loans to agricultural producers. Credit quality deterioration is attributed to weather-related problems and, more recently, to low commodity prices that are often below breakeven levels for many producers. Another year of depressed commodity prices will further stress agricultural producers and their local economies and likely will have a negative effect on banks' performance. In addition, oil prices, until recently at record lows,[5] continue to pressure Oklahoma rural economies.

The appearance of strength in the composite agricultural bank ROA may be misleading because 36 of the 107 Oklahoma agricultural banks are Subchapter S banks. These banks reported an average ROA of 1.71 percent for the second quarter of 1999, which can be attributed, in part, to the favorable tax treatment associated with S corporation status. The remaining 71 non–S corporation Oklahoma agricultural banks reported an ROA of only 1.07 percent for the same period, down 9 basis points from second-quarter 1998.

[4] Agricultural banks are defined as banks with over 25 percent of total assets deployed in agricultural land or production loans.

[5] As discussed in previous issues of ***Regional Outlook.***

Table 2

Dallas Region Profitability Remains Strong during Second-Quarter 1999

Percentage	U.S.	Region	Colorado	New Mexico	Oklahoma	Texas
Return on Assets	1.21	1.34	1.53	1.35	1.27	1.31
Return on Equity	14.07	16.09	20.32	16.02	14.11	15.85
Net Interest Margin	3.89	4.24	4.93	4.50	4.23	4.11
Non-Interest-Bearing Deposits (% Total Assets)	11.38	16.49	19.64	13.65	12.14	17.02
Leverage Ratio	7.78	7.91	7.40	8.02	8.14	7.94
Loan-to-Asset Ratio	61.42	57.58	51.59	53.34	60.01	58.49
Past-Due Loans	1.98	2.22	1.95	2.49	2.17	2.25
Charge-Off Rate	0.49	0.37	0.43	0.38	0.25	0.38
Percent Unprofitable	6.71	5.77	4.95	6.15	7.28	5.36

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

Subchapter S Election Helps Boost Profitability Levels of Small Institutions

When Congress passed the ***Small Business and Job Protection Act of 1996,*** insured institutions became eligible beginning in 1997 to elect S corporation status. (S corporations are also known as Subchapter S or Sub S corporations, which refers to the section of the Internal Revenue Code administering S corporations.) Since that time, over 1,300 banks and savings institutions have elected Subchapter S status, representing more than 12 percent of the industry. The Dallas Region was headquarters to 313 Sub S banks as of June 30, 1999, or 24 percent of all Sub S banks nationwide.

For federal income tax purposes, an S corporation is treated as a pass-through entity similar to a partnership and is not subject to any federal income taxes at the corporate level. Sub S shareholders include their proportionate share of a Sub S bank's income with their personal federal income tax computation. This generally eliminates tax at the corporate level and usually lowers the overall burden for the bank and its shareholders. Therefore, S corporation shareholders generally pay their share of federal income taxes regardless of whether cash is distributed to shareholders.

Small institutions are more likely to elect S corporation status because of the limitation on the number of shareholders that can participate (currently 75). The national median size for S corporation banks was $56 million as of June 30, 1999. In the Dallas Region, 238 small banks and thrifts (institutions with assets of $100 million or less) elected S corporation status as of the end of second quarter 1999; these institutions control almost $12 billion in assets and represent 25 percent of all the Region's small banks. As shown in Table 3, Texas was home to 180 S corporation institutions as of June 30, 1999, up from 40 institutions just two years ago. Texas ranks first in the nation in the number of S corporation banks and assets held.

Subchapter S banks and thrifts are located primarily in the central United States (see Map 1); the Dallas, Chicago, and Kansas City Regions account for 83 percent of all Sub S institutions nationwide. The majority of agricultural banks also are located in these areas of the country. The preponderance of small unit banks is one explanation for the geographic concentration of Sub S institutions. In addition, agricultural banks[6] represent the largest single bank group electing S corporation status; more than 27 percent of Dallas Region agricultural banks had elected S corporation status as of the end of second-quarter 1999. Twenty-four percent of the assets held by Oklahoma institutions were in Sub S banks as of June 30, 1999, the highest percentage of any state in the nation.

S corporation elections are making it increasingly difficult to examine long-term profitability trends and can mask earnings deterioration between periods. In the aggregate, the growing number of S corporations has helped offset marginal profitability at other small banks. For example, small Sub S banks and thrifts in the Region reported an ROA of 1.81 percent for the second quarter of 1999. Non–Sub S institutions in the Region reported an ROA of 0.98 percent for the same period. Meanwhile, small Sub S institutions nationwide reported an ROA of 1.62 percent, 67 basis points higher than small, non–Sub S banks and thrifts. The net effect of the favored Sub S tax treatment is to increase Sub S banks' profitability. Sub S bank results could make it more difficult to compare current results with prior periods,

[6] Banks and thrifts with more than 25 percent of total loans held in agricultural land or production.

Table 3

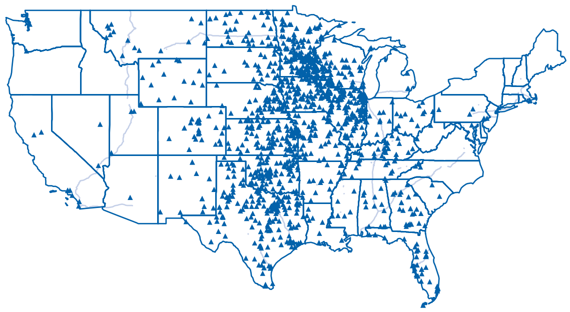
ROA Advantages Increase Attractiveness of S Corporation Status

	June 30, 1999		March 31, 1997	
	Number	$ Millions	Number	$ Millions
Texas	180	19,301	40	3,525
Oklahoma	92	11,025	30	1,535
Colorado	27	2,271	7	414
New Mexico	14	1,449	4	317
United States	1,305	124,278	411	26,485

Note: ROA = return on assets
Source: Bank and Thrift Call Reports, June 30, 1999

Map 1

Subchapter S Banks
Are Concentrated in the Midwest



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

when Sub S banks were less prevalent. In fact, in an interview with the ***American Banker,*** Richard A. Soukup, a partner at ***Grant Thornton LLP,*** acknowledged that "S corporation and non–S corporation banks cannot be compared."[7]

Other Factors That Differentiate Sub S Banks

Because a Sub S bank's tax liability passes through the corporation to the shareholders, Sub S banks have a much higher dividend payout ratio than non–Sub S banks. For calendar year 1998, Sub S banks in the Region paid out almost 90 percent of earnings in dividends, compared with nearly 71 percent for non–Sub S banks (see Table 4). Typically, Sub S banks also have a higher leverage ratio. A lower percentage of Subchapter S banks—2.2 percent—are unprofitable, compared with 7.31 percent of non–Sub S banks for Dallas Region institutions in calendar year 1998.

While the S corporation election offers tangible tax savings to shareholders, there are also potential disadvantages: the limitation on the number of shareholders makes raising additional capital difficult, few noncash options are available for making acquisitions, and there is pressure to pay dividends to fund shareholder tax liability rather than retain capital that may be required for safety and soundness purposes. The latter disadvantage may be particularly problematic when an institution takes a large provision for loan losses but has not yet charged off specific loans. These potential disadvantages could raise safety and soundness concerns should an institution incur significant operating losses.

Legislative Initiatives

The ***American Bankers Association*** and other banking trade groups have supported legislation to expand the eligibility of Sub S status to counter credit unions' tax-advantaged status. U.S. House Resolution 2488, known as the ***Taxpayer Refund and Relief Act of 1999,*** was introduced on July 13, 1999. On August 5, 1999, the House and Senate approved the bill; however, the president vetoed the legislation. Two of the bill's more popular provisions may be attached to future legislation: excluding bank investment securities from passive income limits and a clarification of qualifying bank director stock.[8] In addition, bank trade groups have indicated they will continue to support legislation increasing the number of shareholders from 75 to 150.

[7] "Agencies to Adjust ROA Lists for S Corporation Skewing." *American Banker,* February 5, 1999, page 6.

[8] According to the *American Bankers Association Subchapter S Registry Report,* August 1999, page 2.

Table 4

Higher ROA and Dividend Payout Ratios Distinguish Sub S Banks

	Dallas Region			United States		
As of 12/31/98	Sub S	Non–Sub S	Combined	Sub S	Non–Sub S	Combined
Count	270	1,176	1,446	1,072	9,391	10,463
Return on Assets	2.30	1.04	1.16	1.98	1.18	1.16
Assets ($ Billion)	30	301	331	100	6,556	6,656
Leverage	8.96	7.74	7.85	9.53	7.77	7.59
Past-Due Ratio	2.89	2.32	2.37	2.71	1.96	2.17
Dividend Payout Ratio	89.11	70.97	73.18	81.29	65.56	66.11
% Unprofitable	2.22	7.31	5.74	3.45	7.49	5.75

Source: Bank and Thrift Call Reports, December 30, 1998

While there is no statistical information available on how many financial institutions are eligible to elect Sub S status, almost 5,000 small banks are not currently Sub S. Since many of the eligible institutions have already elected S corporation status, the rate of growth of the number of S corporations will likely slow. However, if some of these legislative initiatives are eventually enacted, more banks may elect this tax-advantaged status.

Dallas Region Maintains High Profitability Levels despite a Higher Allocation of Securities

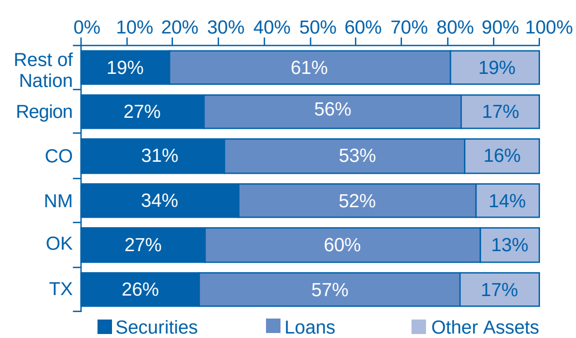
The Dallas Region differs significantly from other parts of the country in its composition of funding liabilities, most notably the higher percentage of core deposits and less extensive use of other borrowings. The advantage of this lower funding-cost structure may help determine how assets are allocated among loan types and securities investments. This discussion examines the asset side of the balance sheet, particularly the securities and mortgage components.

Securities Are a Major Component of Dallas Region Balance Sheets

The Dallas Region is unique in that it has a higher percentage of securities on its balance sheet than any other part of the country. As shown in Chart 2, Dallas Region financial institutions invested 27 percent of total assets in securities compared with 19 percent for the rest of the nation as of June 30, 1999. Institutions that have more than 30 percent of total assets in securities investments include commercial banks with assets of less than $1 billion and all institutions in Colorado and New Mexico. The Region's savings banks and large U.S. commercial banks hold the smallest percentage of securities to total assets, each less than 15 percent.

CHART 2

Dallas Region Insured Institutions' Asset Allocation Is More Heavily Weighted to Securities than the Rest of the Nation



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

While there is little empirical data to confirm why Dallas Region institutions, on average, hold a higher percentage of securities than the rest of the nation, there are two possible explanations.

First, Dallas Region banks and thrifts enjoy a much lower cost of funding. This cost structure enables institutions to hold lower-yielding assets and achieve similar ROA levels. The Region's commercial banks have a greater share of deposits in non-interest-bearing deposits—19.7 percent of total assets compared with 4.1 percent for savings institutions and 10.8 percent for institutions nationwide (see ***"Banks and Thrifts Report Strong, but Somewhat Weaker, Performance in Third Quarter," Regional Outlook,*** third quarter 1999). These deposits provide a low-cost source of funding and are a key reason why the Region's commercial banks maintain competitive levels of profitability, even with a relatively low loan-to-asset ratio.

The other reason is rooted in Texas' and Oklahoma's real estate and oil crisis in the late 1980s. Harvey Rosenblum, Federal Reserve Bank of Dallas Senior Vice President and Director of Research, describes this as follows:

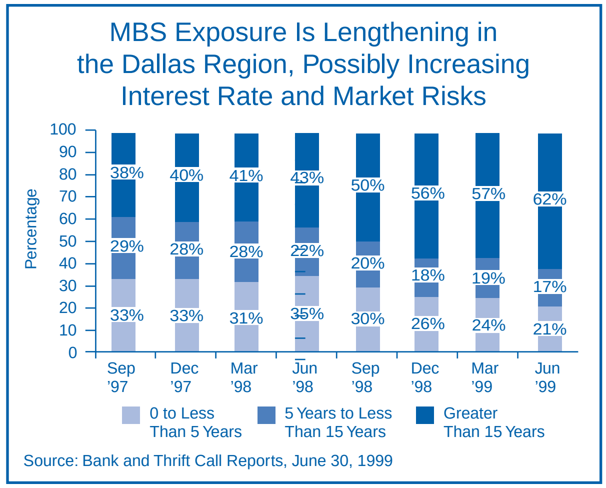
> *During the second half of the 1980s the Texas banking industry experienced a depression. Unlike a recession, a depression is more than an economic event; it is a psychological trauma that becomes indelibly stamped in one's memory and in the industry's "genetic code." In these circumstances, it takes a long time to forget the ordeal, and behaviors are altered to avoid repeating past mistakes associated with the event.... The balance sheets of Texas banks reflect more caution than they did a decade and a half ago.*[9]

[9] Federal Reserve Bank of Dallas *Southwest Economy,* Issue 3, May/June 1999, pages 5–6.

So why does the Dallas Region hold a greater percentage of securities? The answer may very well be a combination of a lower cost of funding and a conservative mind-set. The bottom line is that the Region's banks and thrifts have enjoyed strength in earnings and credit quality since the Region's recovery in the early 1990s.

The higher allocation of securities typically indicates a more conservative risk profile. Moreover, the strength and duration of the economy suggest that this asset allocation may be a conscious choice to reduce credit risk. However, there is also the potential for increased levels of exposure to interest rate risk and market risk. In particular, in an increasing interest rate environment, bond values often depreciate and cash flows may suffer.

CHART 3



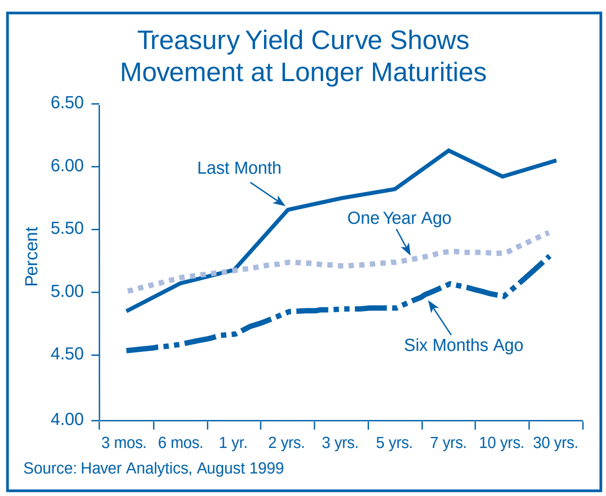
Maturities of Mortgage-Backed Securities Lengthen

Mortgage-backed securities (MBS), pass-through,[10] and non-pass-through represented 53 percent of total securities in the Dallas Region as of June 30, 1999, up from 40 percent at year-end 1990. The aggregate dollar amount exceeds $47 billion and represents 14.2 percent of the Region's total assets. For the Region, MBS maturities have been lengthening; in fact, MBS maturities over 15 years increased from 38 percent to 62 percent over the two-year period ending June 30, 1999 (see Chart 3). Financial institutions across the nation have also seen an increase in maturity, but not to the same degree. For the nation, MBS maturities over 15 years have increased from 35 percent to 48 percent over the same period.

There are primarily two reasons why investors would seek longer maturities on a bond investment. First, the expectation that interest rates will decline increases the value of the bond. Investors also may want to gain additional yield because higher rates are generally paid for longer maturity instruments to compensate for the uncertainty of what interest rates may do over time. Over the past year interest rates have risen, and, more important, the slope of the yield curve has steepened (see Chart 4), making long-term instruments more attractive to investors. As of August 31, 1998, the spread between the 30-year Treasury bond and 3-month Treasury bill was 50 basis points. Six months later the spread was 81 basis points, and as of August 31, 1999, the spread was 120 basis points. Lenders now have a greater incentive to lengthen the maturity of debt securities. However, the longer maturities expose banks to increased market risk and interest rate risk.

In addition, in a declining interest rate environment, there is a higher prepayment risk associated with MBS when borrowers refinance at lower rates. In a rising interest rate environment, the value of the underlying security falls as the present value of the cash flow decreases. Loss exposure on longer maturities in a rising interest rate environment is magnified because the investor will continue to receive the lower interest rate for a longer period. The ***American Banker*** recently reported that "investors are shying away from mortgage-backed securities despite a strong housing market and

CHART 4



[10] Defined as a debt instrument secured by an undivided interest in a pool of mortgage loans. Investors receive pro-rata shares of the cash flows from the underlying mortgages.

declining prepayment rates."[11] Craig Ellinger, associate director for MBS at Chicago-based ***PPM America Inc.,*** stated, "The fear of inflation and concern that the market could become flooded with securities is hurting the entire fixed-income sector."[12] Some analysts are voicing concern that these factors could lead to a liquidity crunch for MBS similar to what was seen in the fall of 1998.

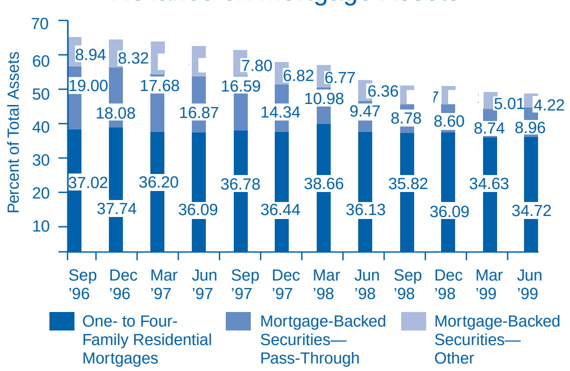
Savings Banks Reduce Holdings of Traditional Mortgage Products

In contrast to commercial banks, Dallas Region savings banks decreased their investment in residential mortgages (direct loans and MBS) from 65 percent of total assets as of September 30, 1996, to 48 percent at midyear 1999 (see Chart 5). During the past three years, the Region's savings banks increased their allocation of higher-yielding construction and consumer loans. Construction loans increased from 9 to 14 percent of total loans while consumer loans increased from 15 to 20 percent of total loans. Whether this is an attempt to diversify portfolios or seek higher yields is uncertain, but construction and consumer lending typically are associated with greater volatility during economic downturns.

[11] "Wall Street Watch: Investors Reluctant to Embrace Mortgage-Backed," *American Banker,* September 7, 1999.
[12] *Ibid.*

CHART 5

Dallas Region Savings Banks Reduce Reliance on Mortgage Assets



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

Conclusion and Summary

In conclusion, Dallas Region banks and thrifts differ in very tangible ways from financial institutions across the county. The Region tends to have a higher share of securities investments, perhaps because of lower funding costs or caution rooted in memories of the last real estate and oil crisis. Lower Region funding costs, on average, counterbalance lower-yielding securities investments resulting in the Region's ROA tracking at or above the national average since 1990. MBS influence many banks' profitability levels, with MBS representing over half the total securities portfolio as of June 30, 1999. While MBS maturities lengthened for the nation and the Region, 62 percent of the Region's MBS have maturities in excess of 15 years, significantly higher than the national average. Dallas Region financial institutions' unique asset mix may very well reduce levels of credit risk, but holding a greater percentage of securities in these institutions' portfolios appears to expose many institutions to increased levels of interest rate risk and market risk.

Dallas Region Staff

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