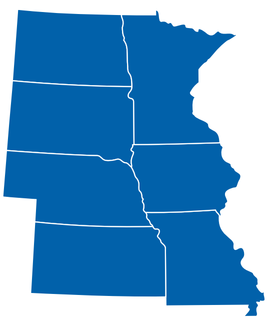
Regional Outlook

Federal Deposit Insurance Corporation — Fourth Quarter 2000

FDIC
Kansas City
Region



Regional Perspectives

◆ *Kansas City Region community banks have experienced compression in net interest margins since 1992* **even though they have increased loan-to-asset ratios significantly, a tactic that has helped to boost margins in the past. The compression in net interest margins can be attributed largely to increasing competitive pressures on both sides of the balance sheet. Should the economy weaken, declining loan-to-asset ratios could depress margins further. In addition, many banks have been increasing levels of credit risk or interest rate risk to compensate for narrowing margins, which could heighten their vulnerability to an economic downturn.** *See page 3.*

By Richard D. Cofer, Jr., Senior Financial Analyst
John M. Anderlik, CFA, Regional Manager

In Focus This Quarter

◆ *Emerging Risks in an Aging Economic Expansion*—**This article focuses on the potential risks of current economic conditions to insured depository institutions. Although the current conditions may appear to be ideal, some imbalances are emerging: rising energy prices, tight labor markets, a less robust stock market, a large trade deficit and strong U.S. dollar, rising household debt burdens, increased corporate leverage and rising potential default risk, and, in some metropolitan areas, overheated housing and commercial real estate markets. At the same time, aggregate risk within the banking industry appears to have risen, as evidenced by softening profitability, growing reliance on noncore funding, heightened levels of interest rate risk, and increasing concentrations in traditionally higher-risk loan categories. A confluence of these trends could heighten the vulnerability of some insured institutions.** *See page 11.*

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REVISION:

The article "Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding" in the Third Quarter 2000 issue of the ***Regional Outlook*** has been revised to correct a data-related error. The revision affects Chart 4 and Chart 11 of the report. Please see www.fdic.gov/bank/analytical/regional/ro20003q/correction.html for revised versions of Chart 4 and Chart 11, along with an additional explanation of how the revision affects the article.

Regional Perspectives

- **Kansas City Region community banks have experienced compression in net interest margins since 1992, largely because of competitive pressures on both sides of the balance sheet.**

- **This compression has occurred even though banks have increased loan-to-asset ratios greatly, a tactic that typically helps to boost margins. During past economic expansions, increasing loan-to-asset ratios led to higher aggregate net interest margins.**

- **Should the economy weaken, net interest margins could continue to decline because of falling loan-to-asset ratios. Banks also could experience asset quality or interest rate risk problems because of attempts to compensate for narrowing margins.**

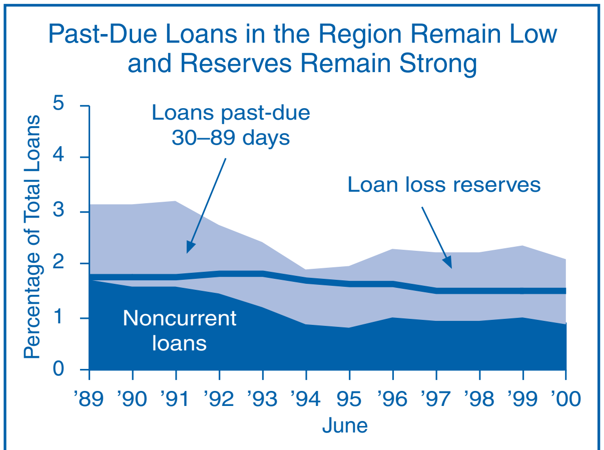
Declining Net Interest Margins and Rising Loan-to-Asset Ratios— a Disturbing Paradox

Commercial banks with total assets under $250 million,[1] the vast majority of the Kansas City Region's insured institutions, have benefited greatly from the continuing, record-setting economic expansion. This business cycle, which finished its thirty-eighth uninterrupted quarter of expansion in September 2000, has provided the setting for the best of scenarios: strong asset and loan growth coupled with low credit losses and record profitability.

As of midyear 2000, the Region's small community banks continue to report strong financial performance. Asset quality is sound; as seen in Chart 1, aggregate delinquent and noncurrent loan levels remain low, particularly in relation to reserve levels, and are well below the levels of the late 1980s and early 1990s. Although capital ratios have declined in recent years, they remain high relative to historic levels. As seen in Chart 2, the moderate deterioration in capital can be attributed to unrealized losses on securities portfolios, which have grown as interest rates have risen. Strong earnings performance compared with historical levels has been the primary reason banks have been able to maintain adequate capital levels while achieving significant asset growth.

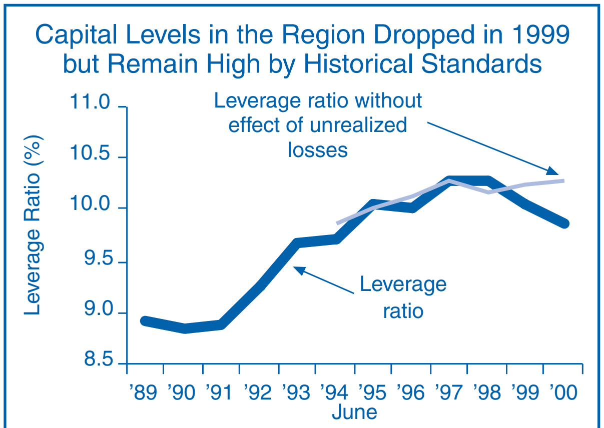
However, despite these favorable conditions, a significant problem has emerged for many commercial banks: narrowing net interest margins (NIMs). This article, the first of two in a series, examines the factors contribut-

CHART 1



Source: Bank Call Reports, community banks

CHART 2



Note: Unrealized losses were not calculated before 1994.
Source: Bank Call Reports, community banks

[1] As of December 31, 1999, FDIC-insured commercial banks with total assets less than $250 million represented 93 percent of the total commercial banks in the Region.

ing to NIM compression and how they have affected banks on an aggregate level. The current economic expansion differs from those of the 1970s and 1980s in that it has been characterized by rising loan-to-asset (LTA) ratios and declining NIMs. Historically, LTA ratios and NIMs have moved in the same direction. The article concludes with a look at how current NIM compression and insured institutions' responses to it could affect the Region's banks adversely. As a follow-up, the first quarter 2001 ***Regional Outlook*** article will examine how groups of banks have reacted differently to the factors contributing to NIM compression, creating significantly different risk profiles.

Net Interest Margin Compression Has Been Significant and Widespread

In the aggregate, the Region's 1,754 community banks[2] have experienced compression in NIMs since 1992.[3] After peaking at 4.50 percent in 1992, the aggregate NIM fell five out of seven years to 4.23 percent in 1999 (see Chart 3). This compression caused pretax return on assets (ROA) to drop 16 basis points, from 1.78 percent to 1.62 percent, over the same period. During this time, slight improvements in reported total noninterest income, noninterest expense, and loan loss provision expense as a percentage of total average assets kept the pretax ROA from falling further.

Since 1992, 1,288, or 73 percent of the Region's community banks, reported a decline in NIMs. Of banks that experienced NIM compression, the median decline was 52 basis points. Chart 4 emphasizes the widespread declines by showing the distribution of NIMs among community banks in 1992 and 1999. Clearly, the NIM distribution has turned downward in the past seven years (as shown by the shift of the curve to the left), illustrating that NIM declines have not been concentrated in a few institutions.

The declining NIM trend and its effect on net income is perhaps a greater concern for banks in the Kansas City Region than elsewhere because this Region is dominated by smaller banks. Smaller institutions typically rely more heavily on NIM to generate revenue than do larger banks. Large financial institutions (banks and thrifts with total assets of $1 billion or more) have diversified their revenue sources over the past 10 to 15 years. The broader array of product offerings enables them to generate higher levels of noninterest income. As a result, they have reduced reliance on net interest income (NII). Community banks have not generated the same growth in noninterest income, so NII remains very important for them. This can be seen in Chart 3, which shows that NII represents a significant portion of community banks' net operating revenue.[4] Community banks' aggregate ratio of NII to net operating revenue was 84.8 percent in 1999, while the national ratio for banks and

CHART 3

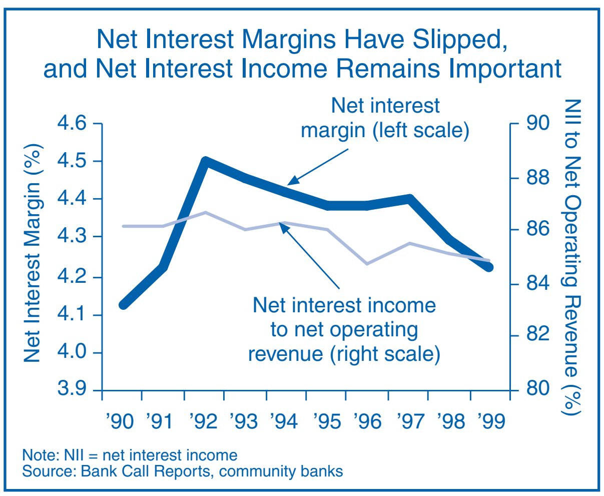
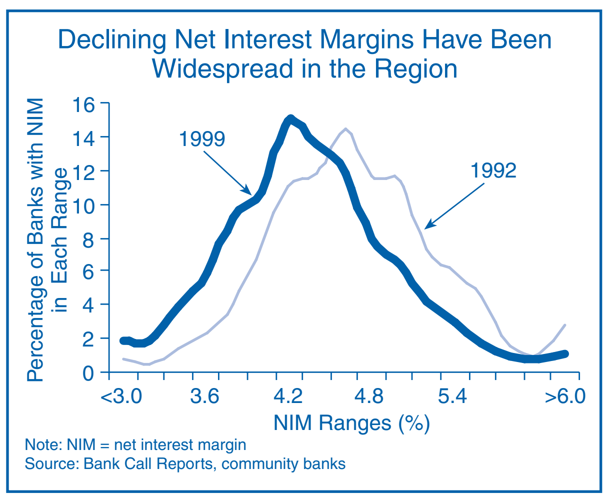


CHART 4



[2] We define community banks as FDIC-insured commercial banks with total assets less than $250 million as of year-end 1999 that meet the following criteria: have been in operation throughout the 1990s and were in operation for at least three years as of January 1, 1990; are not considered credit card banks (banks with at least 50 percent of total loans in credit card receivables); and have not utilized push-down accounting treatment owing to merger in the 1990s.

[3] Unless otherwise noted, any year date refers to year-end.

[4] Net operating revenue is net interest income plus noninterest income.

thrifts with total assets under $1 billion was slightly under 75 percent. The ratio was even lower, at less than 60 percent,[5] for institutions with assets of greater than $1 billion.

Competitive Forces Are Compressing Net Interest Margins

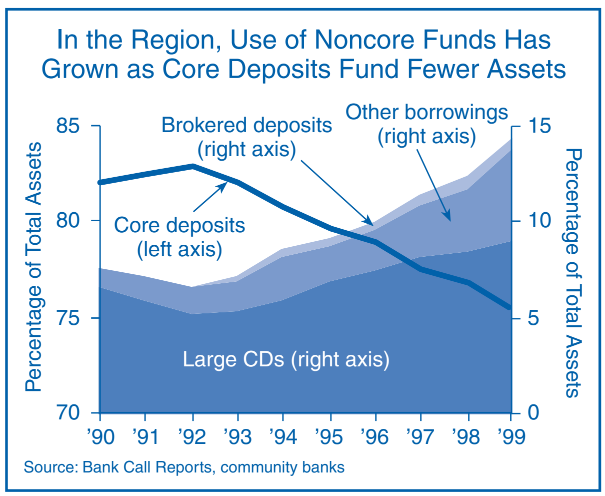
Strong competitive pressures on both sides of community banks' balance sheets are responsible for the declining NIMs. On the asset side, loan competition has grown significantly during the 1990s. Small banks are experiencing more competition from larger banks that, spurred by desire for growth and the ability to branch interstate, continue to expand into new markets. The growth in credit union membership and the numbers of finance companies and mortgage lenders, as well as a surge in business-affiliated financing arrangements such as company-branded credit cards and lines of credit, illustrates the increase in nonbank competition. These nontraditional arrangements come from an ever-expanding array of businesses, ranging from retail shopping to home improvement and farm implement dealerships. Moreover, a surge in the lending activities of government-sponsored enterprises, such as Farm Credit System institutions, has had a direct competitive impact. Competition from new and unexpected sources could intensify as the enactment of the Gramm-Leach-Bliley Act of 1999 promotes the entry of new competitors into the banking arena.[6]

This increased competition for loans has contributed to an ongoing decline in loan yields since 1995. Overall, aggregate community bank loan yields gradually declined an average of 7 basis points per year from 1995 through 1998, and then plummeted 38 basis points in 1999. Some of the 1999 slide can also be attributed to interest rate movements; as the yield curve flattened in 1997 and 1998, competitive pressures prompted bankers to slide further out along the yield curve to meet borrower demand for longer-term, fixed-rate loans.

On the liability side of the balance sheet, competitive pressures for retail deposits have hindered community banks' ability to maintain high levels of core deposits.[7] These pressures include increased industry competition as well as strong disintermediation of funds into nonbank investments such as mutual funds. Furthermore, household savings rates continue to decline nationally, magnifying these competitive pressures by reducing the pool of available funds that financial institutions can pursue. Demographic trends specific to the Kansas City Region also have contributed to the reduction in potential deposits for many community banks.[8] Most rural counties in the Region have been losing population for decades, and some are losing population at an accelerating rate, making it difficult for banks to raise funds locally.

Because of these trends, banks' core deposit levels have not kept pace with asset growth, and, as a result, insured institutions in the Region have increased reliance on noncore funds. As seen in Chart 5, community banks' core deposits-to-assets ratio has declined every year since 1992, from 82.9 percent then to 75.4 in 1999. Conversely, noncore funds have grown from 6.7 percent of total assets in 1992 to 14.5 percent in 1999. Since noncore funding generally carries a higher cost than core deposits, this shift has contributed to higher interest expenses, applying downward pressure on NIMs.

CHART 5



[5] Puwalski, Allen. Federal Deposit Insurance Corporation. May 2000. Increasing Interest Rate Risk at Community Banks and Thrifts. *Bank Trends,* p. 1.

[6] For further detail on the Gramm-Leach-Bliley Act of 1999 and unitary thrifts, see "New Banking Entrants Could Soon Alter the Region's Competitive Landscape," *Regional Outlook,* fourth quarter 1999.

[7] Core deposits are defined as the average of total deposits, less time deposits of $100,000 or more, less deposits in foreign offices.

[8] For further detail on these demographic changes and their impact on community banks, refer to "Depopulation Threatens the Viability of Many of the Region's Rural Counties," *Regional Outlook,* first quarter 2000.

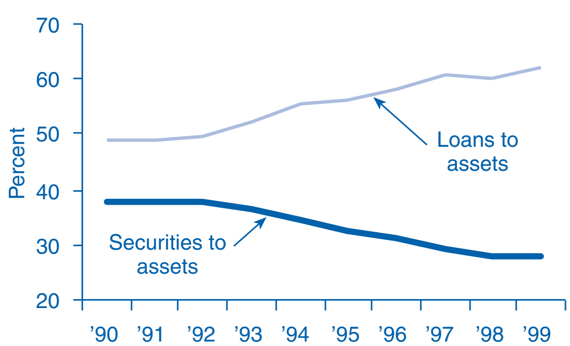
Increasing LTA Ratios Have Buoyed NIMs, but Not as Much as during Prior Expansions

Although competitive trends on both sides of the balance sheet have contributed to NIM compression, community banks' higher loan volumes have helped support NIMs. Because loans typically generate higher yields than other earning assets, such as securities, banks commonly increase lending in an economic expansion while liquidating lower-yielding securities. Conversely, in an economic downturn, loan demand declines and banks tend to prefer the relative safety of securities portfolios. What is striking about the current economic expansion is its unprecedented length, which has encouraged community banks to increase the aggregate LTA ratio from 48.7 percent in 1990 to 62.4 percent in 1999, the highest level ever reported.[9] Over the same period, community banks' aggregate securities-to-assets ratio declined from 37.7 percent to 27.7 percent. Chart 6 illustrates these movements.

A strong positive link exists between banks' LTAs and NIMs in that, at least in the aggregate, banks that are willing to accept the credit risk of making more loans have been rewarded by higher NIMs. Refer to Table 1, which divides community banks into quintiles based on 1999 LTA ratios. The table shows that community banks in the higher LTA quintiles reported higher NIMs than banks in the lower LTA quintiles. Moreover, in general, banks reporting high LTAs in 1999 grew loan volume to the highest level and experienced the least NIM compression since 1992.[10]

CHART 6

The Region's Community Banks Have Shifted Significantly from Securities to Loans



Source: Bank Call Reports, community banks

Although it is generally true that community banks with high LTA ratios have been rewarded with higher NIMs during this economic expansion, in prior expansions the relationship between loan levels and margins was much stronger. As seen in Chart 7, there was a strong relationship between the LTA ratio and NIM throughout the 1970s and 1980s, as changes in LTA ratios were followed by parallel changes in NIMs. Both the aggregate LTA and NIM moved upward during expansionary periods (such as the early 1970s and late 1980s) and downward during recessionary periods (such as the prolonged agricultural crisis of the early and mid-1980s). History shows that if all else remains equal, increases in higher-yielding loans will push NIMs higher.

However, beginning in 1992, NIMs and LTA ratios began to move in opposite directions. The aggregate NIM actually declined 27 basis points from 1992 to 1999, while over the same period the aggregate LTA ratio rose 13.2 percentage points. The last large increase in LTAs reported by community banks occurred in the 1970s, when an 8.0 percentage point increase in the aggregate LTA ratio between 1973 and 1979 was associated with a 92-basis-point jump in the aggregate NIM.

Why has this occurred? It is unlikely that the strong connection between the LTA ratio and NIM has disappeared. Intuitively, it appears that increasing levels of performing, higher-yielding loans in place of securities will affect NIMs positively. The more likely explanation is that the competitive forces described earlier, which have been placing downward pressure on community bank margins during this economic expansion, did not exert as much influence in earlier decades. As a result, higher LTA ratios are pushing up NIMs, but have been more than offset recently by other factors that have been pressuring NIMs downward.

[9] The earliest year for which usable data were available is 1973.

[10] The second article in this series will highlight community banks that have reported exceptions to this observation (i.e., reported high LTAs but low NIMs or vice versa).

TABLE 1

In Aggregate, Higher LTA Ratios in the Region Lead to Higher NIMs					
	1999 LTA Quintile Breaks (%)	LTA 1999	NIM 1999	LTA Change 1992–1999	NIM Change 1992–1999
Quintile 1	< 50.8	41.9	3.78	5.9	–0.44
Quintile 2	50.8–58.2	54.4	3.96	8.4	–0.41
Quintile 3	58.2–64.3	61.5	4.23	10.1	–0.33
Quintile 4	64.3–71.1	67.7	4.35	13.2	–0.23
Quintile 5	> 71.1	76.8	4.61	17.5	–0.12
All Banks		62.4	4.23	12.5	–0.27

LTA = loan to asset; NIM = net interest margin
Source: Bank Call Reports, community banks

Banks Have Accepted Higher Credit and Market Risk to Overcome Competitive Pressures

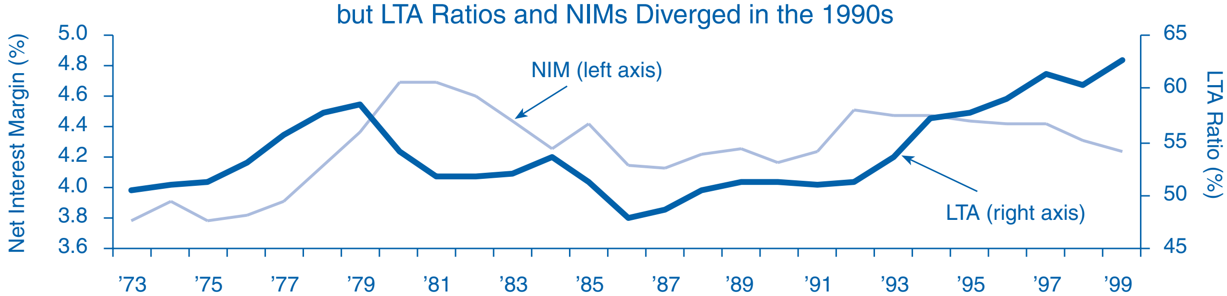
To compensate for the competitive factors compressing NIMs, community banks have increased levels of credit risk and market (interest rate) risk. For example, community banks have increased LTA levels and heightened credit risk within loan portfolios. As shown in Chart 7, community banks have pushed the aggregate LTA to its highest reported level. Community banks last experienced an LTA ratio close to the current level nearly 20 years ago, when the LTA ratio peaked at 58.4 percent prior to the agricultural crisis of the 1980s. Since loans are generally higher-risk investments than other earning assets, higher LTA ratios suggest heightened credit risk and possibly a higher tolerance for risk by management. In fact, history has shown a direct and strong connection between bank failures and high LTAs.[11]

In addition to increasing loan volumes, community banks have made some significant changes to the loan mix, potentially increasing credit risk. For example, aggregate loan portfolios have shifted toward a higher concentration of commercial real estate loans,[12] which typically carry more credit risk than other types of loans and have experienced higher charge-off rates in prior economic downturns. Community banks' aggregate proportion of commercial real estate loans to total loans has increased from 10.8 percent in 1990 to 17.3 percent in 1999.

Moreover, community bankers may have increased market risk by repositioning a sizable amount of loan portfolios farther out on the repricing timeline. After remaining constant from 1992 to 1995, the volume of loans that reprice within 12 months declined from 60 percent in 1995 to 50 percent in 1999. Chart 8 (next page) shows

CHART 7

Increasing LTA Ratios Contributed to Higher NIMs during Prior Expansions, but LTA Ratios and NIMs Diverged in the 1990s

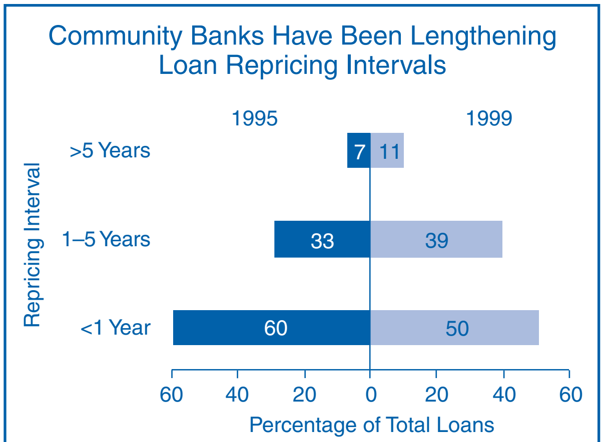


Note: This chart was assembled using commercial banks with less than $250 million in assets and excludes de novo banks for their first three years of existence and credit card banks. In addition, banks that were involved in a push-down merger were excluded for the year when the merger occurred. Community banks, as defined in this article, differ slightly from this definition. This difference was necessary to build the chart back to 1973, because community banks were paired back only to 1990. Numerical differences between reported results of community banks and the set of banks used for this analysis are minimal.
LTA = loan to asset; NIM = net interest margin
Source: Bank Call Reports

[11] FDIC Division of Research and Statistics. 1997. *History of the Eighties—Lessons for the Future,* pp. 68–75.

[12] Commercial real estate is defined as construction and development loans secured by real estate, commercial real estate, and multifamily residential real estate.

CHART 8



Source: Bank Call Reports, community banks

the magnitude of this change in the aggregate repricing structure of community banks between 1995 and 1999. Most of the change occurred in the repricing interval between one and five years, which increased from 31 percent of total loans in 1992 to 39 percent by 1999. The volume of long-term (reprice in five years or more) loans also has increased since 1995, as a flattening yield curve increased borrower interest in long-term, fixed-rate loans. Longer loan repricing terms could generate higher yields, but also could increase vulnerability to upward interest rate movements.

Looking Ahead Should the Economy Slow

First, we must ask this question: Are the competitive pressures that are affecting community banks cyclical, meaning that they will reverse when the business cycle turns downward, or are they secular? If they are cyclical, then they can be expected to dissipate in a recession. However, if they represent permanent changes to the competitive landscape, this fact could suggest a new paradigm of lower NIMs for community banks.

We believe that most of the current forces are secular competitive pressures that did not exist or were not as intense in prior periods. Legislative, demographic, technological, and other changes have increased competition significantly for community banks. These new competitive forces cannot be expected to dissipate in the next recession.

- *Competition from banking institutions has increased.* The enactment of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, providing for nationwide interstate branching, created a new competitive battleground for banking services. Larger institutions are slowly entering markets that traditionally had been served by smaller banks.

- *Competition from nonbanking entities has increased.* Finance companies, mortgage companies, equipment dealers, and other nonbank players have entered the loan markets, placing pressure on bank loan yields. Credit unions continue to gain membership, spurred by consumer interest and the Credit Union Membership Access Act of 1998, which broadens the ability of federally chartered credit unions to expand membership bases. The Gramm-Leach-Bliley Act of 1999 has enabled nonfinancial companies to offer banking services.

- *Depopulation trends are intensifying.* Many banks in the Region are finding it difficult to attract deposits in declining communities, and depopulation trends will not reverse in an economic downturn. In fact, they could intensify.

- *Technological advances have enabled consumers to shop for loan and deposit rates from an array of sources.* The advent of the Internet, electronic funds transfer mediums, and the proliferation of money-management information has begun to blur the demarcation of traditional banking services. These developments are creating savvier consumers and enabling them to shop a broader market for financial services. Generally, consumers are much more educated about their investment options, are willing to invest more in equities and bonds to maximize returns, and can now easily learn the pricing schedule of a much broader market and can act on that information with ease. As a result, both banks and nonbank financial service providers find themselves in a competitive market that continues to grow from local to regional and beyond.

These changes could lead to the development of a new relationship between LTA ratios and NIMs. The 1990s could be the first example of a systemic downward shift in community banks' NIMs. The result would be that rising LTA ratios would not boost NIMs to the high levels previously experienced. Should a recession occur, these secular changes could push NIMs even lower. However, while many of the current competitive pressures appear to be secular, they also are cyclical to some degree. For example, strong investment in equity markets, driven by returns that banks cannot match, has placed upward pressure on deposit rates. However, an economic downturn very likely would affect equity and bond markets adversely, making the returns and safety of bank deposits more attractive.

Regardless of whether the competitive pressures of the 1990s result in a permanent reduction in community banks' NIMs, one cyclical adjustment will be made, assuming historical trends hold: The aggregate LTA ratio will decline when the business cycle turns. Recall Chart 7, which shows that the trend of the LTA ratio generally mirrors the business cycle. The LTA ratio declined during each economic downturn, particularly during the 1980s, when farm banks' LTA ratios plunged as a result of the agricultural crisis. During recessions, the demand for loans declines as businesses and consumers retrench. Concurrently, the supply of credit shrinks, as increasing noncurrent loan levels reduce bankers' willingness to lend.

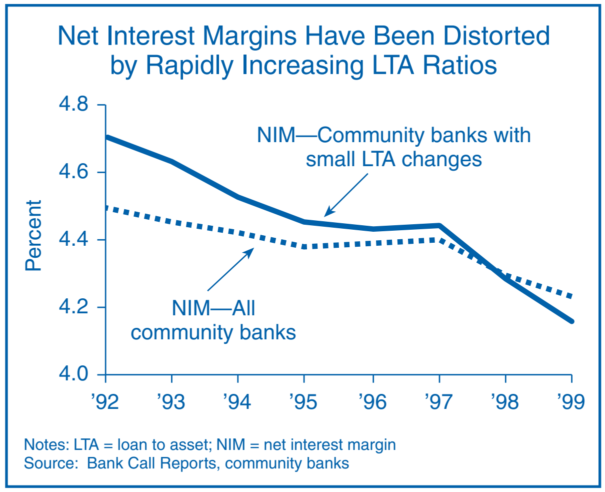
While rapidly increasing LTA ratios helped support NIMs against competitive pressures during the 1990s, rapidly declining LTA ratios could cause NIMs to plummet. As Chart 7 shows, in the past declining LTA ratios were followed quickly by declining NIMs. The difference this time is that secular competitive forces may cause NIMs to be lower than in prior decades.

If LTAs decline to historically "normal" levels during the next economic downturn, how far could NIMs fall? To suggest an answer to this question we conducted two analyses, both of which seek to determine how banks would have fared in the 1990s given the competitive forces that existed, but assuming that LTA ratios remained at 1992 levels. As illustrated in Chart 7, the aggregate LTA ratio in 1992 is approximately the "normal" level seen in relatively stable periods (1973 to 1975, 1981 to 1983, 1988 to 1992), reflecting neither the peak nor trough of economic cycles.

The first analysis examined community banks that did not share in the robust LTA ratio growth in the 1990s. Since these 352 institutions[13] were subject to the same competitive pressures as their peers, yet did not mask the effect on NIMs by significantly increasing LTA ratios, their NIM performance in the 1990s provides insight into what other banks may experience should LTA ratios decline. As illustrated by Chart 9, while

[13] We examined community banks that showed a cumulative change between –2.0 and 5.0 percentage points in LTA ratios between 1992 and 1999.

CHART 9

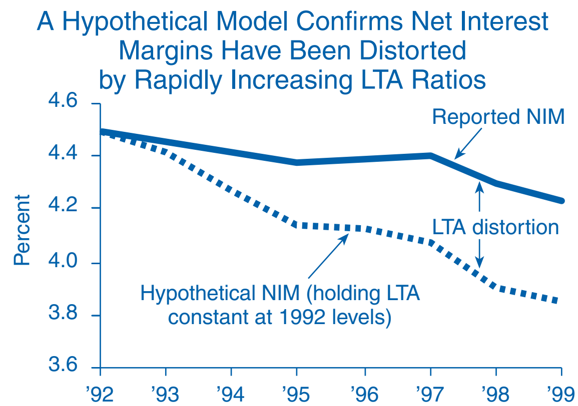


these banks experienced a higher aggregate NIM than all community banks in 1992, this gap closed over the next seven years; these institutions reported a 54-basis-point drop in the aggregate NIM, compared with a 27-basis-point drop for all community banks. On the positive side, these banks may not experience the same declines in NIMs during the next economic downturn as other community banks because their NIMs already reflect the competitive forces that are compressing margins.

For the second analysis, we constructed a model, holding LTA ratios of the 1,754 banks constant at 1992 levels. This model suggests, holding all other factors equal, how community bank NIMs might have been affected by increased competition without the benefit of rising LTA ratios. The results, presented in Chart 10 (next page), show a wide disparity between actual and modeled NIM performance from 1992 through 1999. The actual aggregate NIM was 4.23 percent, while the aggregate NIM holding LTAs at 1992 levels was 3.85 percent, suggesting that increasing LTA ratios have boosted NIMs by 38 basis points.

In addition to their vulnerability to declining LTA ratios, community banks would experience heightened vulnerability to credit risk and market risk in an economic downturn because they have accepted more exposure in both areas. It is noteworthy that much of the additional credit risk and market risk exposure has occurred in the latter part of this economic expansion. For example, loan growth rates in the past four years have been much greater than those of the first five years of the expansion. Moreover, much of the potential increase in interest rate risk depicted in Chart 8

CHART 10



Notes: LTA = loan to asset; NIM = net interest margin
Source: Bank Call Reports, community banks

occurred in the past three years. These significant changes have helped mitigate NIM compression. At this stage of the economic expansion, this situation raises questions about the potential impact on asset quality should the economy falter. As Federal Reserve Board Chairman Alan Greenspan noted in 1998, "All too often at this stage of the business cycle, the loans that banks extend make up a disproportionate share of total non-performing loans."[14] The next recession will show whether community banks in the Kansas City Region have managed risks wisely, and whether earnings performance throughout the expansion was commensurate compensation for taking the additional risk.

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[14] Speech to Congress. February 24, 1998.

Emerging Risks in an Aging Economic Expansion

- **The economy and the banking and thrift industries are reporting generally healthy conditions. However, the economic expansion is aging, and it is unlikely that the vigor experienced during the first half of 2000 can be sustained.**

- **Likewise, record banking and thrift industry profits, healthy capital cushions, and good asset quality of recent years may not be sustainable. Declining net interest margins, rising commercial loan losses, tighter liquidity, and riskier asset composition are among the warning signs that industry performance may have peaked for this business cycle.**

- **Specific areas of concern include growing reliance on noncore funding; heightened interest rate risk; increased exposure to market-sensitive revenues; deteriorating credit quality; rising leverage among businesses and households; and signs of imbalance in some residential and commercial real estate markets.**

Although no readily apparent situations or imbalances suggest that a recession or widespread banking problems will develop in the near term, warning signs are present. A highly competitive banking industry shapes the environment in which pressures on insured institutions are unfolding. The presence of a large share of newly chartered banks in some areas appears to be raising the risk profile among all institutions in certain markets. Publicly owned companies remain under intense pressure to grow earnings and increase shareholder value. In addition, local banking environments exist in which a confluence of risks is generating heightened vulnerability for all participants, even during healthy economic times. Complacency in these environments may have negative repercussions for many insured institutions going forward.

Imbalances Are Appearing amid a Healthy Macroeconomic Environment

The performance of the U.S. economy contributes to the opportunities and risks financial institutions face. The current cyclical expansion, now nine and one-half years old, is displaying signs of aging while setting a record for longevity. A consensus forecast calls for moderate real gross domestic product (GDP) growth through 2001, following robust gains in the first half of 2000. Current conditions might be called a "soft landing," in which real GDP growth slows to a sustainable noninflationary rate of 2.5 to 3.5 percent, and unemployment hovers around recent rates.

Although the current macroeconomic environment might appear to be the best of all possible worlds, areas of concern exist. One is that sustained prosperity tends to foster higher levels of risk taking, overconfidence, and complacency. For example, the turmoil in world foreign exchange and financial markets during 1997 and 1998 illustrates how dramatic imbalances can develop and trigger disruptive adjustments even during healthy economic times.

Currently, no specific situation or imbalance seems to threaten the viability of the expansion. However, as detailed below, several likely will contribute to slower economic growth. Situations that warrant monitoring include the following:

- The repercussions from higher energy prices are unfolding. Historically, oil price shocks have weakened several other long-lived economic expansions.

- Short-term interest rates rose over the past year while longer-term rates declined, resulting in a modest inversion of the yield curve. This relationship may inhibit the profitability of some lenders' practice of borrowing short term and lending longer term and also complicate the interest rate risk management process for some insured institutions.

- Continuing low unemployment suggests that demand for additional workers will go unfilled, thus limiting economic growth or triggering bidding wars that increase workers' compensation and, potentially, inflation.

- Stock market sentiment is no longer strongly bullish. A pullback from high valuations and optimism could trigger negative repercussions on consumers' net worth and spending as well as on the level of business investment.

- A large international trade deficit and strong U.S. dollar may be an unsustainable combination over the long run. Meanwhile, repatriated profits of U.S. corporations are being trimmed by the dollar's strength relative to the euro and other currencies.

- Household debt burdens are historically high, with leverage rising the most in recent years among low- and middle-income households. These households' access to credit has increased as lenders competed more fiercely for customers.

- Corporations are more highly leveraged, and potential default risk rose in the past year across a range of industries. Meanwhile, downgrades of publicly traded corporate debt issues are exceeding upgrades by a 2 to 1 ratio.

- In some metropolitan areas, overheated housing markets are developing, in which home prices are rising dramatically and exceeding gains in median incomes.

- Potential signs of excess commercial real estate construction are appearing in several urban areas where banks' construction loan growth also is strong.

Economic indicators of what lies ahead are not clear-cut, and each possible scenario contains a set of potential challenges for insured institutions and regulators. Should economic growth slow considerably, current vulnerabilities, such as highly leveraged borrowers' debt loads and overheated housing markets, could worsen significantly. As evidenced by the rash of bank failures during the 1980s, it doesn't always take a national recession for problems to develop. Alternatively, sustained rapid growth might foster new vulnerabilities and allow current imbalances to intensify or build up. For example, speculative construction could accelerate, stock market volatility could increase, or ballooning trade deficits could generate turmoil in foreign exchange markets.

Signs of Strain Are Also Appearing amid Healthy Banking and Thrift Industries

With the long economic expansion as a backdrop, insured institutions in the aggregate are performing very well. However, the record profits attained in recent years may not be sustainable. The losses posted recently by several large institutions are striking examples of increased appetite for risk resulting in significant financial loss during a period of strong economic growth. While these are isolated instances, they are indicative of the increasingly competitive environment facing the financial services industry.

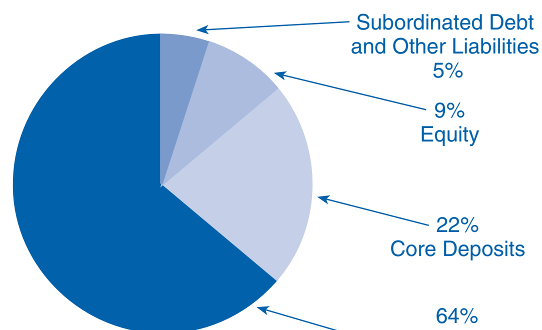
Overall industry profitability is beginning to soften, led primarily by rising commercial loan losses at large institutions and declining net interest margins in institutions of all sizes. Credit card loss rates, which had been steadily falling since late 1997, have stalled in recent quarters, suggesting that recent increases in interest rates and energy costs not only are affecting businesses but also are taking a toll on some consumers. Other signs suggesting that aggregate risk within the system has risen include the growing reliance on noncore funding to support asset growth, heightened interest rate risk at many institutions, growing concentrations in traditionally higher-risk loan classes, and a shift in institutions' overall asset mix toward higher-risk categories. A brief discussion of these risks follows.

Funding Patterns Heighten Liquidity Concerns

Lackluster core deposit growth is placing pressure on bank earnings and contributing to rising liquidity risk in the banking system. During the past five years, the compounded annual rate of core deposit growth for all insured institutions was just 2.8 percent. Assets over this time grew at a 6.6 percent rate. Accordingly, a significant portion of the industry's growth has been funded by noncore sources (see Chart 1). The higher cost and rate sensitivity of these funds put downward pressure on net interest margins, particularly in a rising rate environment.

CHART 1

Most of $2 Trillion of Asset Growth since 1995 Was Funded with Noncore Funds



Source: Bank and Thrift Call Reports, June 2000 and June 1995

To compensate for higher funding costs, the industry has pursued growth in higher-yielding asset classes that are traditionally both riskier and less liquid. For example, almost 37 percent of the asset growth in the past five years has come from nonresidential real estate and commercial and industrial loans.

For institutions that fund illiquid assets with wholesale sources, any adverse events that trigger a lack of confidence in the institution may result in higher funding costs, thus placing further pressure on margins. In efforts to obtain funding, an institution also may pledge a greater portion of its best quality assets as collateral, further reducing liquidity. Finally, in instances where funding needs have exceeded available liquidity, the forced sale of illiquid assets to meet funding outflows could result in losses if market conditions are unfavorable. Presumably, the FDIC, as insurer, would suffer greater losses if such an institution failed, because it would be relying on proceeds from the liquidation of less liquid, and potentially lower-quality, assets to satisfy the claims of insured depositors.

Subprime lenders, in particular, tend to rely heavily on noncore funding to pursue aggressive growth strategies. Chart 2 illustrates the extent to which noncore funding exceeds the level of liquid assets for this group. The chart suggests the difficulty these institutions may encounter if forced to convert assets to meet funding outflows. Although subprime lenders may use noncore sources to fund riskier assets to a greater extent than the industry at large, this illustration exemplifies a systemic trend that is raising liquidity risk industrywide and is increasing risk to the insurance funds.

Increasing Levels of Interest Rate Risk Challenge Some Institutions

The refinancing boom of the late 1990s spurred a significant shift into longer-maturity assets for many insured institutions. During this period, a vast majority of mortgage borrowers opted for longer-term, fixed-rate loans, which they obtained at historically low rates. A great deal of the higher-rate or adjustable-rate loans that borrowers refinanced were held in the portfolios of insured institutions, which contributed to a general lengthening of the maturity of assets held at insured institutions.

The trend toward longer-term, fixed-rate assets has been particularly pronounced among mortgage lenders. For example, state-chartered savings banks, which are traditionally mortgage lenders, have experienced a dramatic increase in long-term assets. As of June 30, 2000, almost 45 percent of the median savings bank's earning assets were not scheduled to reprice for five years or longer (see Chart 3).

Fixed-rate mortgage-related assets at federally chartered thrifts have risen similarly. From year-end 1995 through first quarter 2000, the percentage of fixed-rate mortgage-related assets at thrifts with assets less than $1 billion rose from 49 percent to 60 percent of mortgage-related assets. Some thrifts and savings banks, therefore, have significant exposure to rising rates from low-yielding long-term assets.

CHART 2

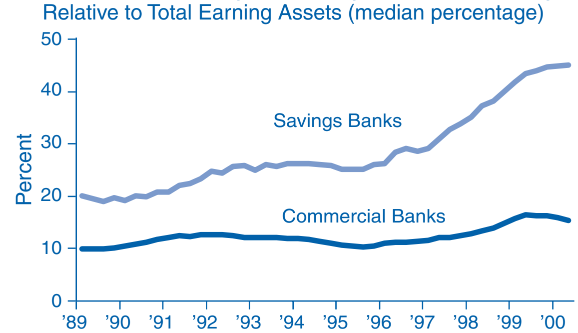
Subprime Lenders' Growing Dependence on Noncore Funding Strains Liquidity

Source: FDIC Division of Supervision and Bank and Thrift Call Reports (data are merger adjusted)

CHART 3

Growing Concentration in Long-Term Assets Elevates Interest Rate Risk

Share of Assets Maturing or Repricing in Five Years or Longer Relative to Total Earning Assets (median percentage)



Source: Bank Call Reports, excluding Thrift Financial Report filers

While most commercial banks do not have as high exposure to rising rates as savings banks, some may have taken on significant risk. The median savings bank has a ratio of long-term assets to earning assets that corresponds to the ratio level for the 93rd percentile of commercial banks. Although the 93rd percentile is in the tail of the commercial bank distribution, almost 600 commercial banks have a concentration in long-term assets that exceeds that of the median savings bank. These institutions may be exposed to significant interest rate risk as well.

While assets have lengthened considerably for many institutions, there has not been a corresponding extension of liabilities. To the contrary, funding pressures are tending to make bank liabilities more rate sensitive. These diverging trends generate concern, especially in a rising interest rate environment. That is, rate increases drive up the cost of funds more rapidly than earning asset yields at institutions with liability-sensitive interest rate risk postures. In a significantly higher interest rate environment, many institutions' current postures likely would cause heavy margin erosion.

Most institutions that have high concentrations in long-term assets also have strong capital and an asset mix that contains lower credit risk than that of many other institutions. Among savings banks, interest rate risk primarily arises from significant concentrations in residential mortgage loans, whereas the typical commercial bank's exposure is more likely to arise from large holdings of long-term securities. However, some institutions with concentrations in long-term assets also may have lower capital levels, a higher-risk asset mix, or poor earnings. Rising rates could weaken these institutions and make it more difficult for them to weather adverse economic or other developments.

Dependence on Market-Sensitive Revenues Increases Earnings Volatility for Some Institutions

During the recent generally favorable conditions in financial markets, the share of revenue earned from business lines susceptible to financial market volatility has increased substantially for some of the industry's largest institutions. Among these revenue sources are fees and gains from asset management, brokerage, investment banking, venture capital, and trading activities. The 19 institutions most active in these lines of business earned over 26 percent of their net operating income from such sources in the second quarter of 2000. Other large institutions also have reported a growing dependence on these volatile sources of revenue.

Turbulence in the financial markets has led to greater earnings volatility for some of these institutions. Stress in the financial markets could weaken the demand for underwriting services or significantly reduce trading revenues or venture capital gains. Furthermore, the same factors that are causing volatility in the financial markets could hamper loan growth and lead to slower revenue growth from core business lines. Should increased earnings volatility from exposure to market-sensitive revenues combine with slower revenue growth from core business lines, some institutions could face significant earnings challenges.

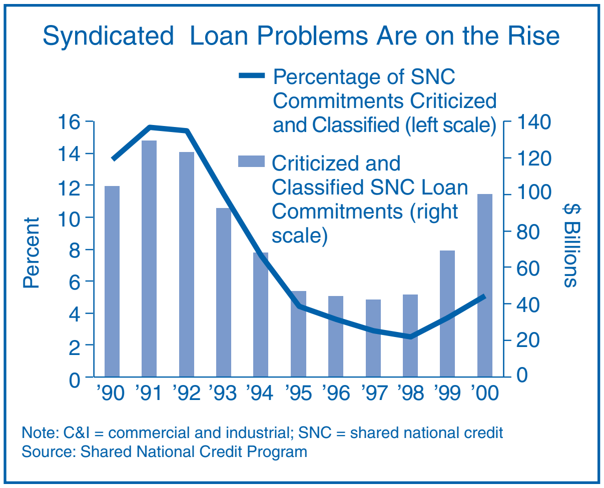
The Rising Level of Problem Business Loans Is Centered in Large Banks

Second quarter 2000 commercial and industrial (C&I) credit quality indicators at banks deteriorated for the eighth consecutive quarter. Noncurrent C&I loans—those on nonaccrual status plus those 90 days or more past-due—rose 13 percent over first quarter 2000 levels to $14.5 billion, or 1.4 percent of total C&I loans. Noncurrent loan levels for the period ending June 2000 were 40 percent higher than the year-earlier level. Net C&I loan loss rates also continue to edge higher but remain well below those experienced by banks in the late 1980s and early 1990s.[1]

Large banks, particularly those active in syndicated lending, are bearing the brunt of deteriorating C&I loan quality. Recent increases in criticized and classified shared national credits (SNCs), which are loans exceeding $20 million that are shared among three or more lending institutions, are illustrated in Chart 4. In the 2000 SNC review, criticized and classified credits increased 44 percent over 1999 levels to 5.1 percent of total SNC commitments. Furthermore, the bulk of the increase was in the more severe *classified* categories, which now comprise 64 percent of total criticized and classified credits, compared with 54 percent at the year-earlier review.

[1]During second quarter 2000, banks posted an annualized net C&I loss rate of 0.67 percent, up from 0.55 percent for second quarter 1999. For comparison purposes, net quarterly annualized C&I loss rates averaged 1.11 percent from fourth quarter 1991 to fourth quarter 1993.

CHART 4



C&I loan quality indicators continue to deteriorate despite generally favorable economic conditions. Three factors explain much of this deterioration: certain weak industries, rising corporate debt burdens, and the seasoning of syndicated loans underwritten from 1997 to 1998, when many banks significantly eased business lending standards.

Industry Sector Weaknesses

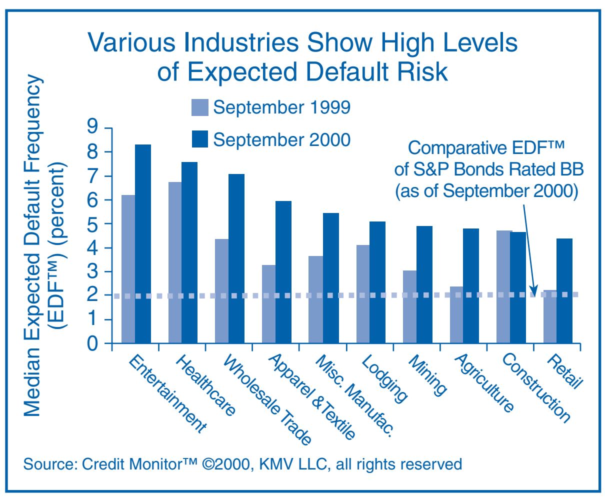
The financial stresses facing healthcare and entertainment companies (cinema operators in particular) have been well publicized. While the healthcare and entertainment sectors have contributed significantly to the decline in commercial credit quality, problems within these two sectors do not account for the full extent of the increase in noncurrent loans and problem SNC loans. Both of these sectors are within the broader services sector, which experienced a $4.6 billion increase in criticized and classified credits from the 1999 to the 2000 SNC review. However, this increase accounts for only 15 percent of the $30.8 billion increase in criticized and classified SNCs overall.[2] The expected default probabilities evident in market-based information can be used to identify other industry sectors experiencing financial stress. ***KMV LLC*** has developed a model that uses publicly available information to estimate the likelihood of default of individual firms.[3] KMV's model is used by many lenders to monitor and evaluate obligor risk and credit risk trends. Applied to the analysis of industries, the output of KMV's model is just one of a number of indicators that suggest weaknesses in certain industry sectors.

Sectors that include a high proportion of firms with high default probabilities (median one-year default probabilities exceeding 4 percent) are shown in Chart 5. Using entertainment as an example, the bars in the chart show that in September 2000, one-half of publicly held entertainment firms had greater than an 8 percent chance of defaulting on their obligations within one year. In September 1999, this same proportion of entertainment companies had a substantially smaller (6 percent) chance of defaulting within a 12-month period. The median likelihood of default for all the industries shown in the chart far exceeds that of ***Standard & Poor's***-rated, BB-grade (sub-investment-grade) obligors as of September 2000, as indicated by the dotted line in the chart.

Rising Corporate Debt Burdens

U.S. corporate debt burdens, as measured by the debt-to-net-worth ratio for nonfarm, nonfinancial businesses, continue to increase. This ratio reached 83 percent in the second quarter of 2000, up from 72 percent as of year-end 1996. Although debt burdens remain below the 1988–1992 average of almost 87 percent, U.S. businesses are nevertheless becoming increasingly vulnerable to rising credit costs and disruptions in credit availability.

CHART 5



[2] See the interagency release of SNC results at www.occ.treas.gov/ftp/release/2000-78a.pdf.

[3] KMV Credit Monitor® uses information from a firm's equity prices and financial statements to derive KMV's Expected Default Frequency (EDF™), which is the probability of the firm defaulting within a one-year period. The main determinants of a firm's likelihood of default: the firm's asset value, the volatility of the firm's asset value, and the degree of financial leverage.

Seasoning of 1997–1998 Vintage Loans

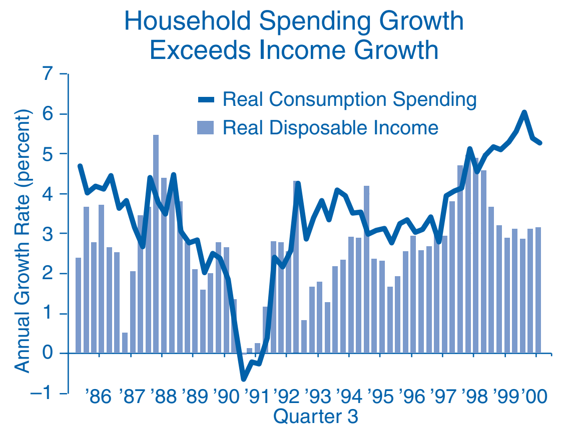
Results of recent supervisory surveys suggest that banks are tightening terms and conditions on loans to small-, middle-, and large-market obligors. However, this tightening follows a relaxation of standards in prior years that has contributed to a heightened level of risk in banks' loan portfolios.[4] Not coincidentally, the period between 1995 and 1998 saw a sharp rise in the proportion of lower-graded, higher-risk credits categorized as leveraged transactions by ***Loan Pricing Corporation.*** Leveraged loan originations—those priced at 150 basis points or more over the London Inter-Bank Offer Rate (LIBOR)—rose from 12 percent of total syndicated loan originations in 1995 to 31 percent in 1999. According to a recent ***Standard and Poor's*** commentary, many banks have acknowledged that 1997 and 1998 vintage credits are beginning to produce higher problem loan levels.[5]

Household Sector's Leverage Is High, and Imbalances Are Appearing

Consumers are enjoying the benefits of the economic expansion, as jobs are plentiful, home ownership remains generally affordable, and credit seems to be readily available for financing motor vehicles and other major purchases. These conditions contributed to record high sales of cars and light trucks during the first nine months of 2000, helping sustain the consumer spending growth shown in Chart 6. One corollary of high vehicle sales, however, is softening prices for used vehicles. Consequently, some lessors—including banks—are realizing lower-than-expected residual values on leased vehicles, which, in turn, are triggering losses in their lease portfolios. This situation illustrates one problem that lenders can encounter even in good economic times.

Spending growth remained robust in recent quarters even as gains in disposable income slowed. The gap between income and spending growth is "financed" as households draw down savings, tap capital gains, refinance mortgages, assume more debt, or undertake some combination of these measures.

CHART 6



Source: Bureau of Economic Analysis via Haver Analytics, Inc.

From 1995 through 1998, and likely since then, the increase in both leverage and debt servicing burdens has been concentrated among low- and middle-income households. Among families holding debt in 1998, debt payments exceeded 40 percent of disposable income for nearly 20 percent in the $10,000 to $24,999 income group and nearly 14 percent in the $25,000 to $49,999 group.[6] One concern is that these debt-laden families may have inadequate financial resources to make payments should adverse conditions or job loss occur. In such instances, lenders could be doubly affected if households draw on their credit card and home equity lines of credit, further compromising their repayment ability, in order to sustain spending in excess of income. The recent rise in credit card losses in banks' card portfolios and rising losses in the portfolios of subprime lending specialists may indicate that strains among some households are spilling over to lenders. ***Moody's Investors Service*** expects credit card losses to rise through 2001, according to a recent analysis of prospects for the U.S. credit card industry.

Overheated residential real estate markets in several metropolitan statistical areas (MSAs) may be another warning of economic imbalances. Dramatic gains in home resale prices in San Francisco stand out (see Chart 7), but this market is not alone in experiencing appreciation considerably higher than income growth. In some markets, where financial-services or information-technology workers are concentrated, bidding wars for properties may reflect the fact that affordability is

[4] See Federal Reserve Board's *Senior Loan Officer Opinion Survey on Bank Lending Practices for May and August 2000* and Surveys of Credit Underwriting Practices for 1999 and 2000 from the Office of the Comptroller of the Currency.

[5] "U.S. Bank Loan Portfolios Reflect Rise in Corporate Bond Defaults." July 20, 2000. *Standard and Poor's Commentary*.

[6] Kennickell, Arthur B., Martha Starr-McCluer, and Brian J. Surette. January 2000. "Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances." *Federal Reserve Bulletin*. Vol. 86, 1–29.

enhanced by gains in wealth rather than in income. Even so, similar surges in home resale prices in the past often were not sustainable. The subsequent years of stagnant or falling collateral values caused financial stress among some homeowners and their lenders. Further concern about residential real estate lenders arises because pockets of speculative construction under way in some markets may produce units that become increasingly difficult to sell at anticipated asking prices.

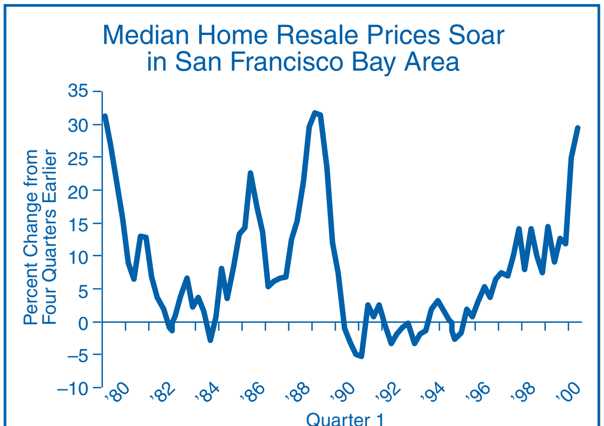
Construction and Development Loan Growth Is Accelerating

Commercial real estate (CRE) construction across all property sectors has grown during this expansion, with office construction particularly active. The amount of office space completed in mid-2000 was the largest since 1989 and is projected by ***Torto Wheaton Research*** to continue rising. Not surprisingly, construction and development (C&D) loan volume, growth rates, and concentrations are trending upward rapidly. While total private real estate spending grew about 6.5 percent over the four quarters ending midyear 2000, C&D loans at insured institutions rose by 26 percent. C&D loan growth has remained above 20 percent since 1997, and the aggregate volume of C&D loans is the highest since 1989.

Such growth is contributing to higher concentrations of C&D loans relative to Tier 1 capital. At current levels, concentrations do not begin to approach those of the late 1980s. However, several metropolitan areas have a large percentage of insured institutions reporting high and rising concentrations. Table 1 (next page) shows MSAs with at least 15 nonspecialized community banks[7] and at least one-third of those institutions reporting concentrations in C&D loans equal to at least 100 percent of Tier 1 capital. The Atlanta MSA stands out. Sixty-five percent of Atlanta's 85 nonspecialized community institutions reported C&D loans exceeding 100 percent of Tier 1 capital on June 30, 2000, and 35 percent reported a concentration exceeding 200 percent. The aggregate C&D concentration for all 85 institutions in the MSA was 156 percent, the highest among MSAs with at least 15 institutions of similar size and nature. Several other markets also include significant shares of institutions with high concentration levels.

Nine of the 16 markets highlighted in Table 1 not only have a relatively high percentage of C&D loan exposure but also appear vulnerable to overbuilding in two or more property types.[8] While these markets show no clear signs of emerging economic stress, lenders there clearly may be at greater risk should economic or real estate conditions sour. Other concerns regarding CRE lending arise from a recent ***Office of the Comptroller of the Currency*** survey, which reports heightened credit risk in CRE portfolios and predicts it will increase through 2001. In addition, respondents to a midyear 2000 FDIC survey of examiners reported more frequent comments about excess office and retail space.

CHART 7



Source: National Association of Realtors via Haver Analytics, Inc.

Increasing Share of De Novo Institutions Raises the Stakes in Some Markets

A common element among the metropolitan markets listed in Table 1 (next page) is the presence of newer institutions. In 10 of the 16 markets, at least 20 percent of the nonspecialized community institutions are less than three years old. The drive to build market share among these institutions, particularly if they are publicly traded entities, is increasing the competitive pressure on banks and thrifts in these markets. In some instances, the aggregate cost of deposits within the MSAs has risen faster than in the nation as a whole, risk

[7] The term "nonspecialized community bank" refers to institutions with total assets under $1 billion that are not specialty institutions such as credit card or trust banks.

[8] See "Ranking Metropolitan Areas at Risk for Commercial Real Estate Overbuilding," *Regional Outlook,* third quarter 2000, which identifies markets where new construction is high relative to existing stocks of space.

TABLE 1

High C&D Loan Exposure Appears in Various MSAs		
MSAs with 15 or More Nonspecialized Community Institutions*	Share (%) of Institutions* with C&D Concentrations > or = 100% of Tier 1 Capital	Aggregate C&D Loans Relative to Aggregate Tier 1 Capital (as %) in This MSA*
Atlanta, GA	**65**	**156**
Phoenix–Mesa, AZ	**56**	**131**
Memphis, TN–AR–MS	52	154
Portland–Vancouver, OR–WA	**47**	**146**
Oakland, CA	47	163
Nashville, TN	44	103
Riverside–San Bernardino, CA	42	110
San Diego, CA	41	90
Grand Rapids–Muskegon–Holland, MI	40	81
Seattle–Bellevue–Everett, WA	**39**	**98**
Salt Lake City–Ogden, UT	**38**	**56**
Fort Worth–Arlington, TX	**38**	**110**
Dallas, TX	**36**	**95**
Las Vegas, NV–AZ	**35**	**119**
Lexington, KY	34	80
Denver, CO	**33**	**113**

*Sample includes institutions with total assets under $1 billion that are not specialty institutions such as credit card or trust banks.
Note: Boldface indicates major MSAs identified at risk for excess commercial real estate construction in Regional Outlook, third quarter 2000.
C&D = construction and development, MSA = metropolitan statistical area
Source: Bank and Thrift Call Reports for June 30, 2000

profiles are being elevated, and aggregate leverage ratios are falling, despite the influx of capital from the new institutions. Highly competitive environments have the potential to increase risk taking by negatively affecting underwriting standards and balance sheet composition.

Farm Sector Challenges Continue

Much of the agricultural industry is experiencing stress because of low commodity prices, compounded in some areas by low yields resulting from weather- or disease-related problems. Strong global competition and high worldwide production during the past several years have resulted in large crop inventories, depressed prices, and limited prospects for a price turnaround in the near term. In the aggregate, record levels of government payments have helped the nation's farms maintain a generally stable financial condition but have not eliminated the stress in this sector. In fact, the ***U.S. Department of Agriculture*** projects that at least one in four farm businesses in several regions[9] will not cover net cash expenses in 2000, suggesting that the viability of highly leveraged farmers may be in question.

Fortunately, the aggregate condition of nearly 2,100 insured agricultural banks—institutions with 25 percent or more of loan portfolios in agricultural credits—remains healthy. Generally, agricultural banks continue to report favorable asset quality, earnings, and capital positions. However, they are experiencing somewhat elevated levels of noncurrent loans compared with nonagricultural institutions. Agricultural banks are disproportionately represented among the weakest 25 percent of institutions nationwide in terms of noncurrent

[9] These are USDA's Basin and Range, Mississippi Portal, Fruitful Rim, and Southern Seaboard regions. See www.ers.usda.gov/briefing/farmincome/fore/regional/regional.htm.

loan levels. In addition, rising levels of carryover debt at farm banks may translate into higher losses in the future if commodity prices remain low.

The strains in the farm sector also have implications for nonfarm banks in agricultural areas. In several agriculture-dependent states, such as Montana and the Dakotas, for example, where farmers' earnings are depressed and the economies not well diversified, nonagricultural banks are reporting higher noncurrent levels than insured institutions elsewhere in the nation.

Summary

The long-lived economic expansion has contributed to the banking and thrift industries' record levels of profitability and asset quality. However, as the expansion has matured, both consumer and corporate leverage has risen considerably. Bank liquidity is becoming increasingly strained by lackluster core deposit growth, which has been insufficient to fund strong loan demand. This trend has resulted in a decided shift into higher-risk asset classes to mitigate margin pressures arising from the greater reliance on noncore-funding sources. Furthermore, interest rate risk has risen significantly for many institutions, and after nearly a decade of improving asset quality, the level of problem loans is increasing.

Clearly, high levels of profitability in recent years have been achieved, in part, by an increased appetite for risk. Concern arises because insured institutions' current profitability is being negatively affected by some recent trends, despite the sustained economic expansion. And, while capital levels have remained fairly stable, the amount of risk being leveraged on the industry's capital base is on the rise. Just as a rising tide is said to float all boats, a strong economy can mask potential problems that will become evident should the economic tide turn, particularly in institutions or markets where above-average risk is concentrated. Insured institutions' safety and soundness may be most vulnerable in situations where banks and thrifts are exposed to multiple challenges, whether because of strategic decisions or because of repercussions from economic and banking forces beyond their control.

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