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- **Economic Conditions and Emerging Risks in Banking**—This article provides an overview of economic conditions and banking industry trends, with a primary focus on potential risks to insured depository institutions.
  - **Economic Developments**—Low interest rates, dormant inflation, and rising stock markets have all contributed to a generally positive near-term outlook for the U.S. economy. See page 3.
  - **Trends Affecting Banking Lines of Business**—Although credit conditions appear strong, risks exist in the major banking lines of business. See page 7.
    - **Consumer Lending**—Continued high consumer loan loss rates raise questions about how lenders will fare under less favorable economic circumstances. See page 8.
    - **Commercial Lending**—Corporate loan growth accelerated in 1998 even as the corporate sector showed signs of stress. See page 9.
    - **Commercial Real Estate and Construction Lending**—Selected metropolitan markets are experiencing rapid commercial development despite declining indicators of demand. See page 10.
    - **Agricultural Lending**—Falling commodity prices threaten U.S. farm operators. See page 11.
    - **Funding and Interest Rate Risk**—Intense competition and the changing term structure of interest rates have presented challenges for banks and thrifts. See page 12.
  - **Indicators of Industry Performance**—Weaknesses appear to be developing for banks with certain types of exposures, and the dispersion in performance among insured institutions is increasing. See page 13.

Regional Perspectives

- **Region’s Economic and Banking Conditions**—Unemployment rates remained low in 1998, but personal income grew relatively slowly. Low commodity prices depressed farm incomes in 1998 and are expected to continue to stress agriculture and related industries in 1999. Farm banks continue to report satisfactory operating results, but the level of problem loans is increasing in parts of North Dakota and Minnesota. See page 16.
- **Low Energy Prices Threaten Jobs in Kansas and North Dakota**—Low oil prices have already caused the permanent shutdown of many oil wells in Kansas. If low prices persist, losses of energy-related jobs are expected in Kansas and North Dakota. See page 18.
- **Sprint’s New Office Complex May Challenge Kansas City’s Office Market**—Vacancy rates throughout the metropolitan area are expected to increase significantly over at least the next two years after Sprint relocates to its new office complex in Johnson County, Kansas. See page 21.

By the Kansas City Region Staff
The *Regional Outlook* is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation for the following eight geographic regions:

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Economic Conditions and Emerging Risks in Banking

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

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

Economic Developments

Conditions Have Improved Markedly since Late 1998

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

Consumer Spending and Business Investment Are Key to Economic Strength

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

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

The underlying factors that drive consumer spending are strong. Low unemployment and rising real incomes have boosted the Conference Board’s consumer confi-
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Chart 1
Low Interest Rates and High Stock Prices
Fuel Consumption and Investment

<table>
<thead>
<tr>
<th>Year</th>
<th>Personal Expenditures* (%)</th>
<th>Investment in Producers’ Durable Equipment* (%)</th>
</tr>
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<tbody>
<tr>
<td>1990</td>
<td>20</td>
<td>10</td>
</tr>
<tr>
<td>1991</td>
<td>15</td>
<td>5</td>
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<td>1997</td>
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<td>–10</td>
</tr>
<tr>
<td>1998</td>
<td>–10</td>
<td>–5</td>
</tr>
</tbody>
</table>

* Annual Inflation-Adjusted Rate of Change
Source: Bureau of Economic Analysis

Chart 2
Housing Starts and Home Sales Reflect the Strength of the Consumer Sector

Conditions Vary across Industry Sectors

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

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

Percent Decline in Prices from January 1997 to March 1998

- All commodities*:
  - Tin: –5.3%
  - Steel: –7.7%
  - Wheat: –29.1%
  - Benzene: –36.2%
  - Crude Oil: –40.6%
  - Gasoline: –47.4%

* Producer Price Index (PPI)

Source: Journal of Commerce, Bureau of Labor Statistics

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

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

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

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

Despite the weakness in foreign demand that was observed during much of last year, U.S. exports rose sharply at the end of 1998. Total exports jumped by 19.7 percent during the fourth quarter, contributing 2.0 percent of the total 6.0 percent growth in GDP during the
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quarter. This unexpected increase in U.S. exports involved nearly every region of the world except Eastern Europe. Export shipments increased across most product types, with the greatest increase in activity observed in capital goods.

The Outlook for the Global Economy Remains Uncertain

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

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

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

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

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

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

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

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

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

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

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

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

The second type of shock that could end the expansion is a sustained period of deflation. Concern about deflation arises from the low prices many commodity producers are receiving and the effects of foreign currency devaluations on U.S. import prices. Although these trends have helped to keep U.S. inflation and interest rates low, at some point they could impose a heavier burden on U.S. businesses by shrinking revenues and profit margins, mirroring what has already occurred in some commodity-based industries.¹

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


**Trends Affecting Banking Lines of Business**

**Overview**

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

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

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

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

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

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

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

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

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

**Commercial Lending**

Commercial Loan Performance Remains Strong but Corporate Financial Strains Are Developing

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

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

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8 The Merrill Lynch U.S. Investment Grade Corporate Bond Master Index indicates that corporate bond spreads over ten-year Treasury rates rose 58 percent, an increase of 63 basis points, from the end of July 1998 to the end of October 1998.
9 See the Bureau of Economic Analysis Corporate Profit Index.
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also reflected in the level of corporate bond defaults, which Standard and Poor's reported at 48 ($10.8 billion in affected debt) in 1998, up 182 percent from 1997 levels (up 150 percent in dollar volume terms).\(^{11}\)

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

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

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

Commercial Real Estate and Construction Lending

Construction Loan Growth Accelerates as Overbuilding Pressures Increase in Certain Markets

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

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

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\(^{13}\) Syndicated loans are credit facilities made to medium and large corporate borrowers by a group or syndicate of lenders. Analysts often segment this market into “leveraged” lending (loans to heavily indebted companies) and nonleveraged lending.

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

\(^{15}\) Construction loan growth captures growth in both residential and nonresidential development.
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has not yet abated to reflect moderating demand levels. Overbuilding concerns may be tempered to the extent that tighter commercial real estate lending standards slow the pace of development.

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

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

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

Agricultural Lending

Farm Banks Threatened by Falling Commodity Prices

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

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

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

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

19 A substantial portion of the USDA’s projected decline in the net cash income for U.S. farmers over the next five years is attributable to reductions in government payments to farmers.
bank crisis of the mid-1980s. Current favorable factors include 1) lower debt-to-equity for farm producers; 2) substantially lower interest rates; 3) moderately appreciating farmland prices relative to the more rapid appreciation (and subsequent price corrections that followed) in the 1970s and 1980s; and 4) better underwriting practices by farm lenders. Nevertheless, if weak exports of farm products and low commodity prices continue for the remainder of this year, the condition of farmers could deteriorate significantly, increasing financial stress at insured farm banks.

**Funding and Interest Rate Risk**

**Deposit Funding Becomes More Difficult to Obtain**

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

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

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

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

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

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

Indicators of Industry Performance

Market Signals for the Banking Industry Are Mixed

Diminished concerns over the near-term economic outlook and reduced financial market volatility resulted in a sharp turnaround in investor attitudes toward banks in the fourth quarter of 1998. During the quarter, the SNL Bank Stock Index1 rose 21 percent, recovering all of the value it lost during the turmoil of the third quarter. The index has continued to rise in 1999.

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

Bank Performance Remains Strong but Earnings Variability Is Increasing

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

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


Chart 11

The Range of Profitability for Commercial Banks Is Increasing

Return on Asset Distribution

Top 5th Percentile

Bottom 5th Percentile

Source: Bank Call Reports

22 This index tracks the market capitalization of approximately 520 banking companies.
ROA for six selected groups of banks segregated by line of business concentrations. This chart reveals that bank performance varies considerably by business specialty. For example, the distribution of ROA of credit card lenders differs significantly from that of other bank groups, including other consumer lenders. Small specialized banks and commercial lenders followed credit card lenders as the groups with the greatest variability in profitability in 1998. Moreover, 75 percent of the least profitable commercial banks were members of small specialized or commercial groups. New banks have also influenced the dispersion of bank ROA. Banks chartered in 1997 and 1998 make up more than 60 percent of the industry’s worst performers. However, earnings variability widened in 1998 even when newer institutions are excluded from the analysis.

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

**Summary**

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

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

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23 Banks with at least 50 percent of managed loans in managed credit card receivables and at least 50 percent of managed loans in total managed assets.
24 Banks with consumer loans and single-family mortgages in excess of 50 percent of assets that do not meet separate credit card or mortgage lending concentration thresholds.
25 Banks with total assets less than $1 billion, and less than 40 percent of assets held in loans, that do not fall in other business specialties. Members of this group include de novo banks and more seasoned banks with low loan activity, such as trust companies.
26 Banks with 25 percent or more of assets in commercial and commercial real estate loans.
trending downward. Finally, sustained weak commodity prices are placing strains on farmers and could eventually lead to higher agricultural loan delinquencies.

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

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

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

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Regional Perspectives

• Unemployment rates remained low throughout the Kansas City Region at the end of 1998, but personal income grew more slowly than in other Regions. Low commodity prices depressed farm incomes in 1998 and are expected to continue to stress agriculture and related industries in 1999.

• Low oil prices in 1998 have caused losses of energy-related jobs in Kansas and North Dakota. Job losses may be permanent as some low-volume oil wells are abandoned.

• Sprint’s relocation from various office buildings throughout the Kansas City metropolitan area to its new world headquarters in Johnson County, Kansas, is expected to significantly affect office vacancy rates over at least the next two years.

Region’s Economic and Banking Conditions

Iowa, Minnesota, Nebraska, North Dakota, and South Dakota all had unemployment rates below 2.8 percent in December 1998, representing the five states with the lowest unemployment rates in the nation. The Region’s unemployment rate at this time stood at 2.9 percent, comparing favorably with a national rate of 4.3 percent. The growth rate for the Region’s total annual nonfarm employment slowed slightly in the fourth quarter after falling below 2 percent in October. By year-end, the growth rate had declined further, to 1.8 percent. The goods-producing sector has slowed more than the services sector, especially in the manufacturing and durable goods segments.

Despite generally strong employment trends, points of vulnerability have become apparent in the Region’s economy. Low commodity prices for the Region’s major agricultural products resulted in a decline in farm incomes and, in turn, a negative effect on the rural communities that depend on agriculture. Evidence of eroding farmland values continues to accumulate across the Region, as expectations of reduced farm earnings influence land purchase decisions.

According to Bureau of Economic Analysis (BEA) estimates of 1998 personal income growth, through the third quarter 1998, the Region’s growth rate of 4.3 percent is the lowest of the eight BEA regions. This compares to a national rate of 5.0 percent. Iowa, North Dakota, and South Dakota, three of the most agriculture-dependent states, exhibited the slowest growth in the Region.

The Boeing Company announced in February 1999 that 2,600 jobs will be eliminated from the Wichita, Kansas, plant by the end of 1999. Hiring by Boeing and other aircraft manufacturers was a principal driver of prosperity in Wichita in 1997 and 1998. The industry employed more than 44,000 workers in 1998.

Low crude oil prices because of imbalances in international demand and supply are stressing the oil and gas producers in Kansas and North Dakota and are likely to lead to reductions in employment, as highlighted in this issue of the Regional Outlook.

This quarter’s Banking Scorecard highlights the condition of the Region’s farm banks as of year-end 1998. As the scorecard shows, farm banks continue to perform well in aggregate despite the low commodity prices that existed in 1998. However, continued low prices in 1999 could dampen aggregate results significantly. Farm banks in northeast North Dakota and northwest Minnesota already are experiencing increased loan quality problems due to built-up stress of several years of poor crop yields before 1998’s plummeting crop prices.
In aggregate, as of December 31, 1998, the Region’s farm banks (the 1,355 FDIC-insured financial institutions whose agricultural operating loans and agricultural real estate loans make up at least 25 percent of their total loans) continued to report strong financial conditions. Reported earnings and capital levels remain strong by historical standards.

In aggregate, problem loans remain manageable despite the precipitous drop in corn, soybean, and wheat prices that occurred in 1998. Generally, significant changes in farm bank past-due loan ratios lag decreasing prices by at least two harvests because banks typically “carry over” unpaid loans from a poor year into subsequent years, suppressing the loans’ delinquency. As such, aggregate past-due ratios in the Region still reflect farmers’ strong earnings in 1996 and 1997. However, in the northeast corner of North Dakota and the northwest corner of Minnesota, farmers have experienced several poor years due first to disease-ravaged wheat harvests and then by low wheat prices in 1998. As a result, past-due and noncurrent loans are rising in these areas, and continued low prices forecasted for 1999 could signal even higher levels of problem loans.

Source: Bank Call Reports
Prices of crude oil and natural gas have declined significantly since early 1997, threatening employment in the energy industries of Kansas and North Dakota. Much of the employment at risk is located in sparsely populated areas that are already suffering the effects of low cattle prices during the past several years. These areas also lack other significant employment opportunities for displaced workers. The current period of low prices may lead to a long-term contraction of the industry as many marginal oil wells are permanently abandoned.

**Background**

The price of crude oil, as measured by the benchmark West Texas Intermediate price, has declined from a high of more than $25 per barrel in January 1997 to $12 per barrel in February 1999. Chart 1 shows the downward trend of the price in 1998, which was below the 1995 to 1999 average of $18.63.

Many industry analysts believe that the recent decline in oil prices results from long-term trends in the industry that will not be permanently reversed in the foreseeable future. Improvements in the technology of developing and producing crude oil have reduced costs substantially over the past decade. Continuing successful exploration in the North Sea and modernization of the industry in countries such as Argentina, Malaysia, and Venezuela have added to global capacity. The Organization of Petroleum Exporting Countries (OPEC) has had continuing difficulties enforcing its production-controlling agreements. OPEC met in late November 1998 in an attempt to reduce production quotas and uphold the world price. While OPEC members agreed on production cutbacks during a March 1999 meeting, many observers question the long-run viability of the strategy. Major producers such as Saudi Arabia and Kuwait may be tempted to increase their production volume in the lower price environment.

Oil prices throughout the United States are strongly affected by forces in the global marketplace. The United States produces more than 6 million barrels of oil per day, accounting for 10 percent of global production. In November 1998, Kansas and North Dakota produced 107,000 and 100,000 barrels of oil per day, respectively, suggesting that the level of their production is not great enough to affect the market price.

Prices of natural gas, an important product in Kansas, also declined in 1997 and 1998, from $3.82 per million British thermal units at the beginning of 1997 to $1.78 in February 1999, as a result of abundant supplies and weak demand brought on by the generally mild winter of 1998 to 1999.

**Kansas’ Stripper Wells Are Most Vulnerable**

In Kansas, total oil production declined from 40 million barrels in 1997 to 29 million barrels in 1998 as many independent producers reduced or ceased production in response to the low prices. Economic returns to pumping oil declined across the state.

The Kansas industry is especially vulnerable because of the prevalence of low-volume wells, known in the industry as “stripper wells.” A 1998 study by the Kansas Geological Survey estimated the importance of stripper wells to the state’s industry. The study concluded that 98 percent of the state’s 41,500 wells produce fewer than 15 barrels of oil per day and account for more than 73 percent of total production in the state. The study also concluded that nearly 18 percent of the state’s natural gas production comes from strip-

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2. Stripper wells are defined as those with daily production of fewer than 15 barrels.
Table 1

<table>
<thead>
<tr>
<th></th>
<th>1998 Daily Production (000 Barrels)</th>
<th>Number of Wells</th>
<th>Barrels per Well</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kansas</td>
<td>107</td>
<td>41,520</td>
<td>2.6</td>
</tr>
<tr>
<td>North Dakota</td>
<td>100</td>
<td>3,000</td>
<td>33.3</td>
</tr>
<tr>
<td>Texas</td>
<td>1,580</td>
<td>164,499</td>
<td>9.6</td>
</tr>
<tr>
<td>U.S. Total</td>
<td>6,250</td>
<td>574,000</td>
<td>10.9</td>
</tr>
</tbody>
</table>

Sources: Kansas Corporation Commission; North Dakota Industrial Commission; Railroad Commission of Texas; U.S. Department of Energy

per wells. Stripper wells face added risks in the current environment because they typically incur higher costs of extraction. Because such higher-cost wells are no longer competitive in the current low price environment, many may be withdrawn from production permanently. In 1998, more than 1,480 wells were abandoned in Kansas. The decision to abandon a well is usually irreversible.

Table 1 compares the average productivity of Kansas and North Dakota wells to those of Texas and the United States as a whole. Kansas wells produce at volumes considerably below the national average and incur higher costs of extraction.

Low Prices Are Also Affecting North Dakota Oil Producers

North Dakota’s wells are newer and tend to produce higher volumes of oil at lower costs per barrel. As a result, the state’s industry has been slower to react to low prices. Production for 1998 was essentially unchanged from the 1997 level. Evidence has begun to point to a decline in production in North Dakota, however. One leading indicator of the local industry’s health is the rotary rig count, or the number of drilling rigs actively exploring for new oil sites. North Dakota’s rotary rig count has declined from an average of 18 per month in 1997 to 5 in January 1999.

Map 1 shows the geographic distribution of oil and gas extraction jobs in Kansas and North Dakota. In Kansas, the largest concentrations of employment are near the cities of Wichita and Great Bend. North Dakota’s energy-related employment is concentrated in the thinly populated western part of the state.

Distress in the Energy Sector Points to Job Losses

Employment in the oil and gas extraction sector has been on a steady downward trend. According to data from the Kansas Labor Market Department, more than 9,000 workers were engaged in oil and gas extraction in Kansas as recently as 1990, but by the end of last year the number had fallen to just over 6,500. In addition, at the end of last year it was estimated that another 3,000 were employed in supporting industries such as oil field services. More than 500 extraction jobs were lost in Kansas in 1998, mostly from small, independent companies.
If low energy prices persist, they will likely result in significant job losses as 1999 progresses. According to a Kansas Geological Survey\(^3\) analysis, as many as 3,600 jobs in the extraction sector will be at risk in 1999. The same study estimates that another 2,000 jobs will be lost in 1999 owing to indirect effects of depressed energy prices throughout the state’s economy. Companies have been laying off less experienced and lower-paid workers, but the cuts are now moving up the experience ladder, depleting the stock of industry expertise.

In North Dakota, the number of oil and gas extraction jobs declined from 2,480 in 1997 to 2,250 in December 1998, a decline of nearly 10 percent. As noted above, North Dakota oil production did not decline in 1998, but sustained lower prices are beginning to affect employment in that state as well. An industry spokesman quoted in the North Dakota press\(^4\) indicated that oil workers in North Dakota were leaving the industry permanently in reaction to sustained low prices.


\(^4\) S. Fallin, as quoted in the Bismarck Tribune, November 29, 1998.

Implications for Banks

Continued low energy prices could stress banks located in counties with high oil and gas extraction employment (greater than 80 workers). This exposure could come from lending to oil production or petroleum service companies, as well as lending to other companies and industries that support the oil and gas industry. As of December 31, 1998, 53 FDIC-insured commercial banks (with total assets of $6.7 billion) were headquartered in such counties in Kansas, and 8 banks (with total assets of $830 million) were headquartered in North Dakota.

Many of the banks located in oil- and gas-dependent counties\(^5\) may also be experiencing difficulties because of low crop prices that began in 1998. Of the 53 Kansas banks, 23 are considered agricultural banks (with more than 25 percent of total loans in agriculture or agricultural real estate), while 7 of the 8 banks in North Dakota are agricultural. This confluence of low oil and gas prices and low agricultural commodity prices could pose risks to these banks, especially if low prices persist.

Sprint’s New Office Complex May Challenge Kansas City’s Office Market

Sprint, Kansas City’s largest employer, is building a 3.9-million-square-foot world headquarters in suburban Johnson County, Kansas. Sprint plans to vacate about 2.5 million square feet of leased office space in Kansas City over the next three years, which could significantly drive up office vacancy rates in the metropolitan area. Developers have slowed but not stopped speculative office construction in anticipation of Sprint’s move. Perhaps more important is the timing of this significant office project so late in an economic expansion. A recession could dampen the growth in office employment and related demand for office space. Sprint’s new world headquarters is expected to increase Kansas City area vacancy rates, which could adversely affect both owners of existing office properties and the financial institutions that fund such properties.

The Complex Is One of the Largest in the United States

One century after setting up shop as a small telephone exchange in Abilene, Kansas, Sprint is getting ready to move into permanent quarters in Overland Park, Kansas, beginning in the summer of 1999. When completed by 2002, the campus-like setting will have 22 buildings and 18 parking garages set on 257 acres. It will house as many as 14,500 Sprint employees. To convey the scale of the project, observers say that Sprint’s world headquarters will be bigger than the Sears Tower in Chicago. It will have its own child care center, dry cleaners, fitness center, banks, restaurants, post office, and ZIP Code.

Kansas City’s Office Market Is Strong

The Kansas City office market is strong both in absolute terms and in relation to other cities. As of June 1998, Torto Wheaton Research, a national real estate services firm, estimated Kansas City’s office rate at 9.2 percent, while Kansas City-based Cohen Esrey Real Estate Services (C/E) estimated vacancy at 7.4 percent, lower than the 9.4 percent national average. Moreover, average rents have escalated in the past few years after several years of stagnation, another sign of strength. Buoyed by steady office and overall employment growth in the last half of the 1990s, Kansas City’s office market has recovered from the boom-and-bust period of the 1980s and early 1990s. Office construction, for example, peaked in 1986 with 4.2 million square feet of completions, followed by two years of 20 percent vacancy rates and several more years of stagnating rents. Chart 2 shows the activity in this office market since 1987.

1References to Kansas City include the Kansas City Metropolitan Statistical Area (MSA). Office space refers to competitive multi-tenant properties that are 10,000 square feet and over.

2It is important to note that the analysis of real estate markets is not precise. For various legitimate reasons, no two real estate services that monitor office markets will collect and report the same numbers. Collection methodologies, for example, differ from one company to the next, which affects total supply, absorption, and vacancy rates. Thus, we have reviewed several sources, when available, to assess potential risks. For the analysis of this Region, we have relied on Torto Wheaton Research, a national real estate services firm, and Cohen Esrey Real Estate Services, Inc. (C/E), a Kansas City-based firm.

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**Chart 2**

Kansas City’s Office Market Remains Strong, Driving Vacancy Rate Down to 9.2 Percent

Source: CB Commercial/Torto Wheaton Research
During the 1990s, Kansas City absorbed an average of 645,000 square feet of office space annually. Office completions averaged only 425,000 square feet annually over the same period, and most of that was in south Johnson County and downtown. Developers started several office projects during 1997, and office starts through the third quarter of 1998 have already topped 1997’s production. Much of this activity is attributable to Sprint’s new corporate headquarters by itself will be the equivalent of Kansas City’s average annual office absorption level. As a result, unless aggregate office demand rises, any new space built during this period will push up vacancy rates. Over the next two years, Torto Wheaton Research projects that the overall office vacancy rate in Kansas City will rise to 14 percent.

Class A space makes up about one-third and Class B and C space make up the other two-thirds of the office space in Kansas City. Class A vacancies stand at 3.5 percent (C/E 6.6 percent) and run very low across almost all submarkets. Class B and C space vacancies, on the other hand, average 11.9 percent (C/E 8.3 percent). Most of the available Class B and C space is in downtown, where the Class B and C vacancy rate is near 20 percent. It is not unusual for the largest block of available space to reside in larger, older Class B and C buildings in the central business district.

Three Submarkets Are Likely to Feel Sprint’s Impact

Sprint’s new corporate headquarters will most likely affect three of Kansas City’s submarkets: south Johnson County, south Kansas City, and downtown. The first two submarkets contain most of the office space that Sprint currently leases; thus, they may have the most risk of an oversupply of office space. The third submarket may indirectly be affected because of the anticipated surplus of attractive Class A and B suburban office space coming available over the next three years. Although much of Sprint’s effect on Kansas City should be economically favorable, there is some risk that Sprint’s campus could adversely affect these three submarkets.

- **South Johnson County:** This is a strong submarket that commands premium rents. It has attracted the most development of all submarkets in the past few years. Since 1994, it has absorbed nearly 250,000 square feet of office space, with heavier absorption during 1997 and 1998. When completed, Sprint’s new corporate headquarters will increase the size of this submarket by a full one-third. Two competing projections give different views of Sprint’s effect on this submarket. Torto Wheaton Research predicts that the overall vacancy rate in this submarket could rise from 5.1 percent to 19.0 percent over the next two years. C/E, on the other hand, projects that the vacancy rate will remain below 11 percent. The firm estimates that Sprint will retain at least half of the leased space in this submarket and that this submarket will absorb the surplus office space placed on the market rather quickly. It is likely that Sprint’s world headquarters will draw in support businesses that demand office space. In fact, ancillary development has already begun around the campus, including several motels and a commercial business center. If speculative office construction is kept at bay during Sprint’s transition, average absorption should keep vacancies close to C/E’s expectation.

- **South Kansas City:** South Kansas City has been fairly stable for several years, but it has had minimal new office construction and slow absorption. Sprint occupies about one-third of the 3 million square feet of office space in this submarket. Even

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8 The Kansas City MSA office market can be broken into submarkets, each with differing degrees of supply, absorption rates, and vacancies. We chose three that may be affected more than any other submarket. Downtown office space is the largest submarket, containing nearly 13,142,000 square feet, and it also has the highest vacancy rate—14.1 percent. South Johnson County is the second-largest office submarket, with 8,132,000 square feet and a 5.3 percent vacancy rate. South Kansas City is the fifth-largest submarket, with 3,646,000 square feet and an 11.9 percent vacancy rate.

9 According to C/E, Sprint leases about 3 million square feet and owns another 1 million square feet of office space in Kansas City. Reportedly, Sprint leases more than 1 million square feet of office space each in south Johnson County and south Kansas City, and approximately 250,000 square feet in downtown.

10 For this time period, Torto Wheaton Research reports an average of 196,000 square feet, and C/E reports an average of 268,000 square feet.

11 Torto Wheaton Research forecasted the vacancy rate from June 1998. The firm used historical absorption averages, known construction, and planned projects to produce the projection. C/E estimates a much higher absorption level, which accounts for the difference between the two vacancy forecasts.

12 Some comments were obtained from a March 2, 1999, telephone interview with C/E’s senior vice president, Tim Schaffer.

13 Estimates vary as to the current south Kansas City market vacancy rate. Torto Wheaton Research reports an 11.9 percent vacancy rate for this submarket, and C/E estimates it at 2.4 percent.
though this submarket has no current office construction projects, Sprint’s departure could push up vacancies significantly. Over the next two years, *Torto Wheaton Research* forecasts a rise in vacancies to nearly 14 percent of stock. C/E estimates that the vacancy rate may rise as high as 15 to 18 percent by 2001. C/E also believes that the amount of surplus space will be a temporary condition and will be attractive to businesses looking for relatively new suburban office space and ample free parking. Nonetheless, the potential surplus space in south Kansas City may discourage escalating rent rates until the market reaches equilibrium. Marginal-quality office space in this submarket may be especially vulnerable to stagnated rents and prices.

**Downtown:** Sprint’s new corporate headquarters may soften Kansas City’s largest submarket, even though Sprint currently occupies very little of its office space. Downtown has strengthened over the past few years because developers have built relatively little new office space in the suburbs. Since 1994, downtown has absorbed about 200,000 square feet of office space annually. Although new construction could add up to 250,000 square feet of office space over the next two years, C/E predicts that another 460,000 square feet of office space will become available in 1999 from companies relocating to the suburbs. Like Sprint, businesses often find suburban office markets more desirable than downtown because suburban office space is generally newer and can satisfy increasing demands for more technologically friendly office space. Sprint’s move will open up about 2 million square feet of Class A and B suburban office space, which may prove attractive to current downtown tenants. *Torto Wheaton* forecasts vacancies over the next two years to remain near the 14 percent range in this submarket. C/E forecasts a higher risk of rising vacancies for both Class A and B space.

**Implications for Insured Institutions**

Sprint’s phased-in move to its new complex is expected to have a significant effect on short-term office vacancy rates in the Kansas City metropolitan area. The forecasts used in this article assume that the economy will remain strong, so vacancy rates could be worse than projected should the economy dip into a recession during Sprint’s relocation. Another factor worth watching is the critical role that developers will play in determining the condition of Kansas City’s office market in the near future.

The increasing vacancy rates forecasted could affect financial institutions that fund office projects. In particular, banks that fund Class B and C space, which is expected to be hardest hit by Sprint’s relocation, could see an increase in credits with cash-flow problems should underlying properties experience extended periods of higher vacancy levels. With the uncertainty facing Kansas City’s office market over the next few years, financial institutions that are involved in real estate lending should continue to apply sound, fundamental lending principles.

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